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Published in association with New York Stock Exchange,
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Consulting editors: Steven A. Rosenblum, Karessa L. Cain,
and Sabastian V. Niles, Wachtell, Lipton, Rosen & Katz

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Introduction—the spotlight on boards

Steven A. Rosenblum, Karessa L. Cain, and Sabastian V. Niles Wachtell, Lipton, Rosen & Katz

The ever evolving challenges facing corporate boards prompt an updated snapshot of what is expected from the board of directors of a major public company—not just the legal rules, but also the aspirational "best practices" that have come to have almost as much influence on board and company behavior. The end goals of boards remain the same: overseeing the successful, profitable, and sustainable operations of their companies. But the pressures that confront directors, from activism and short-termism, to ongoing shifts in governance, to global risks and competition, are many. The submissions contained in this guide provide additional perspectives on the current corporate governance environment and the challenges—and opportunities—faced by boards of directors.

In the current environment, boards are expected to:

- Establish the appropriate "tone at the top" to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements, and ethically sound strategic goals.
- Choose the CEO, monitor his or her performance, and have a succession plan in case the CEO becomes unavailable or fails to meet performance expectations.
- Maintain a close relationship with the CEO and work with management to encourage entrepreneurship, appropriate risk taking, and investment to promote the long-term success of the company (despite the constant pressures for short-term performance) and to navigate the dramatic changes in domestic and worldwide economic, social, and political conditions.
- Approve the company's annual operating plan and long-term strategy, monitor performance, and provide advice to management as a strategic partner.

- Develop an understanding of shareholder perspectives on the company and foster long-term relationships with shareholders, as well as deal with the requests of shareholders for meetings to discuss governance and the business portfolio and operating strategy.
- Evaluate the escalating demands of corporate governance activists designed to increase shareholder power.
- Work with management and advisors to review the company's business and strategy, with a view toward minimizing vulnerability to attacks by activist hedge funds.
- Organize the business, and maintain the collegiality, of the board and its committees so that each of the increasingly time-consuming matters that the board and board committees are expected to oversee receives the appropriate attention of the directors.
- Plan for and deal with crises, especially crises where the tenure of the CEO is in question, where there has been a major disaster or a risk management crisis, or where hard-earned reputation is threatened by a product failure or a socio-political issue. Many crises are handled less than optimally because management and the board have not been proactive in planning to deal with crises, and because the board cedes control to outside counsel and consultants.
- Determine executive compensation to achieve the delicate balance of enabling the company to recruit, retain, and incentivize the most talented executives, while also avoiding media and populist criticism of "excessive" compensation and taking into account the implications of the "say-on-pay" vote.
- Face the challenge of recruiting and retaining highly qualified directors who are willing to shoulder the escalating workload and time commitment required for board service, while at the same time facing pressure from shareholders and governance advocates to embrace "board refreshment", including issues of age, length of service, independence, expertise, gender and diversity, and provide compensation for directors that fairly reflects the significantly increased time and energy that they must now spend in serving as board and board committee members.
- Evaluate the board's performance, and the performance of the board committees and each director.
- Determine the company's reasonable risk appetite (financial, safety, cyber, political, reputation, etc), see to the implementation by management of state-of-the-art standards for managing risk, monitor the management of those risks within the parameters of the company's risk appetite, and oversee that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision making throughout the organization.
- See to the implementation by management of state-of-the-art standards for compliance with legal and regulatory requirements, monitor compliance, and respond appropriately to "red flags."
- Take center stage whenever there is a proposed transaction that creates a seeming conflict between the best interests of stockholders and those of management, including takeovers and attacks by activist hedge funds.
- Recognize that shareholder litigation against the company and its directors is part of modern corporate life and should not deter the board from approving a significant acquisition or other material transaction, or rejecting a merger proposal or a hostile takeover bid, all of which is within the business judgment of the board.
- Set high standards of social responsibility for the company, including human rights, and monitor performance and compliance with those standards.
- Oversee relations with government, community, and other constituents.
- Review corporate governance guidelines and committee charters and tailor them to promote effective board functioning.

To meet these expectations, it will be necessary for major public companies (1) to have a sufficient number of directors to staff the requisite standing and special committees and to meet expectations for diversity; (2) to have directors who have knowledge of, and experience with, the company's businesses, even though meeting this requirement may result in boards with a greater percentage of directors who are not "independent"; (3) to have directors who are able to devote sufficient time to preparing for and attending board and committee meetings; (4) to provide the directors with regular tutorials by internal and external experts as part of expanded director education; and (5) to maintain a truly collegial relationship among and between the company's senior executives and the members of the board.

We thank each of the contributors to this guide for their thoughtfulness and hope you find their perspectives of value.

NYSE: Corporate Governance Guide

Tom Farley, President New York Stock Exchange, an Intercontinental Exchange Company

Foreword

The relationship between companies and their shareholders has never been more important than it is today. Open communication as well as trust in both management and the board are critical to building long-term relationships with investors, which allow companies to stand out amongst an ever-increasing range of global investment options.

The New York Stock Exchange has long recognized the role of good corporate governance in protecting shareholder value and, in turn, the capital markets. In 1895, the Exchange recommended that companies issue a full report of their annual operations at least 15 days before the shareholder meeting. In 1899, we began requiring regular financial statements of all listed companies. We supported one share, one vote initiatives in 1926 and the establishment of proxy solicitation regulations in 1927. Furthermore, in recognition of the critical role the board plays in supporting good governance, we urged listed companies to have at least two outside directors on the board starting in 1956. In 1977, we required that listed companies have independent audit committees comprised of outside directors. Finally, in 1999, well before Sarbanes-Oxley Act of 2002 (SOX) regulations, we required domestic listed companies to have audit committees of at least three independent directors, and set financial expertise requirements for the committees.

This long history of supporting good corporate governance is the reason we are pleased to be bringing you *NYSE: Corporate Governance Guide*. We are very grateful to our partners on the project, including our publisher and expert contributors. Our collective goal is to help you navigate the changing landscape of corporate governance today. To that end, the guide covers a broad spectrum of topics from selecting and developing a high quality board and succession planning to ensuring a board works effectively as a team. It goes on to explore a range of topics that a board must address if it is to enable the company to achieve its full potential including strategy, risk management, communicating with shareholders, and overseeing an effective ethics and compliance program.

Companies need corporate governance policies that place the interests of their shareholders first. In today's world of increasingly complex regulation it is necessary to supplement a skillful compliance team with an equally strong governance program. Effective governance and compliance programs must be tailored for the unique and continually evolving circumstances of each corporation, and a well-functioning board is at the heart of that challenge. Even privately held companies would benefit from establishing good governance practices now, as this would allow them to position themselves well for meeting investor expectations down the road. After all, good governance is about enabling entrepreneurship and innovation within a framework of accountability, which ultimately increases trust in our capital markets and allows us to continue to lead globally.

Regards,

NYSE: Corporate Governance Guide

Contents

PART I

STAKEHOLDER PERSPECTIVES ON CORPORATE GOVERNANCE

Electronic version of this guide available at: nyse.com/cgguide

1 The evolution of corporate governance: key trends and issues facing directors today

Deborah Scally, Editor and Director of Research, and Erica Salmon Byrne, Executive Vice President, Compliance and Governance Solutions NYSE Governance Services

It's the question of the moment: what kind of board does your company need to maintain a competitive edge? Industry and leadership experience are obviously important factors and most boards have added a financial expert thanks to the Sarbanes-Oxley Act, but does your board have information technology (IT) expertise? Social media savvy? How about an international perspective? The implementation of Dodd-Frank has also meant time spent on say-on-pay and executive compensation, putting an additional spotlight on the compensation committee and your shareholder communication initiatives.

Given the meteoric rise in IT risk, it is likely your board either already has a director who is well versed in information technology and data security or is looking for one to help it better understand the company's IT risk profile. The same is true for the fast-growing realm of social media; its increased use as a competitive strategy in recent years has brought correspondingly greater risks. And if your company is contemplating expansion outside of the US, bringing in a board member with international experience is a must. At the same time, more attention must be paid to the tricky arena of anticorruption and compliance with the Foreign Corrupt Practices Act (FCPA), with its minefield of risk. And yet none of this should become a distraction from the core mission of a director: to effectively represent shareholder interest and focus on enhancing shareholder value.

There are five key categories board members should be thinking about as they think about corporate governance today: board composition and effectiveness, leadership challenges, executive compensation, risk management, and strategic planning. While compensation and succession are long-running themes, there are new twists on risk oversight that reflect the current corporate environment, both technologically and globally.

Assessing board composition

For any given company, there must be both management and a governing body that are up to the task of meeting current challenges. And while many of the requisite skills are the same year after year, corporate challenges continue to evolve that require new blood and fresh approaches.

While the concept of "refreshment" is more readily applied to employees and management, there's a growing trend among investors and academics to apply it to boards as well. Shareholders want to ensure that the boards of the companies in which they own stock are capable of handling the leadership and governance demands of the current marketplace and that the highest standards of independence are being met. This viewpoint reflects the belief that today's corporate boards are one step further from the days when boards were often formed under the auspices of long-standing friendships or business favors—and stayed that way.

Today's board members are well aware they need to stay sharp. Two thirds of directors in NYSE Governance Services' 2014 "What Directors Think" (WDT) survey found the need to periodically refresh the board with new blood as either important (51 percent) or critically important (16 percent), with another 26 percent saying that refreshing the board is at least somewhat important.

And the time has never been more appropriate for a jaundiced look at board composition. According to WDT survey partner Spencer Stuart, among S&P 500 boards, retirement ages are being pushed back, and as a result, board members are becoming older and more entrenched. Yet, one irony today is that adding younger board members to the ranks inadvertently means these new directors may one day end up with longer-than-average tenures. Along those lines, the WDT survey asked directors whether it would create a problem for a board member to serve as much as 30 years on one board. Respondents were split on this point, with 53 percent saying yes, 47 percent no.

Most boards have formal policies regarding ongoing board service and tenure. Just over half (53 percent) of directors reported that their boards employ a mandatory retirement age. In addition, 39 percent said their boards require a mandatory resignation submission in the event of a personal reputational event, such as a bankruptcy or arrest, and 28 percent require a mandatory resignation if a director fails to garner a majority vote. However, fully half of those surveyed said the latter is not required nor needed, which may indicate a preference by directors to evaluate each case individually rather than under blanket guidelines.

In addition to examining the methods boards are using to refresh their ranks, an important function is for boards to undertake a healthy self-evaluation to ensure all sitting members are contributing something unique and relevant to the whole. This is often an important step when there is a vacancy on the board. Industry experience is often viewed as a compelling factor for selecting a board member, especially in terms of how a candidate could contribute to the competitive growth and strategy of the company. The 2013 Spencer Stuart Board Index revealed that 23 percent of new directors were retired chief executive officers (CEOs), chief operating officers (COOs), chairmen, presidents, and vice chairmen, compared with just 16 percent in 2012. And, for the first time, fewer active CEOs than retired CEOs joined S&P 500 boards, 77 versus 79.

One area that is a focus for 2014 within this idea of board composition is initiatives to promote board diversity. Thought by many to have benefits above and beyond a perception of political correctness, board diversity has gained momentum in countries that have put their regulatory muscle behind such initiatives. Here in the US, we are now seeing institutional investors place increased emphasis on this issue as well, with high-profile investor/director collaborations on the rise.

Ironically, despite the earlier finding in the WDT survey noting that two thirds of directors believe it's important to refresh the board, they rated themselves least effective in terms of the nominating/governance committee's process to effectively encourage board turnover and to create a board that has a balance of needed skills and diversity. It's worth noting that two of the bottom four results in this category are related to board composition and turnover challenges, indicating many directors are attuned to the fact that these important areas need more attention in the future. In analyzing the methods used by boards to encourage healthy turnover, 85 percent of directors surveyed said board assessment/evaluation is an effective tool to encourage board refreshing. Boards use annual board evaluations to assess the effectiveness of the board as a whole as well as the contributions of individual directors, which can identify directors who are underperforming or whose skills no longer represent a good fit with the strategic direction of the business.

Choosing company leaders

Since 2002, succession planning has continually topped the list of challenges for boards. This is one of those "get it right" issues that continues to be a struggle for boards. Interestingly, it's long-term succession that on average board members lack confidence in—not short-term. Fully 81 percent of the WDT respondents indicated that the company's succession plan would proceed without a hitch in the event their CEO was immediately unable to perform his or her duties. While these findings might seem at odds, they more likely reflect the distinction between an emergency plan and a successful, long-term succession plan. Boards tend to take on this issue with great vigor when they are faced with an imminent CEO change (planned or otherwise). However, when not faced with that urgency, boards may avoid delving into detail on this issue out of deference to the incumbent.

Outside the CEO role, there is a rising trend to include other key senior management roles in the succession planning process. Many companies these days have a formal process to assess internal candidates for roles, including the chief financial officer (CFO), the general counsel (GC), the head of internal audit, and so forth. This likely reflects a growing understanding that these roles are as important to the continued success of the organization as the CEO.

Another tough leadership decision boards have to face is whether to split the chairman/CEO role, an issue that was elevated following the financial crisis of 2008. In light of increasing investor pressure, it's not surprising that many companies are doing so. However, external forces to persuade boards to split the roles are often met with just as many compelling internal reasons to combine them. In the end, boards need to feel comfortable they are doing the right thing for the company—and for the right reasons. The separation of the two positions is unwise if it leads to board micromanagement; many also argue that separation is essential in order to establish that the board has the right and responsibility to be certain that the company's business strategy is given a tough and challenging review.

Yet another thorny issue related to board leadership emerges when a CEO steps down and is subsequently offered the chairman's seat. Whether such appointments stem from personal board loyalty or a desire for continuity, the situation is far from ideal, governance experts say, because the perception of influence from a past CEO is usually too much to overcome.

The common thread running through these issues involves board independence and effectiveness. While a good relationship must exist between the board and senior management to run a successful company, there must also exist a healthy separation for good decision-making at the board level.

Setting executive compensation

Since 2010, every public company has been through some level of angst related to Dodd-Frank–imposed legislation requiring a shareholder advisory vote on executive pay. In year one, the fear of the unknown created the lion's share of work and worry, but most companies saw smoother roads in subsequent years. In this year's WDT survey, 45 percent of directors surveyed said their board spent more time on say-on-pay in 2013 than the previous year, and 24 percent acknowledged receiving tougher scrutiny from shareholders. On a positive note, fully 70 percent said their efforts to improve shareholder communications paid off and termed 2013's proxy season a smoother experience.

Interestingly, when asked if three years of say-on-pay had resulted in making executive pay more aligned with shareholders' interests, only 21 percent of those surveyed agreed. Nearly two thirds (62 percent) said no, because, in their opinion, executive pay was not out of alignment in the first place. This will continue to be an area of focus for directors, however, because of the new Securities and Exchange Commission (SEC) rule regarding disclosure of CEO/median employee pay ratios.

Managing risk

Of paramount importance year after year is the board's responsibility to oversee risk across the enterprise. As a demonstration that boards are fulfilling this role appropriately, 87 percent of those surveyed in the WDT survey affirmed that new strategic objectives are reviewed by the full board to ensure they align with the company's risk appetite. But there is no denying the job is an overwhelming one. In terms of what would improve the board's ability to oversee risk, 44 percent of directors said getting management reports with more key highlights but fewer details would be helpful, while 29 percent said more lead time to digest those reports would be appreciated. However, some directors obviously feel overwhelmed and find the process burdensome and a distraction. Meanwhile, 33 percent said the ability to delegate risk to a separate committee that could keep closer tabs would be advantageous.

Interestingly, nearly 40 percent of those surveyed agreed they could do a better job at risk oversight if they had a better understanding of how to do so. Hot spots crop up all the time, and even traditional risk areas are often murky.

For example, 20 percent of respondents said they are not confident in directors' understanding of the many facets of IT risk, one of the most elusive new risk areas for companies today.

Thinking strategically

In addition to overseeing compensation and risk and finding the right company leaders, board members must keep profitability and increasing shareholder value in their crosshairs. Without meeting these goals, all the others hold little value. Therefore the board's role in shepherding strategic planning for future growth is imperative, particularly in an environment where competitive change happens quickly.

Accordingly, 81 percent of directors in the WDT survey chose strategic planning as a top agenda item—the most popular response, followed by mergers and acquisitions (M&A) opportunities (61 percent), succession (47 percent), global business strategy (42 percent), and IT strategy (38 percent).

Looking ahead

In all, directors this year appear to be laser focused on ways they can help their companies grow and prosper in the year ahead and are working to better understand and come to grips with the battery of risk elements that continue to make the job more challenging. In doing so, they are on track to ensure that their boards are operating as effectively as possible and have the requisite skill sets to ask the right questions and stay ahead of the risk curve.

2 Real look at corporate governance

David F. Larcker, James Irvin Miller Professor of Accounting, and Brian Tayan, MBA 2003 Stanford Graduate School of Business

Researchers have taken a thorough and critical look at corporate governance from various perspectives. They have studied how legal, social, and market forces influence the control mechanisms that companies adopt to discourage self-interested behavior. They have examined the structure and operations of the board of directors. They have explored processes of the board, including strategy, risk management, CEO succession planning, performance measurement, compensation, audit, and the consideration of mergers and acquisitions to determine the relation of each to governance quality and performance outcomes. The result is a vast research literature across multiple disciplines that chronicles the association between corporate governance choices and the likelihood of future success or failure.

For the most part, the findings of this research are modest. Many observed structural features of corporate governance simply have little or no relation to governance quality. For example, there is relatively little evidence that the structure of the board materially influences a company's operating performance (positively or negatively) or that it decreases the likelihood of adverse events such as bankruptcy, earnings restatement, or significant lawsuit. For other governance decisions—such as whether to pay directors in cash or stock, or to award executives golden parachute severance payments—the research results are so mixed as to be effectively inconclusive. While there is evidence that governance programs are critical to success—such as proper risk management or a workable CEO succession plan—it is the quality with which the program is designed and implemented rather than its mere presence that determines whether it will be successful.

Simply put, many of the "best practices" recommended by activists, pundits, proxy advisory firms, and regulators are not supported (and in some cases contradicted) by rigorous research.

Why? If best practices are indeed best practices, shouldn't their value be evident in the research? What does it mean that it is not? What should directors do to ensure that they have the best system in place to protect and enhance corporate value for shareholders and stakeholders?

Research summary

There is no shortage of opinion when it comes to best practices in corporate governance. Take, for example, the issue of whether to separate the chairman and CEO roles and require an independent chairman. According to one shareholder group:

> We believe that the role of the Chief Executive Officer and management is to run the business of the company and the role of the board of directors is to oversee management. We believe given these different roles and responsibilities, leadership of the board should be separated from leadership of management.[1]

Proxy advisory firm Glass, Lewis & Co. agrees with this position: "We ultimately believe vesting a single person with both executive and board leadership concentrates too much oversight in a single person and inhibits the independent oversight intended to be provided by the board on behalf of shareholders."[2] According to the head of a large pension fund: "This is just a fundamental principle of corporate governance. Obviously, common sense is that there should be separation between the chairman of the board and CEO."[3]

Unfortunately, there is little empirical support for this "common sense." The issue of chairman independence has been extensively studied by countless academics and rigorously demonstrated to have no material impact on governance quality one way or the other. For example, Baliga, Moyer, and Rao (1996) examine companies that announce a separation (or combination) of the chairman and CEO roles. They find no abnormal positive (or negative) stock price reaction to these announcements. They also find no material impact on subsequent operating performance. They conclude that although a combined chairman/CEO "may increase potential for managerial abuse, [it] does not appear to lead to tangible manifestations of that abuse."[4] Similarly, Boyd (1995) provides a meta-analysis of studies on chairman/CEO duality and finds no statistically significant relationship between the independent status of the chairman and future operating performance.[5]

The empirical evidence for other best practices is similarly inconclusive. There is little systematic evidence that it benefits a company to have a lead independent director; maintain fully independent audit, compensation, and nominating and governance committees; limit the size of the board; declassify the board; restrict board interlocks; or pay directors in stock rather than cash (see Table 1 for a summary).[6]

Given this, there are four implications that directors should bear in mind when designing a corporate governance system for their company:

1. Rely on data.
2. Consider the context.
3. Focus on functions, not features.
4. Keep an organizational perspective.

Rely on data

First, corporate directors should adopt governance standards only to the extent that there is empirical justification for doing so, or when the benefit of doing so is established by rigorous data. This sentiment was expressed by Myron Steel, former chief justice of the Delaware Supreme Court, who wrote:

> Until I personally see *empirical data* that supports in a particular business sector, or for a particular corporation, that separating the chairman and CEO, majority voting, elimination of staggered boards, proxy access with limits, holding periods, and percentage of shares—until something demonstrates that one or more of these will effectively alter the quality of corporate governance in a given situation, then it's difficult to say that all, much less each, of these proposed changes are truly reform. Reform implies to me something better than you have now. Prove it, establish it, and then it may well be accepted by all of us.[7]

Table 1

Board Attribute	Explanation	Findings from Research
Independent chairman	The chairman of the board meets NYSE standards for independence.	No evidence that this matters.
Lead independent director	The board has designated an independent director as the "lead" person to represent the independent directors in conversation with management, shareholders, and other stakeholders.	Modest evidence that this improves performance.
Number of outside directors	Number of directors who come from outside the company (non-executive).	Mixed evidence that this can improve performance and reduce agency costs. Depends primarily on how difficult it is for outsiders to acquire expert knowledge of the company and its operations.
Number of independent directors	Number of directors who meet NYSE standards for independence.	No evidence that this matters beyond a simple majority.
Independence of committees	Board committees are entirely made up of directors who meet NYSE standards for independence.	Positive impact on earnings quality for audit committee only. No evidence for other committees.

Continued on next page

This standard should be a precondition of all governance changes, both those mandated by law and those voluntarily adopted by corporations. Governance changes are costly, and failed governance changes even more so. They are costly to the firm in terms of reduced decision-making quality and inefficient capital allocation, and they are costly to society in terms of reduced economic growth and value destruction for both shareholders and stakeholders. Careful empirical analysis can go a long way toward better understanding what works and does not work so that changes can be made in a cost-effective manner.[8] There is no question that governance is important to the success of an organization. The fundamental challenge for directors is to understand *which* governance practices improve corporate outcomes and *why*.

Consider the context

Second, directors should take into account context. Governance systems cannot be completely standardized because their design depends on the setting. Take again the issue of whether to require an independent board chairman. This structure has not been shown in the research literature to uniformly benefit companies because there are certain contexts in which it is favorable and others in which it is not.

Table 1 (continued)

Board Attribute	Explanation	Findings from Research
Bankers	Directors with experience in commercial or investment banking.	Negative impact on company performance.
Financial experts	Directors with experience either as public accountant, auditor, principal financial officer, comptroller, or principle accounting officer.	Positive impact for accounting professionals only. No impact for other financial experts.
Politically connected directors	Directors with previous experience with the federal government or regulatory agency.	No evidence that this matters.
Employees	Employee or labor union representatives serve on the board.	Mixed evidence on performance.
"Busy" boards	A "busy" director is one who serves on multiple outside boards (typically three or more). A busy board is one that has a majority of busy directors.	Negative impact on performance and monitoring.
Interlocked boards	An executive from Company A sits on the board of Company B, while an executive from Company B sits on the board of Company A.	Positive impact on performance, negative impact on monitoring.
Board size	The total number of directors on the board.	Positive impact on performance to have smaller board if company is "simple," larger board if company is "complex."
Diversity	The board has directors that are diverse in background, ethnicity, or gender.	Mixed evidence on performance and monitoring.
Classified (or staggered) boards	A board structure in which directors are elected to multiple-year terms, with only a subset standing for re-election each year.	Mixed evidence on performance and monitoring.
Director compensation	The mix of cash and stock with which directors are compensated.	Mixed evidence on performance and monitoring.

An independent chairman can be beneficial when a company promotes a new CEO, particularly an insider with no previous experience at the CEO level. It can also be beneficial when company performance has declined and significant changes to strategy, operations, or culture are needed that require management's complete attention while the board considers whether a change in leadership or sale of the company is necessary. It might also be appropriate when the company has received an unsolicited takeover bid, which management might not be able to evaluate independently without consideration for their own job status.

However, having an independent chairman can also cause several potential disadvantages. First, it can be an artificial separation, especially when the company already has an effective chairman/CEO in place. It can make recruiting a new CEO difficult when that individual currently holds both titles or expects to be offered both titles. It can lead to inefficient decision-making because leadership is shared. And it can create addition costs to decision-making when specialized information about company operations does not easily transfer from the CEO to the chairman (known as an "information gap"). Finally, a separation between the chairman and CEO can weaken leadership during a crisis.[9]

For these reasons, the correct structure will depend on context. This is true not only for the issue of whether to require an independent director but also for the vast majority of corporate governance policies.

Focus on functions, not features

Third, directors should place more emphasis on the *functions* of governance and less on *features* of governance. To illustrate the difference, consider the following sets of questions:

Risk management

1. Does the company have a risk management program? Does the full board of directors oversee risk management, or is this a responsibility of the audit committee or dedicated risk committee?
2. Do the board and management understand how various operational and financial activities of the firm work together to achieve the corporate strategy? Have they determined what events might cause one or more of these activities to fail? Have these risks been properly managed or mitigated?

CEO succession

1. Does the company have a CEO succession plan in place?
2. Is the CEO succession plan operational? Have qualified internal and external candidates been identified? Does the company engage in the rigorous evaluation of internal talent and manage their development to support long-term succession needs?

Executive compensation

1. What is the total compensation paid to the CEO? How does this compare to the compensation paid to the CEOs of peer institutions?
2. How is the compensation package expected to attract, retain, and motivate qualified executive talent? Does it provide appropriate incentive to achieve the goals set forth in the business model? What is the relationship between large changes in the company stock price and the value of stock awards held by the CEO? Does this properly encourage short- and long-term performance without excessive risk?

In each of these, the first set of questions asks about a governance feature, the second about a governance function. A focus on the latter will almost certainly yield more benefit to the organization. One mistake that experts often make is to assume that the presence of the feature necessarily implies that the function is performed properly. That is, if a succession plan is in place, the assumption is that it is a good one; if there is a risk committee, the company is diligent about managing risks; if compensation is not excessive, it provides the correct incentives. And yet the research evidence suggests that this is not always the case. In designing governance systems, directors should move beyond the simple decision of whether to adopt a governance feature and instead tackle the more difficult—and substantive—question of how to design a governance system that will add tangible value by encouraging the pursuit of corporate objectives and discouraging self-interested behavior.

Keep an organizational perspective

Fourth, despite the important role that laws and regulations play in corporate governance, directors should not lose sight of the fact that corporations are organizational entities and their oversight requires an organizational perspective. This means that effective governance solutions will take into account the realities that come with managing and monitoring groups of individuals, including personal and interpersonal dynamics, models of behavior, leadership, cooperation, and decision-making. At a minimum, the following elements should be considered before deciding on the types of controls and procedures that are required to properly govern the organization:

Organizational design

What is the structure of the company? How does the structure encourage or restrict individual initiative? Does it allow for self-interested or unethical behavior? Are controls appropriate given this structure? How were they developed? Were they intentionally designed, or did they evolve from historical practice? How should they be modified?

Organizational culture

What is the culture of the organization? Does it encourage individual performance, or cooperation? Do employees self-monitor, or are checks and balances necessary? Is risk-taking encouraged, tolerated, or discouraged? What level of trust are employees afforded? Is this merited?

CEO personality

Who is the CEO, and what motivates this individual? What is his or her leadership style? What are the individual's ethical standards? What is the "tone from the top," and what behaviors does this encourage? How does this affect the choices made by other members of the senior management team?

Board quality

What are the qualifications of board members? Why and how were they selected? Do their qualifications match the full set of needs of the organization? What skills are missing? How will these needs evolve in the future? Is there a real succession plan for board members?

Directors should pursue this type of analysis further and with greater rigor. Doing so will require tools and techniques across disciplines. It is a mistake to think that corporate governance can be adequately understood from a strict economic, legal, or behavioral (psychological and sociological) perspective. All of these views are necessary to understanding complex organizational systems.

Furthermore, this necessarily implies that the optimal system of governance will be firm-specific and take into account its unique culture and attributes. Adopting "best practices" will likely fail because that approach attempts to reduce a complex human system into a standardized framework that does not do justice to the factors that make it successful in the first place. This explains why two companies can both succeed under very different governance structures.

Conclusion

Context is critical to designing an effective corporate governance system. The appropriate system for a company to adopt will be the one that is best fitted to it, given its environment, strategy, and operations and also given its culture, leadership, and the quality of individuals who work there every day. As tempting as it might be to select an "off-the-shelf" solution of standard best practices, no effective one exists. Companies are organizational entities and a system that is optimal for one company is unlikely to produce the same results at another. In the end, the best hope for a best-practice solution to corporate governance is the careful thought and critical analysis of well-informed and well-intentioned directors, taking into account the individual variables that have the greatest bearing on the company's long-term success or failure.

Notes

1. The Walt Disney Company, form DEF-14A (Jan. 18, 2013).

2. "Proxy Advisers Urge Split of Chair, CEO Roles at Disney," *Reuters* (Feb. 26, 2013).

3. Interview with Jack Ehnes, "CALSTRS vs. Disney's Iger," CNBC (Feb. 22, 2013).

4. B. Ram Baliga, R. Charles Moyer, and Ramesh S. Rao, "CEO Duality and Firm Performance: What's the Fuss?" *Strategic Management Journal* (1996).

5. Brian K. Boyd, "CEO Duality and Firm Performance: A Contingency Model," *Strategic Management Journal* (1995).

6. For a review of the research literature, see: David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New York, NY: FT Press, 2011).

7. Emphasis added. Myron Steele, "Verbatim: 'Common Law Should Shape Governance,'" NACD Directorship, February 15, 2010.

8. Careful theoretical analysis is a key foundation of careful empirical research. Best practice white papers published by "blue ribbon panels" are is not the same as careful theoretical analysis.

9. For more on this debate, see Millstein Center for Corporate Governance and Performance, "Chairing the Board: The Case for Independent Leadership in Corporate North America, Policy Briefing No. 4," Yale School of Management (2009).

CHAPTER 3: Perspectives from ratings agency, institutional investors, and shareholder services

3A An institutional investor's viewpoint on corporate governance

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Institutional investors comprise a large, growing, and diverse group of shareowners ranging from, at one end of the spectrum, activist hedge funds that may take concentrated positions in a relative few companies for a short period of time, to, at the other end of the spectrum, broadly diversified index mutual funds that typically have much longer holding periods. As a large mutual fund manager, with the majority of our clients' assets invested in our index funds, Vanguard falls squarely in the latter category. While there may be some consistency among the views of institutional investors on various issues, these different investment perspectives may inform divergent views as to ideal corporate governance arrangements. Given this diversity of perspectives, it would be impossible to faithfully present in this chapter the views of all mutual funds, let alone all institutional investors. As such, a range of views on issues will be discussed here, and references to "we" and "our" will indicate Vanguard's view on a particular matter.

We view corporate governance not as an end unto itself, but rather as an enabler of long-term value creation and protection. We believe that value is maximized by creating a system of rights and responsibilities that (1) ensures the accountability and responsiveness of the corporation to its shareholders; (2) promotes behaviors and compensation practices that reinforce a long-term perspective; and (3) encourages a rich dialogue on matters of importance between investors and companies. These beliefs translate into three dimensions—quantitative, qualitative, and collaborative—each of which is discussed in more detail in this chapter. The quantitative dimension includes those objective, structural governance features that we believe are important for the creation and protection of long-term value. The qualitative dimension encompasses a range of more subjective considerations, such as board composition and effectiveness and compensation design, which, though far from black and white, are critically important to us as investors. And finally, the collaborative dimension captures the degree to which companies seek and respond to the views of their shareowners on critical matters.

Quantitative dimension

An initial survey of a firm's governance typically starts with an assessment of the objective structural features that define the allocation of rights and responsibilities among shareholders, directors, and managers. These include, among other things, the mechanisms through which directors are identified, nominated, elected, and removed; the framework within which executives are compensated; and the ways in which shareholders may initiate action independent of the directors.

Historically, there has been tremendous focus on ensuring a meaningful complement of independent directors on the board, as well as board committees comprising exclusively independent directors. This focus on independence figures prominently in the NYSE's listing standards and is evaluated closely by investors in their consideration of corporate boards. Though critical, independence is a necessary, but not sufficient, attribute of the majority of a company's directors. Other, more subjective, considerations for director effectiveness are discussed further in the qualitative section of this chapter.

That said, one area in which independence has been a particular focus is in the leadership of the board. There has been tremendous pressure from many investors for a mandatory separation of the roles of the chief executive officer (CEO) and chair of the board. Despite this pressure, among US companies, it is still relatively common for one person to hold both titles. According to research from Farient Advisers, approximately 60 percent of S&P 500 constituents have combined chair/CEO roles, while among the broader market (Russell 3000), only about 45 percent of companies vested both roles in the same person. The concern of those advocating for mandatory separation is that a combined chair/CEO is inherently conflicted in that he or she is a member of the very management team that the board is tasked with overseeing. Acknowledging this concern, the vast majority—nearly 80 percent—of those in the S&P 500 with combined chair/CEO roles now designate an independent director as a lead or presiding director. From our perspective, so long as this lead or presiding director has input into board agendas, and most important, is empowered to convene the other directors independent of the chair, we believe that each board should be able to determine how it ensures leadership independent of management.

With respect to the entire board, we believe that the value of the shareholder franchise is maximized when directors are subject to annual elections (ie declassified boards) and where a majority of the votes cast is required to elect them. This view is increasingly held by a wide spectrum of investors. We believe that these standards maximize directors' accountability to shareholders by providing a mechanism for their replacement, either individually (in response to concerns over their independence, performance, or fitness for service) or in extraordinary circumstances *en masse* (in response to egregious governance or performance failures, or in connection with a hostile change in control).

There has been significant attention paid to board declassification in recent years as many companies—typically at the behest of their shareholders, either through precatory proposals or other engagement—have migrated to annual election of all directors. As of December 2013, nearly 90 percent of companies in the S&P 500 Index had declassified boards (or were in the process of declassifying). This is a stark change from only five years prior, when only 65 percent of the S&P 500 was declassified. Across the broader market—the members of the Russell 3000, excluding the S&P 500—about 50 percent of boards are still classified, with a gradual shift toward declassification (4 percent since 2010). (FactSet SharkRepellent)

In our discussions with companies about board declassification, they typically raise two concerns. First, they argue that annual election will interfere with the board's long-term perspective and stability by creating more frequent director turnover. Our observations across thousands of companies indicate that average board tenure is not materially different between companies with classified boards and those subject to annual election. In fact, according to data compiled by Glass Lewis LLC, among S&P 500 directors, there is a mere nine-month difference in average tenure between members of classified boards (9.65 years) and declassified boards (8.92 years). Across the broader market (ie the remainder of the Russell 3000), there is virtually no difference, with the average tenure of classified board directors at 9.37 years and their declassified board counterparts at 9.17 years. The second objection to declassification that companies may present is that it eliminates the board's negotiating leverage with a hostile acquirer. While a hostile acquirer could run a proxy fight to replace a majority of the sitting directors with new directors predisposed to a deal, as a practical matter, this does not happen with any discernible frequency. In fact, according to data from FactSet SharkRepellent, there were only 10 instances among Russell 3000 companies between 2009 and 2013 in which a controlling faction of the board was replaced. In every one of these situations, the replacement of directors by shareholders was motivated primarily by an egregious corporate governance track record or persistent underperformance, not a typical hostile takeover.

Our interest as practically permanent shareholders is not to leave companies defenseless against hostile overtures that undervalue their long-term prospects, or activist interventions that seek short-term changes with damaging long-term effects. We also want to guard against structures such as classified boards that may have the effect of entrenching management and insulating them from appropriate accountability to their shareowners. To this end, we have not objected to companies' use of shareholder rights plans (otherwise known as "poison pills") to stem the accumulation of "creeping control" by potential acquirers and provide the board with negotiating leverage. At the same time, we believe that these plans should be short-term in nature and used primarily to respond to transient threats (eg temporary dislocation in stock price that enables an opportunistic hostile approach). We view the classified board and long-term shareholder rights plans not approved by shareholders as relatively permanent solutions to what are typically temporary issues. We do not believe that governance should pose impediments to accountability for companies that are the targets of acquirers or activists as a consequence of persistent underperformance.

Inasmuch as we consider annual election of directors an important manifestation of the board's accountability to shareholders, we also view as important the requirement that directors receive a majority of the votes cast in order to be elected. This preference applies only to uncontested director elections (ie those in which the number of nominees equals the number of open seats). As a practical matter, a plurality standard should apply in those instances where there are more nominees than available seats to ensure that all seats are filled. We believe that a director's failure to get a majority of the votes cast in his or her favor is an unequivocal statement by shareholders that should be generally respected by the board. As a general matter, most directors are re-elected by an overwhelming majority of the votes cast; during 2013, directors at US companies received, on average, 95 percent support for their re-election. According to data from the Council of Institutional Investors, only 57 directors out of more than 17,000 nominees failed to garner a majority of the votes. While we have historically been comfortable with arrangements in which a board has the authority to either accept or reject a director's resignation, we are troubled by instances in which boards appear to have disregarded shareholders' votes by retaining a failed director without substantively addressing the reason(s) behind the vote outcome. Of the 57 directors noted above, only eight ceased to serve after failing to get a majority of the votes. In the remaining instances, a board's unwillingness to respect the objective outcome of an election makes us increasingly skeptical of their ability to discharge other elements of their fiduciary obligations as shareholder representatives.

While the annual shareholder meeting is typically the venue in which matters are presented for shareholder approval (and appropriately so), there may be extraordinary situations in which shareholders should be able to take action independent of the board. (The most frequently cited potential actions to be taken in these instances are the removal and/or election of directors and the consideration of a transaction not supported by the board.) The typical mechanisms for this "shareholder override" are the ability for holders of a prescribed percentage of the outstanding shares to either call a special meeting of shareholders or to take action by written consent. As a general rule, where written consent is permitted, we believe that a majority of the shares outstanding is an appropriate threshold. In fact, we believe that a majority of shares outstanding should be the most stringent requirement for any matter presented for a shareholder vote; accordingly, we are generally opposed to provisions requiring a supermajority (typically ranging from two thirds to 80 percent) of the outstanding shares to approve either changes to the company's articles or significant transactions. There is debate among investors with respect to the appropriate threshold to call special meetings. Shareholder proposals are often submitted seeking the ability of holders of as few as 10 percent of the outstanding shares to call a meeting; our view is that 25 percent of the outstanding shares may be a more appropriate level to strike the appropriate balance between a level that is low enough to be achievable (remember, this is just to call the meeting, not to approve the action) and high enough to prevent meetings from being called—and the associated costs being imposed on all investors—by a small minority of shareholders whose views are not shared by a sufficient complement of other investors to suggest that they may prevail in a shareholder vote.

In some respects, these mechanisms serve as substitutes for one another in that they both permit shareholders to initiate a course of action independent of the board (where permitted under the relevant corporate statute and the company's articles). While the approaches are equivalent from the perspective of initiating action independent of the board, the special meeting route is most consistent with the typical framework for shareholder approval of actions. Because a party soliciting action by written consent needs only to accumulate the requisite consents (typically within a certain time period), all shareholders may not be equally informed as to the solicitation (as distinct from the special meeting, which would follow the same notification rules as the annual meeting). Further, since action may be taken as soon as the requisite consents are received and presented to the company, as distinct from votes cast at a special meeting on a certain date, there is inherently less predictability to the process for written consent as opposed to the special meeting. The use of these mechanisms is extraordinarily rare, and their presence serves, in large part, as a deterrent to board intransigence. That said, written consent has been used increasingly in recent years to initiate the replacement of directors at companies with persistent governance and/or performance issues.

One other quantitative factor of particular concern is the consistency between economic ownership and voting power. In short, we share the position of most other institutional investors that voting rights should be directly proportional to economic ownership (ie one share, one vote). Capital structures in which one class of shareholders has voting rights that are superior to those of other owners are antithetical to this view. While these structures may be more common with recently public companies—especially those with founders who retain a controlling voting interest despite a minority economic position—we believe that as companies mature, these arrangements should be phased out or eliminated in their entirety.

Qualitative dimension

While the objective, structural indicia of governance are critically important to investors, its "softer" manifestations may be even more so. Paradoxically, investors have historically focused a significant proportion of their energies on addressing the more quantitative attributes of governance—precisely because they're more easily measured or observed—when it's these more qualitative considerations (board composition and effectiveness, for example) that are the ultimate determinants of corporate viability. We've observed innumerable instances in which, despite governance structures deemed suboptimal against many investors' standards, independent directors have made decisions in shareholders' (not necessarily their own) best interests. Even in the face of "insulating" or "entrenching" governance provisions, the reality that we've observed is that the vast majority of corporate directors are well qualified, well intended, and truly engaged on shareholders' behalf. Nonetheless, we anticipate that investors will continue to advocate for quantitative, structural governance provisions in order to protect their ability to effect change in the future. We have frequently said that our desire for governance reforms shouldn't be interpreted to reflect dissatisfaction or concern with current management or directors, but rather a desire to ensure that we have the option to effect change in the future if things go awry.

Given the board's central role in overseeing management (including its responsibility for CEO hiring and succession), few things should be more important to investors than the effectiveness of the board. As noted earlier, there is wide agreement on the necessity of substantial independence on the board, both generally, as well as in a leadership role (ie chair or lead/presiding director). Though necessary, independence is by no means sufficient for high-quality directors. In addition to independence in form as well as substance, directors must also bring qualifications that are relevant to each particular board assignment. These qualifications will necessarily vary based on the company itself (eg its industry, stage of development, geographic distribution of business), as well as the other directors on the board. Each board must determine the appropriate complement of skills and qualifications needed by the board as a body and must then select a group of directors that bring these attributes to bear in the right proportion. Boards must consider the appropriate mix of "generalists" (eg those with executive, financial, and/or academic credentials) and "specialists" (ie those with specific industry or functional experience relevant to the company's business); boards should also consider other personal attributes (eg gender, ethnicity, national origin) when assembling a board that is uniquely positioned to serve their investors' best interests. While this could be viewed as an objective, "check the box" exercise to fill out a skills matrix, in reality it is likely far more art than science. The ongoing opportunity for boards through disclosure and engagement (as discussed more later in this chapter) is to convey to investors what skills, experiences, and attributes they view as important for their board to possess and how each director contributes to that portfolio of skills.

There has been growing debate on the subject of board refreshment and the variety of "automatic" mechanisms to generate board turnover. Among these are term limits and mandatory retirement ages for directors and/or deeming directors non-independent after a certain period of time. Each of these, though objectively effective in necessitating the replacement of directors and, thus, refreshing the board, also has the potential side effect of removing from service directors who still have much to contribute and who are staunchly independent advocates for investors' interests. The benefit of these provisions (ie that they are largely immune from manipulation) is also their limitation (ie that they limit the ability of a well-intended, well-functioning board to make exceptions). Regardless of the existence of these formal provisions, where directors are subject to annual elections, shareholders have the ability to express their preferences as to directors' continued service by voting accordingly.

We have not adopted explicit tenure limits—either at the individual director level or for the board in aggregate—though it is a growing discussion topic with companies. More relevant in our view is the rigor and effectiveness of each board's self-evaluation process and its consequent impact on board membership. In our view, a board's exclusive or primary reliance on automatic mechanisms to replace directors may be indicative of a board whose evaluation process lacks substance. Ensuring that the board's aggregate capability continually represents the best complement of skills and perspectives to effectively oversee the corporation's future (as opposed to its past) is second perhaps only to CEO succession planning among the board's key strategic imperatives.

Finally, while evaluating compensation may seem like a purely quantitative process, the variety of approaches and the variability of the outcomes make it a largely qualitative exercise. Indeed, the design and execution of an executive compensation program and the degree to which it effectively links pay and performance provide a window on the board's thinking and their stewardship. While there is a long-running debate on the appropriate quantum of CEO compensation that we will not attempt to resolve here, our focus from a governance perspective is on ensuring that pay is sufficiently aligned with corporate performance and value creation, and that it is reasonable in the context of a company's peers and the market for executive talent. Given the variety of industries in which companies operate and compete, as well as the variety of sectors in which a single company may have operations, there is generally no universal performance metric or perfect peer group against which to evaluate pay and performance—hence, the qualitative nature of the analysis here. As a result, what investors expect from companies in this regard is robust discussion, disclosure of their rationale, and the context for their pay decisions, with particular attention devoted to the relevance of performance metrics and the rigor of the performance targets that drive incentive compensation.

Collaborative dimension

Our discussion of the quantitative and qualitative dimensions of governance has focused almost exclusively on attributes and behaviors of corporate issuers and their boards. Increasingly, however, both investors and issuers alike are devoting more resources and energy to engaging with one another. This engagement takes various forms at various times but is an increasingly common and effective means of bringing about change. Engagement is likely to be a discussion topic at practically every corporate governance and director education conference, and at least two cross-constituency industry groups—the Shareholder-Director Exchange (SDX) and The Conference Board Governance Center—issued reports on corporate/shareholder engagement in the first quarter of 2014.

While discussion of engagement often jumps right to the one-on-one dialogue between investors and company executives or board members, the Conference Board's *Guidelines for Investor Engagement* (March 2014) makes the point that in many respects engagement, broadly defined, begins with companies' disclosures to investors generally, as well as investors' disclosures regarding their views on key issues. The more context behind their decisions and actions that issuers can provide in their public disclosures, the better positioned investors are to make informed decisions—either regarding voting at the company's shareholder meeting or further engagement. Likewise, the more transparent investors are with their points of view on key issues, the better positioned investee companies are to be responsive to those concerns.

Nonetheless, there are often instances in which one-to-one engagement—beyond communicating through disclosure—

between investors and issuers is a productive exercise. While it is increasingly common for companies and their largest investors to have routinely scheduled opportunities to exchange views (often at a different time of year than the company's annual meeting), the majority of engagements are still reactive—initiated by one party or the other in response to a particular issue. The bulk of reactive engagement initiated by companies tends to be driven by a few factors. Among these are adverse recommendations issued by proxy advisory firms on company proposals or votes actually cast against company proposals by investors. In these instances, executives or board members reach out to investors to explain the company's rationale for supporting their proposals and seek either to refute proxy advisory firm recommendations against them or to convince investors to reconsider their votes.

Investors typically reach out to companies either to clarify information regarding or communicate concerns with proposals to be presented at a shareholder meeting, or to discuss concerns with some aspect of corporate governance (that may or may not be the subject of a shareholder vote). For example, some institutional investors will write to or otherwise contact a subset of companies in their portfolio at which they're seeking to effect some sort of governance reform (eg adoption of majority voting). This outreach is typically the first step in a dialogue between the investor and the company and very often results in the adoption of responsive changes by the company.

There has been ongoing discussion—and ample coverage in the two engagement studies cited earlier—as to the appropriate participants from the company in this dialogue. Investors are increasingly interested in discussing certain matters with members of the board, as opposed to members of management. In particular, where the decision-making on a particular matter is exclusively in the purview of the board (eg compensation of the CEO), investors are more inclined to expect dialogue with the relevant member(s) of the board (eg the chair of the compensation committee for concerns related to CEO pay). To this end, we believe that boards may be well-served by the designation of a committee of directors to serve as the focal point for engagement and other interactions with key shareholders.

Summary

Effective corporate governance structures and practices are of critical importance to all manner of institutional investors. Many, like us, view governance as a key enabler of sustainable, long-term value creation for all shareholders. Though the objective, structural components of the governance framework are the most obviously quantifiable features of the environment, it is ultimately the qualitative aspects (ie do we have the right people serving as shareholders' agents in the boardroom?) that have the most lasting impact. Engagement between investors and the companies they own is critical to ensuring an alignment of long-term interests among all stakeholders.

3B The evolution of active ownership

Martha Carter, Head of Global Research, and Patrick McGurn, Executive Director and Special Counsel ISS

Institutional investors have spent the past three decades developing new ways to monitor and manage their portfolio risks and to encourage the creation of sustainable value. Over the course of the past dozen years, in response to two global market meltdowns, *active ownership* has emerged as the leading option for portfolio oversight.

Cobbled together from a variety of tools and tactics, *active ownership* uses perpetual portfolio monitoring, in-depth engagement, and the utility of the proxy vote as communications tools to forge a bond between shareholders, the directors who represent their interests, and the executive teams that boards select to run companies' business operations. Active ownership has already shown promise as recent proxy seasons have featured fewer contentious meetings and more constructive interaction between those three key stakeholders.

This chapter provides a brief description of this emerging active ownership strategy and unpacks its three component activities—proxy voting, engagement, and the development of governance standards.

Informed voting—Prior to the 1980s, poor disclosure, constraints on shareholders' ability to communicate with their peers, and structural impediments to the exercise of voting rights limited the shareholder franchise. Not surprisingly, the end products of this dysfunctional process were low voter turnout and high portfolio turnover. In response to this, Institutional Shareholder Services (ISS) was founded to aid institutions seeking to exercise their franchise through its core mission of developing and applying both "house view" and institution-specific, custom voting policies. Since the 1980s, the spread of requirements for investors to properly manage their voting activities, improvements in disclosure rules, and the development of a more efficient proxy voting system have lowered the costs connected with voting and raised the benefits to shareholders of exercising those rights.

Active engagement—Investor/issuer interactions were commonplace in recent decades, but the scope of this contact was limited and its impact on long-term value creation was negligible. In sharp contrast, today's investor/issuer engagements seek to promote two-way communications and the sharing of ideas about issues ranging from compensation to business strategy. Such engagement encourages stability and sustainable growth by creating greater trust between the three key constituencies.

Developing governance standards—Competition for listings between markets and shortsighted economic nationalism long undermined the development of strong governance standards. Two global market collapses, however, showed the folly of this competitive death spiral by graphically demonstrating the interdependent nature of global capital markets. In the wake of these economic shocks, national governments (witness the passage of the Sarbanes-Oxley and Dodd-Frank laws in the US), as well as voluntary investment organizations (such as the Council of Institutional Investors [CII] in the US and the International Corporate Governance Network [ICGN] globally) have embraced the concepts of greater transparency, meaningful risk oversight, and enhanced shareholder rights.

Active ownership and proxy voting

Prior to the 1980s, proxy voting was a back-office exercise for most institutional investors, with staff often marking ballots in line with the board/management recommendations. Both the New York Stock Exchange (NYSE) and most voters considered core voting issues such as the election of board members and approval of equity compensation plans to be "routine" voting items worthy of only cursory attention. Activism was rare, and exiting an investment—doing the so-called "Wall Street Walk"—remained the preferred response of most professional investors to underperformance.

In response to a decade of sideways market returns, however, a new breed of activist players, dubbed corporate raiders, emerged in the late 1970s and early 1980s. Fueled by access to cheap credit ("junk" bonds), these opportunistic investors were drawn to the potential to harvest unrealized value in public companies via tender offers, proxy fights, and other forms of activism.

Issuers responded to these challenges by erecting defenses—poison pills, golden parachute severance programs, and other "shark repellants"—and adopting aggressive entrenchment tactics—including discriminatory greenmail payments to potential bidders, which in turn drew the ire of many investors.

Council of Institutional Investors members, along with other like-minded institutions (such as TIAA-CREF) and individual investors (one raider/activist, T. Boone Pickens, formed the United Shareholders Association in 1986 to harness retail investors into a market force), began to address their concerns—initially focused on "shareholder rights" issues such as calls for shareholder votes on poison pills and the adoption of confidential voting—via the shareholder proposal process and public advocacy at the Securities and Exchange Commission (SEC) and other federal agencies. These challenges to managements via proxy contests, shareholder proposals, and opposition to board-proposed charter changes and stock option plans exposed significant conflicts of interest in the proxy process.

Media reports exposing such abusive behavior drew a swift response from the US Department of Labor (DOL), which oversees the Employee Retirement Income Security Act (ERISA) and other federal employee benefits laws. In the late 1980s, the DOL released guidance to pension trustees that clarified their duties to vote shares in line with the best interests of plan beneficiaries. The DOL followed its guidance with a series of examinations of industry voting practices, which led to further guidance about record keeping and other compliance practices. (In 1994, the DOL codified this guidance in an Interpretive Bulletin.)

Spurred by these new fiduciary requirements with respect to proxy voting, asset managers and owners sought to improve the efficiency of their operations. Investor demand and the seasonal nature of proxy seasons around the globe led to the rise of the proxy advisory industry.

Starting in 1985, ISS was the first firm to offer both research reports and proxy voting recommendations. Prodded by further regulatory guidance, many investors also began to explore voting of their international (non-US) holdings. Again, proxy advisers stepped in to assist investors by providing procurement and translation services and proxy analysis for non-US stocks. By the mid-1990s, many large investors also looked to off-load the labor-intensive, physical portion—still dominated at the time by paper documents—of their voting operations to voting agency services created by proxy advisers. Eventually, the emergence of electronic voting led proxy advisory firms and other market intermediaries to create voting and record-keeping platforms. Some investors' desire to use proxy voting policies which were more closely aligned with their particular, unique perspectives, led to the development of "custom" voting agency services whereby recommendations are based on clients' proxy voting guidelines. (Today, ISS applies more than 400 custom policies reflecting their view of proxy issues related to both governance and environmental and social matters.) The SEC's requirement for vote disclosure by investment companies led proxy advisers to add services that help investors to file and post their voting records.

Over the past two decades, the elections of directors and advisory votes on pay have supplanted shareholder resolutions as proxy voters' primary focus. In the early 1990s, shareholders began to focus on director elections. Some investors, including mutual funds, had used "withhold" votes in uncontested director elections as a communicative tool for years, but for most investors voting "no" remained a last resort action. Voters' attitudes sharply shifted in the wake of the Enron and WorldCom scandals. Activists began to push for—and mainstream investors supported—stronger voting rights in boardroom elections, including destaggered director terms, requiring majority voting, and the elimination of broker-may-vote discretion. Over the next several years, annual elections and majority voting would emerge as majority practice—without the need for a change in listing standards or federal law—and the NYSE dropped uncontested director elections and equity compensation plans from its list of "routine" voting items, thus ending discretionary voting on those items.

Starting in 2006, in response to rising investor and public policy attention to rising CEO pay levels, some US activists, borrowing an idea from the UK market, began to call for periodic "advisory" votes on executive pay. Using "say-on-pay" as their rallying cry, activists pushed for voluntary adoption of those votes. Some early successes with nonbinding shareholder proposals helped convince US lawmakers to require such votes in the wake of the 2008 financial market meltdown.

Still, the communicative value of the vote is limited both by the narrow subject matter of the ballot items permitted under state law and the largely binary—for or against—nature of shareholders' choices. Cognizant of these shortcomings, active owners have turned to direct engagement to augment voting.

Active engagement

Engagement—loosely defined as discussions between investors and the public companies in which they invest—is a common component to the public discourse on global corporate governance. While it may be touted as the latest trend, and indeed it is on the rise, the subject of shareholder engagement with companies has been around quite a long time.

Institutional investors, who decades earlier sold their shares as their means of protest, now engage through quiet diplomacy and more public forms of communication to present their positions. Other forms of activism, from sponsoring nonbinding shareholder resolutions to launching full board proxy contests, now serve as catalysts for engagement.

How do investors and companies view engagement, its goals, and its progress? A study (*The State of Engagement between US Corporations and Shareholders*) conducted by ISS for the IRRC Institute (IRRCi) in 2011, found:

- The level of engagement is high—87 percent of issuer respondents and 70 percent of asset managers engaged.
- The frequency of engagement is increasing—50 percent of issuers and 64 percent of asset managers said they are engaging more.
- The pattern of engagement exhibits a bimodal distribution—most institutions engage regularly or rarely, if at all.
- The vast majority of engagements are never made public—80 percent of issuers and 62 percent of asset owners said most engagements remain private.
- Investors and issuers do not always agree on the success of engagements. Issuers tend to think that establishment of a dialogue was a success, while most investors define success as additional disclosure or changes in policies.

Updated in April 2014 (*Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors, and Executives*), the ISS/IRRCi engagement study showed that engagement has become even more important than it was just three years earlier in 2011. While many factors led to an increase in engagement between companies and their shareholders, the regulation that mandates advisory votes on executive compensation propelled the level of engagement to new heights and raised the stakes.

Most of the trends and observations from the initial study were reinforced in the update. Issuers are still more likely to view engagement as a means to an end (garnering favorable proxy votes), while investors are more likely to view engagement as an ongoing process. Conversations with those interviewed for the updated survey showed that issuers tend to think of the duration of engagement in days or even hours, but investors define the duration of engagement in months or years.

Board members are increasingly participants, if not leaders, in the engagement process. Traditionally left for company management, the meetings with shareholders now often include independent directors. These directors are taking up the tasks of discussing strategy, pay practices, risk oversight, shareholder proposals, and other governance topics with the shareholders that they are elected to represent. And the discussion is a two-way street. Increasingly, investors reach out to boards to engage. Boards that listen to shareholders and respond to their concerns often reap the benefits of their engagement at election time.

Engagement of companies and their shareholders across geographical borders is also increasing. Shepherded along by stewardship codes and United Nations Principles of Responsible Investment (UNPRI) signatories, including ISS, the proliferation of engagement and constructive dialogue is a permanent fixture across the global governance landscape.

Letter-writing campaigns, face-to-face meetings, and other forms of engagement have already eclipsed shareholder resolutions as the primary catalysts for changes in governance practices. While the numbers for some types of shareholder proposals pushing for governance reforms have dropped in recent years, the pace of reform has accelerated.

Consider the recent jumps in the use of annual board elections and majority voting at US corporations.

ISS's QuickScore database shows that the prevalence of majority voting (with director resignation requirements) in uncontested boardroom elections at large-cap (S&P 500) firms jumped by nearly 10 percentage points over the course of the past three years—from 69 percent in 2012 to 78.8 percent in 2014.

The spread of majority voting at the broader Russell 3000 universe of firms has been less profound, but perhaps more impressive given the relative lack of shareholder proposal activity outside of the large-cap universe. (As of late May 2014, according to ISS's Voting Analytics database, the number of shareholder proposals pushing for majority voting at Russell 3000 universe companies stands at 27. Seventeen of these proposals target S&P 500 boards.)

A search of the QuickScore database calculates a five-percentage point rise—from 15.9 percent in 2012 to 21 percent in 2014—in the use of majority voting across the Russell 3000 index.

Asset owner participants in Lucian Bebchuk's Shareholder Rights Project at Harvard Law School and other proponents continue to use engagement to destagger directors' terms at a breakneck pace. According to ISS's QuickScore database, the use of annual board terms at S&P 500 companies jumped by more than five percentage points over the past three years—from 67.4 percent in 2012 to 73.6 percent in 2014. Notably, QuickScore data also identifies a sizable group (14.7 percent) of S&P 500 boards that are in the process of returning to annual elections.

As a result, management-proposed destagger charter changes on ballots to date this season now outnumber shareholder resolutions on the topic by a margin of 71 to 15. Sky-high support—83.1 percent of the votes cast as of late May meetings—may help to convince many boards to propose the change without the embarrassment of a lopsided loss at the ballot box.

Developing global standards

In the post–financial crisis environment, global governance standards are on the rise. Over the past five years, market participants have witnessed the convergence of fundamental best practice tenets, such as independence, pay for performance, and shareholder rights. As the convergence of governance trends continues, changes in regulations, corporate disclosures, and shareholder practices will likely align with a model of global active ownership.

One of the most prominent geographical areas for regulatory change is Europe. The European Union made sweeping changes to empower shareholders in the EU Shareholder Rights Directives, breaking down barriers to voting and increasing the available information on which to make informed decisions. As the Directives cascaded throughout Europe, additional changes sprung up. The debate on board diversity led to quotas for women on boards in several markets, such as Norway and France. The opportunity for shareholders to vote on executive pay was added to many markets, including Italy, France, and Switzerland. Recently the UK added a forward-looking binding vote on remuneration policy to its long-standing advisory vote on the pay program.

In Asia the focus on investor stewardship and concerns about the performance of Japanese companies has led to the Financial Services Agency's 2014 release of the investor stewardship code. Taking a lead from the UK stewardship code, the Japanese code articulates seven overarching principles that emphasize disclosure, monitoring, engaging, and reporting as activities for investors. ISS was pleased to be part of the committee that oversaw drafting of the code. Changes to corporate regulation include India's revisions to its Companies Act, with new board member evaluations and additional compensation disclosure, as well as Australia's ASX Revised Corporate Governance Principles and Recommendations, with a new provision for boards to provide a framework for risk management. Both India and Australia also addressed director tenure, which will be part of a board's evaluation of independence of its directors. Investors are likely to see additional stewardship codes, corporate governance changes, and other reforms in Asian markets that want to attract global capital. As such, regulation has driven significant corporate governance changes over the past several years.

In addition to regulatory developments acting as a driver for global standards, the proliferation of investors voting, engaging, and holding portfolios in global markets has brought the discussion of governance topics to a level of worldwide discourse not seen 10 or 15 years ago. Particularly interesting is the movement in portfolios beyond the BRIC markets (Brazil, Russia, India, and China) and into emerging markets. As measured by ISS's universe of companies that it covers on behalf of its institutional clients, increases in portfolio holdings are now being seen in emerging markets in Asia and the Middle East. Expect investors to continue to look in all corners of the globe for the best possible investments, and the governance standards by which the markets operate will play a key role in their investment decisions.

Conclusion

Active ownership is a work in progress. Since no two investors are alike, their approaches to managing risk and monitoring their portfolios will vary widely.

Still, as the foregoing developments indicate, active ownership will continue to evolve, driven by regulation in developing markets, augmented by engagement between companies and their shareholders, and supported by informed proxy voting. Institutional investors will utilize the tools of active ownership to mitigate risk in their portfolios and pursue long-term, sustainable value creation.

Against this backdrop, ISS welcomes the opportunity to engage constructively with all governance stakeholders as we seek to further our mission to provide unbiased governance advice to the global institutional investor community and tools for corporations to mitigate governance risk for the benefit of their shareholders.

3C Corporate governance: perspectives from a credit ratings agency

Christian A. Plath, Vice President, Senior Analyst, and Corporate Governance Specialist Moody's Investors Service

In considering corporate governance in credit analysis, Moody's is confronting two primary questions. First, what aspects of corporate governance are relevant to credit risk? Second, how should we assess the quality of corporate governance and, how should that assessment factor into the credit decision?

Fundamental credit analysis incorporates evaluation of franchise strength, financial statement analysis, and management quality. Moody's views corporate governance as an important analytic element of management quality. To the extent that shareholders as well as creditors and others have confidence that proper systems of management accountability and incentives are in place, they can have greater confidence in the present management of the company. In theory, they also can be more confident that, should management fail to meet emerging challenges, managers will be held accountable, either through early action by the board of directors, or through pressures, up to and including hostile takeover, in the market for corporate control.

While there is substantial overlap between creditor and shareholder interests, there are also important potential conflicts due to the differing structures and risk profiles of debt and equity instruments. Unlike equity holders, whose investments have unlimited upside potential, creditors, including bondholders, face low upside return but high potential downside risk. Equity investors and debt investors may also have very different investment horizons with equity focused more on the short term and debt focused more on the long term. Because of these differences, debt investors will have inherently less risk appetite for increased dividends and share repurchases, increased leverage, investments in risky projects, and aggressive acquisitions. Creditors may also be concerned with structures and processes that might promote excessive alignment with shareholders' interests, including executive compensation policies that are aggressively focused on shareholder returns.

In our analysis of corporate governance and management quality, we consider how competing interests are balanced and examine any evidence of shifting priorities (eg toward more shareholder-friendly financial policies). We take our cues from such things as sometimes subtle changes in business strategy or accounting policy and from our discussions with corporate management teams.

Assessing corporate governance in the ratings process

No "check-the-box" or "one size fits all"

Moody's believes that there is not a single clear formula of good governance that is verifiable and adequate. The cookbook approach has severe limitations in our view. Context is important, including legal and cultural context, industry characteristics, ownership patterns, company growth stage, and other factors. Therefore, while market standards for corporate governance are significant in considering governance, Moody's does not take a "checkbox" approach. We believe that the potential strengths, risks, and mitigating factors of each company's corporate governance must be assessed on a case-by-case basis.

While "one size does not fit all," as many observers say, there are strong reasons to expect certain common good governance attributes in large publicly held enterprises, including clearly independent oversight of management, comprehensible structures of management accountability and succession planning, and rational executive incentive structures. This is particularly true for investment grade companies, where we would expect to find robust corporate governance practices.

Important factor but rarely a central ratings issue

Corporate governance is an important element in our assessment of a company's creditworthiness. While we expect the frequency of severe corporate governance problems to be low, the potential impact for creditors can be high. At the extreme, poor corporate governance, if unchecked, can endanger the viability of the enterprise.

That said, while we consider corporate governance to be an important factor in our analysis, it is rarely a central ratings issue as it is typically one of several elements Moody's analysts need to consider in determining a credit rating. The assessment of corporate governance issues is typically a negative or neutral ratings consideration in North America. Strong corporate governance in and of itself cannot overcome weakness in a company's business strategy or financial profile, but it can help protect a strong business. High-quality corporate governance can reduce the likelihood of future problems and may speed remediation of those problems if they occur. Weak corporate governance on the other hand can put downward pressure on a rating or limit the near-term potential for upward movement on the rating.

Sector considerations are important

Moody's analysts must also consider the unique features of, and current developments in, individual sectors and their impacts on governance and credit quality. For example, Moody's sets a high standard for the governance and management of financial institutions since these companies generally are more exposed to confidence-sensitivity on the part of investors, creditors, and customers than nonfinancial corporates, particularly with respect to funding. Some sectors have distinct ownership issues, such as dual-class shareholding structures in media companies. Certain others may have elevated levels of shareholder activism, such as the technology sector has seen in recent years (see "Shareholder activism" section later in this chapter).

Moody's views on key corporate governance issues

Moody's analysts give particular focus to the following aspects of corporate governance and management quality. The exhibit on the following page summarizes our views on these issues.

Board of directors composition and leadership

In Moody's view, the board of directors is the fulcrum for managing governance relationships and the mechanism by which managers are held accountable. Therefore we regard the quality, reliability, and independence of the board as critical to effective governance. A board of directors

Table 1 Moody's Summary Views on Key Corporate Governance Issues

Issue Area	Moody's View
Board Composition and Independence	• In our view, both shareholders and creditors benefit from robust board oversight of senior management, adequate independence, and appropriate skills and backgrounds of board members.
Board Leadership	• We take the view that the presence of an independent chair or independent lead director with substantive responsibilities improves board effectiveness.
Ownership and Control Issues	• Much depends on context. We tend to have more comfort with widely held firms subject to robust disclosure requirements. Controlled companies present a unique analytical challenge. Controlling owners can operate with a long-term view, in alignment with creditors' interests. However, there can be several risks from controlling ownership, including potential for conflicts of interest and abusive related-party transactions.
Takeover Defenses	• Mixed views, and much depends on context. On one hand, they may focus corporate management in the long term and therefore promote alignment with creditors' interests, but they can also serve to entrench management.
Management Quality	• Depth and experience of senior management and robust succession-planning processes are areas of particular focus.
Executive Compensation	• We are primarily concerned with pay structures and metrics that focus the company on long-term sustainable performance and alignment with creditors' interests. Shareholders' and creditors' interests in this area may differ.
Internal Controls, Compliance, and Risk Management	• A well-functioning and deeply imbedded system of controls and internal checks and balances as a means of reducing operational risk and the overall risk profile of a company. Effective risk management is a key credit concern.
Shareholder Activism	• The more aggressive variety of activism (ie by activist hedge funds) is mostly negative for creditors since activists may agitate for strategic, financial, and policy changes that may benefit shareholders at creditors' expense. However, there have been cases where activism has led to positive outcomes for creditors.

that effectively promotes and protects long-term interests of shareholders and the corporate entity will, by and large, mitigate risk for creditors, by assuring proper oversight of management. Conversely, a board that fails in basic oversight of key areas—such as conflicts of interest, management succession, risk management, internal controls, financial reporting, or strategic planning—poses an additional inherent risk from a creditor standpoint. Important considerations include:

- whether the board has sufficient independence to act as a counterweight to management and major shareholders
- directors that possess appropriate qualifications considering the

organization's size, complexity, and development stage
- appropriate board turnover to allow for the addition of new skills and fresh perspectives
- appropriate committee structure (eg audit, nominating, and compensation) to support the full board in its duties
- sufficient meeting frequency of the full board and key board committees.

On the subject of board leadership, Moody's takes the view that the presence of either an independent chairman or a strong independent lead director with substantive responsibilities improves board effectiveness. Separation helps achieve an appropriate balance of power and increases management accountability to the board. However, the success of any given structure is dependent on the individuals who hold the key roles and how they work together. It is important that the chairman and CEO roles are defined and that the responsibilities and limits of each role are respected.

Ownership and control issues

Ownership characteristics of a firm can have substantial impact on public shareholders and on creditors. We tend to have more comfort with widely held, publicly traded companies that are subject to rigorous public disclosure requirements. However, these companies have their own vulnerabilities. In particular, there is a danger that the managers of the company will make decisions in their own interests or for expedience, rather than the interests of the outside shareholders (the "agency problem"). At its extreme, such behavior, if unchecked, can endanger the viability of the enterprise.

"Controlled" companies may occasion fewer worries about misalignment of managers and shareholders, exactly because there is less separation of management and control (at least to the extent that equity interest is equal to voting interest). A majority holder has power and motivation to monitor performance that a diversified shareholder base lacks. Also, large shareholders, particularly family owners, can encourage long-term decision-making that is in alignment with the long-term horizon of the company's creditors. Creditors may also benefit by some insulation from the short-term pressures of public equity markets.

However, such companies can present their own risks. This concern can be significant at some North American companies, but tends to be a larger issue in many overseas markets, in which controlling shareholders are much more often present. For example, complex ownership structures (eg multiple minority ownership interests or pyramid structures) can magnify the governance challenges boards face in exerting independent oversight over controlling shareholders. This lack of accountability may harm creditor interests in some circumstances, as entrenched managers fail to react appropriately because they lack objective understanding of the situation of the firm, or as the controlling shareholder seeks special advantage. Related-party transactions may give rise to potential conflicts of interest that are often difficult to assess from the outside. "Key man" and leadership transition risks in family-controlled firms can also be a credit concern.

For controlled companies, the creditor impact to a significant degree will depend on who the controlling shareholder is and how that shareholder views fair dealing toward creditor interests. While corporate governance concerns (such as a lack of meaningful board independence) may be present, the owner's maintaining a conservative and disciplined strategy and financial profile can help to offset some of these concerns. Other mitigating factors include material controlling owner wealth invested in the business, transparent ownership structures, absence of multiple-class shares, and robust independent director review and approval processes for related-party transactions.

Management quality

Management quality and operating expertise is ultimately reflected in the other dimensions of our analysis, particularly the company's fundamentals, which over time make up management's "track record." We also separately consider aspects of management quality that we believe directly influence a firm's strategic priorities and long-term performance. Important considerations include:

- the breadth and depth of management experience at senior levels
- "key man" risk-management dominated by one or two individuals
- management entrenchment
- management continuity/turnover
- management capacity and capability to plan and carry out business objectives.

In particular, Moody's views effective CEO and management succession planning as critical to the sound management and oversight of an organization. As such, we view it as a critical board responsibility. A meaningful board role in the management development and succession planning process can provide investors with added confidence. For example, the board can help ensure that competent professionals are involved in the selection process and that the decision criteria fit with the company's vision, mission, values, and strategic choices. The board also can exercise its full powers to resolve any internal conflicts that might arise during the process. Furthermore, the board can help ensure there are both long-term and emergency succession plans in place and that these plans are approved by the board and reviewed on a regular basis.

Internal controls, compliance, and risk management

We regard a well-functioning and deeply imbedded system of controls and internal checks and balances as a means of reducing operational risk and the overall risk profile of a company. This is a particular concern for confidence-sensitive and highly regulated companies such as large financial institutions. Important considerations include:

- the absence of past control issues or financial reporting issues, such as restatements
- processes and procedures for the board and audit committee to assure themselves that the company has adequate internal controls and compliance systems
- whether compliance, internal audit, and risk functions have a high standing in the organization
- audit committee composition, including duties, frequency of meetings, and interaction with key internal and external parties
- whether the company has a history of regulatory, tax, or legal infraction beyond an isolated episode or outside industry norms.

The potential financial reputational damage to companies that fail to properly manage risk is a major threat; therefore, risk management is a key credit concern. In Moody's view, risk management should be tailored to the specific company, but in general an effective risk management system will (1) adequately identify the material risks that the company faces in a timely manner; (2) implement appropriate risk management strategies that are responsive to the company's risk profile, business strategies, specific material risk exposures, and risk tolerance thresholds; (3) integrate consideration of risk and risk management into business decision-making throughout the company; and (4) adequately transmit necessary information with respect to material risks to senior executives and, as appropriate, to the board or relevant committees (eg risk committees in large financial institutions).

Boards have a critical oversight role in the area of risk management, including helping to define the organization's risk appetite and ensuring that a proper risk management framework is in place. The support of the board is critical to creating an overall culture that promotes decision-making at all levels of the firm that is sensitized to risk matters and risk-adjusted performance. The identification and management of risks are generally the responsibility of management. The lack of clear responsibilities between management and the board and the failure of risk-control measures can be substantial credit concerns.

Executive compensation

Moody's believes that understanding executive pay is important in corporate credit analysis for three reasons. First and foremost, incentives for the key leaders help to shape company policies and performance pressures. Second, effective compensation policies are important for executive recruitment and retention. And third, where disclosure on executive compensation is reasonably good (as in the US, Canada, and certain other markets), pay practice can provide some visibility into the relationship between the board of directors and senior management, and on whether management is in fact accountable to the board.

In Moody's view, compensation plans that enhance credit quality show:

- a long-term orientation in pay structure and practice
- a clear connection between pay structure and company strategy
- balance in pay structure, particularly in balance between shorter- and longer-term pay elements
- balance in performance metrics, limiting the extent to which metrics may be gamed and taking bondholder interests into account
- risk-mitigating features (such as caps on incentive award payouts)
- discipline in pay practice over time.

It is important to note that shareholders and creditors are likely to have different views on optimal pay structure due to their differing risk appetites and investment horizons. Moody's therefore tends to favor plans that promote a disciplined attitude about leverage and discourage risky, short-term strategies highly focused on share price.

Shareholder activism

Shareholder activism can take a variety of forms, ranging from large pension funds filing shareholder proposals to activist hedge funds making specific demands for strategic, financial, and operational changes. Moody's is more concerned with the latter type, which has become increasingly prevalent in certain nonfinancial corporate sectors, including the technology, energy, retail, and pharmaceuticals sectors.

Activist pressure can lead to significant changes at target firms, which have the potential to change the company's credit profile. In our view, shareholder activism has generally benefited shareholders but held mixed results for credit investors. In some cases activists have prompted changes that can benefit credit profiles by imposing greater financial and capital discipline or by improving a company's corporate governance practices. But it also increases the risk of future shareholder-friendly actions, including shareholder-focused strategic and financial policy changes, new or expanded share repurchases, and divestitures of cash-generating assets with proceeds potentially passing to shareholders. Activism can also lead to strategic changes that heighten event risk.

We increasingly expect companies in sectors most vulnerable to activists to move proactively to boost shareholder rewards and address other issues to avoid becoming actual targets, for instance by launching share buybacks and paying out special dividends. Such steps can pressure credit metrics by siphoning off cash and increasing leverage. In addition, we expect to see more companies continue to opt for negotiated settlements with activists, rather than waging often long, costly, and bruising public battles, including proxy contests. Company managements and activists are increasingly agreeing to seat activist nominees on the board or to add new independent directors before a shareholder vote on boardroom composition can take place. Several rated firms that have been targeted by activists now have activist nominees serving on their boards, which we think will add to the pressure on corporate managements to boost shareholder rewards.

4 Engaging with investors on corporate governance

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There is no question that US public company executives are engaging institutional investors on governance and related matters much more now than in the past. And in an increasing number of situations in which companies face particular challenges, outside directors also are involved in engagement efforts.

These interactions, in person and by telephone, are conducted both during proxy solicitation periods and in the "off season," the latter being of importance as companies attempt to establish relationships, sound out investors on various issues, and lay the groundwork for voting success at the annual meeting.

In the US, the requirement for periodic "say-on-pay" votes has been a particular engine for engagement. But broader trends—including concentration of institutional holdings; a wider shift of power to shareholders over the last 30 years; and increased willingness of "passive" investors to challenge management and support activists— underlie the movement toward more substantive dialogue on governance issues.

For the chief executive officer (CEO), chief financial officer (CFO), and investor relations (IR) staff, dialogue with active managers at buy-side institutions is nothing new. But governance as a key focus *is* relatively new for most companies, and serious engagement with institutional investors using index and quantitative strategies, or with the buy-side institution's internal corporate governance departments, has intensified.

The roster of participants in governance discussions differs from that for traditional IR, on both sides (investor and corporate).

Buy-side participants in governance dialogue

On the investor side, a number of leading asset managers and asset owners (mainly pension funds but also endowments) have increased staff attention to corporate governance in order to fulfill proxy-voting responsibilities more diligently and more independently. This change has been taking place over the last decade or more, and at times is slow as investors weigh effectiveness in this area with cost control.

Many of these institutions are invested across major portions of the public company universe, either through explicit indexing or through a variety of quantitative approaches to meet perceived optimal diversification.

Many investing organizations at one time handled proxy voting haphazardly at best. Under regulatory pressure to recognize the value of the vote beginning in the late 1980s and ratcheting up in the early 2000s, some institutions shifted at first to heavy reliance on proxy advisory services, most notably ISS. Over time, there was increased interest in making the necessary internal investment to build out in-house competencies that could deliver a bespoke approach more closely tailored to the portfolio management teams' strategy. Research and recommendations from proxy advisory firms continue to play a major role in voting, but most of the largest asset managers either make the final voting decisions themselves or have a proxy firm that makes recommendations based on customized guidelines. Typically in the latter case, some case-by-case matters will be referred to the investor for decision. And in this model, proxy advisory firm voting according to guidelines on more routine issues can and at times is overruled.

Bottom line: at most but not all of the larger asset managers, and at certain fund owners (mainly public pension funds), governance staff plays a key role in the voting decision, so engagement with these individuals can be critical to the outcome of the vote.

New Securities and Exchange Commission (SEC) guidance issued June 30, 2014, may increase pressure on more investment managers to take greater direct responsibility for the vote and to perform due diligence around vote agency services where that duty is delegated under a set of voting policies. The new guidance, called *Staff Legal Bulletin No. 20*, is discussed in Chapter 37 of this guide on proxy advisory firms in a broader discussion of the role of these firms.

Governance staff members generally are not involved in picking stocks, and their knowledge of specific companies is limited, although they typically bring investors better understanding of governance norms and issues. Some fundamental investing organizations have increased integration of governance/proxy voting with investment staff (as opposed to treating proxy voting as a strictly compliance/legal function). But even at these institutions, governance staff members tend to review a portfolio of hundreds or thousands of companies, and their knowledge of the specific company and its industry, and key business drivers, may therefore be limited.

Portfolio managers (PMs) and analysts are becoming more attuned to governance dynamics and more often have greater awareness now of norms and characteristic governance problems and challenges, in part due to increased inclusion of governance in educational programs and Chartered Financial Analyst (CFA) testing. The growth of activist investing also has had an impact here.

As companies engage institutions on governance, they can expect to speak with a range of portfolio managers, analysts, and governance staff members, and it is critical to communicate effectively with all these groups.

Company participants in engagement

Many leading US companies now routinely reach out to investors, including governance departments, on corporate governance and compensation. They have sought to build relationships, and these engagements typically involve a mix of IR, secretary/governance, and human resources (HR) staff, with senior executives brought in regularly. Outside directors also are increasingly involved in selected situations, usually because of the nature of a particular challenge.

Traditional investor relations work focuses on making the case for investment in the company and with buy-side outreach dedicated to guidance and information important for understanding current and near-term performance. Corporate governance engagement, as the term suggests, features more emphasis on structural elements but also tends to involve more explicit focus on certain longer-term matters.

Most often, there is a cross-departmental aspect of this, and it is highly valuable for various functions to work together smoothly. Those typically involved are the head of investor relations (and sometimes the CFO and finance executives more generally), the general counsel and/or corporate secretary, and senior HR staff where compensation issues are at the forefront.

While shareholder interactions would seem to have a natural home in investor relations, it is difficult for IR staff to engage meaningfully without deep understanding of company governance, the board of directors in particular, and executive compensation. At times, financial reporting expertise also comes into play. Also, it is important for IR to realize differences between portfolio manager/analyst perspective and perspective from institutional investor governance departments.

Perhaps the most prominent change on the company side of governance engagements is the increasing involvement of outside directors (especially the lead director or independent chair) in selective governance discussions with investors. This may be common in some markets, but in the US many directors have been leery of such discussions. Factors have included strong US rules around selective disclosure (including those in the Security and Exchange Commission's Rule Fair Disclosure [FD]), as well as fears that the company should speak with one authoritative voice at the top. But in recent years, directors at a significant number of US companies have met with investors notwithstanding these concerns. As with corporate executives speaking with investors one-on-one, care needs to be taken to avoid disclosure of potentially market-moving information and to not to speak for the company in a manner that conflicts with agreed policy. Meetings with investors in this context typically involve listening as much or more than talking in any case, even where the company tees up issues for discussion.

A major reason to engage: there are some subjects that are particularly awkward for a shareholder to address politely in a CEO-led discussion, such as concerns about CEO compensation and succession, or where there are serious investor criticisms of management performance.

Recognize the reality of shareholder power but also its limitations

Activist investors willing to express specific prescriptive views are at the forefront, but even in the absence of an activist holder, the reality is that shareholders, including those classified as "passive," now can have significant sway in the boardroom. Investor views are shaping corporate policies through proxy voting and through engagement, and to maintain good relationships with shareholders to forestall potential challenges from an activist.

A perception of management/board nonresponsiveness can open the door to activists when a company develops performance problems. In a dynamic economy, with companies expected to focus on shareholder value, charges of insularity and resistance to necessary change are potent weapons for activists. Such accusations are particularly effective in the ears of a governance team with personal experience of frustration when attempting to engage with company representatives.

Still, insight into the boardroom from those on the outside is limited, which shareholders widely acknowledge. Fiduciary duty as well as practical ability to actually accomplish corporate goals rests with the board and senior executives, who generally will be given wide latitude to operate so long as performance is acceptable, conflicts of interest are perceived as well managed, and the board and management effectively communicate broad strategy, awareness of the competitive environment, and willingness to listen, change, and adapt as necessary.

Know your investors and recognize their diversity

It is critical to know who your investors are to the extent possible (there are some limits on timely information on ownership). As your investor base shifts over time, you need to be on top of who is moving into, and out of, the stock, and their perspectives. This obviously applies to well-known activist investors, but more generally is critical in understanding your potential supporters and detractors and affects how votes will turn out at annual meetings.

Institutional investors have a range of investment styles, time horizons, interests, degrees of focus (ie do the positions in their portfolio number in the very low double-digits or the thousands), and views on best practices. Their investment strategies will likely inform their view of executive compensation design and appropriate metrics. The wide variation in investment approach is perhaps most clear in the contrasting time horizons of explicit and closet indexers who will hold your stock essentially forever and traders who are quickly in and out of your stock.

This diversity leads to sometimes sharply conflicting views of various holders. Some company executives find this frustrating ("tell us clearly what you want us to do, and then we can do it"). But investor diversity is a reality of the market that cannot be wished away and must be navigated.

Even among fundamental investors, there are a variety of views of a company's future. It is common for the same stock to show up in both growth and value portfolios (labels that arguably convey limited information but hint at the breadth of perspective on a given company).

There are other key sources of diversity among institutional investors. A fundamental distinction is between asset owners (funds in this context) and asset managers. Pension funds often retain voting rights, and some public and union funds are highly active in the governance arena. Views on governance may differ from asset managers, even those who manage investments for the funds. And not incidentally, asset managers may control significantly fewer votes than raw ownership information indicates. Proxy solicitors can help companies understand voting power of particular institutions, as well as voting approach and relative reliance on proxy advisory services.

Geographic location and focus is another differentiator. The investment world is increasingly global, and US companies should anticipate that a number of their major investors will be based overseas and informed by governance standards in their home markets. Investors recognize that certain differences in governance certainly will arise from differing legal frameworks, and probably from cultural factors as well, but they may also believe that their home market represents best practices that should be followed globally. Additionally, there has been some convergence on expectations globally. Certain overseas investors have involved themselves in advocacy in the US and other markets, seeking to drive change.

Investors of course share a desire for strong returns to shareholders, even if some may be more heavily focused on the short term than others. But this commonality should not shroud recognition of difference when seeking to understand investor views or to engage with shareholders.

One further note: a variety of investors may seek active interaction with the company. These of course include shareholder activists who seek fundamental change and who may be willing at times to engage in proxy fights. It also includes usually passive investors who advocate certain governance and/or social and environmental policies. Most of these actors wish to engage in dialogue with companies, and it usually is in the company's best interest to entertain this dialogue, to understand the viewpoint of potentially potent critics, and to communicate the company's perspective on complex issues.

Understand how your investors reach voting decisions

A core IR function is to understand how and why buy/sell decisions are made at particular institutions. With the increased importance of proxy voting, it has become vital for companies facing challenging votes to understand how voting decisions are made at particular institutions.

As suggested above, practices vary. Most larger asset managers either have governance departments, significant PM/analyst involvement in key vote decisions, or both. They generally do not vote automatically with a proxy advisory service. In fact, a number of the largest US asset managers subscribe to both ISS and Glass Lewis, which use differing (if similar) methodologies and whose recommendations routinely differ.

Most but not all of the larger institutions usually are open to engagement by the company to discuss governance generally and specific important proxy votes. However, there are important exceptions to this even among large institutions. Midsize investors often do not engage in dialogue and *can* be more dependent on proxy advisory firms.

To communicate effectively begins with knowing what only you know

Companies face an inherent challenge in communicating what goes on "inside" the company—and especially inside the boardroom—to those on the outside. And insiders cannot communicate effectively without an acute understanding of what they know that will not be visible, or easily understandable, to outsiders.

The public corporation is a complex ecosystem, and insiders often underestimate this challenge. It is easy to forget that you are an expert with specialized knowledge of your company, field, and industry when you spent most of your professional life working with people in the same field. In this context, it is important to remember that governance/proxy voting staff dealing with hundreds or thousands of companies will have a steeper learning curve than portfolio managers and analysts who have more focused responsibilities.

This problem may be most evident in the area of executive compensation, which tends to be complex. An effective executive compensation approach may be highly keyed to the particular circumstances of the company, but if you are to secure shareholder support, you must be able to guide outside shareholders to understanding of the particular circumstances. The communication of the reasoning behind a compensation program, or any strategic business decision, should be as direct and streamlined as is practical and not delivered in a manner that inadvertently communicates condescension to the outside investor.

Tell a story using plain English and selective, simple visuals in the proxy statement and supplemental filings

With a push from the SEC, the movement to bring plain English to certain securities filings made *some* headway more than a decade ago. However, most proxy statements continue to be mired in legalistic language.

The proxy statement *is* a compliance document to be sure (that is, it must provide certain disclosures), but it is not *just* a compliance document any more. For US companies, the proxy statement is the central tool for communicating with investors generally on corporate governance. It should be comprehensible to the nonsecurities lawyer and make use of effective plain English summaries. Most institutional investors view the document in electronic form, which means that companies can make good use of internal hyperlinks to provide a user with easy ability to drill down in the document. This is a tool that most companies are not using in any sophisticated way at this time.

Proxy statements are evolving, and the changes are generally improvements, but companies also must be concerned with consistency year to year. That is, changes should not be overly self-serving or repeatedly radical or erratic. This is true not just from the standpoint of dealing with potential SEC scrutiny but also in establishing credibility with investors over time.

Some companies have managed the difficult challenge of establishing a tone of candor in proxy statements, which can be useful in building credibility with investors over time. This means recognizing where problems have occurred, without being defensive. Understandably, companies (and corporate legal departments) have a concern that admitting to a misstep will contribute to litigation vulnerability. However, excessively glowing proxy statement commentary about company performance year after year, while returns to shareholders are limited, exposes the company to some risk of appearing blind to reality.

Since the advent of say-on-pay, some public companies have begun making better use of graphs in their proxy materials and in supplemental filings. A good picture can be worth a thousand words, as the saying goes (or at least a few hundred words). But, particularly in the proxy statement summary or compensation discussion and analysis summary, try to actually substitute the graph for the words (that is, do not always do both). And remember that this can be overdone if too many graphs are used or they are overly complex, such that they take significant work to decode. Remember, the point is to tell the story effectively to an impatient reader.

Finally, keep in mind that some key investors who read proxy statements are moving beyond check-the-box governance, seeking to understand how the board actually performs, with investors believing that relatively clear windows into that are provided by: company performance, particularly as measured by objective financial metrics and especially the external measure of total return to shareholders (share price change plus dividends); executive pay practices; interactions through engagement; and other indications of how boards respond to shareholders.

It is difficult to convey the substance of board work in written documents, but companies are finding ways to give some understanding of the strengths of their board and individual directors, including through effective communication of how the board thinks about board balance and board succession. Leading companies also have considered how best to communicate the quality of their boards through director biographies and description of qualifications. Highlighting that your board is independent is fine, but realize that nearly all US public company boards (at least those without dual class share structures or a dominant shareholder) have highly independent boards, so that is not going to distinguish your board from others.

One final comment: in the last several years, increasing numbers of companies have filed supplemental proxy materials, sometimes in response to critical proxy advisory service reports. Such materials can be useful in focusing on main messages even if they do not state anything outside the four corners of the proxy statement. The availability of this tool should not take away from efforts to make the proxy statement an effective communications document that anticipates investor concerns.

5 The board's role as strategic advisor

Erica Salmon Byrne, Executive Vice President, Compliance & Governance Solutions, and Deborah Scally, Editor and Director of Research NYSE Governance Services

Over the last several years, US public companies have begun to spend more time both preparing for possible advances from activist investors and communicating with their shareholder bases. Significant increases in the amount of total assets under management by activist hedge funds mean that it is much more common today for companies to regularly update their directors on developments in the area of activist investing and to regularly meet with their largest institutional shareholders along with members of their board.

In light of the broad scope of companies and issues that activist investors are targeting, companies should be proactive in preparing for engagement with an activist investor and examine their business, strategic plan, and governance practices with a view to identifying issues that activist investors may raise. These companies should be cognizant of the increasing media exposure that activist investors and their investments are receiving and be prepared for some level of media and investor scrutiny of the company, directors, and senior management in the event that the company becomes the subject of activist investor interest. A key part of that review process must be leveraging the role the board plays as a strategic advisor.

We all know that the chief executive officer (CEO) and management team are appropriately in charge of developing the company's strategic plan. The plan is then presented to the board of directors for approval during a special planning meeting. Most boards and governance experts say boards should be meaningfully involved in shaping and ultimately approving the strategic plan and major decisions—but if they try to *develop* plans, they're bordering on management. To play their strategic role to the fullest, directors must know when to participate and when to pull back. As the Institute of Corporate Directors advocates, board members should be "nose in, fingers out."

The tricky part is distinguishing meaningful involvement from development.

One positive outcome of the governance debate over the past several years has been that the board of directors is no longer satisfied with simply approving management's strategic plan once every three to five years. Indeed, sound governance practices, coupled with an unstable business environment, have led board members to play a more active role in developing and regularly following up on strategy.

Involving the board of directors in the strategic planning process achieves several objectives:

- adds diverse viewpoints to reinforce the quality of the strategic plan and related decisions
- improves the board's understanding of the organization's business environment and its sense of ownership and accountability
- ensures that the executive team and board members work in a collaborative rather than confrontational setting
- encourages identification of additional critical issues, such as evolving cyberthreats, social media developments, or other external forces that must be taken into consideration when developing a strategic plan
- ensures that the strategic plan is considered in light of other key issues the board is responsible for, including CEO and senior leadership succession.

There is therefore a trend toward boards doing more than simply approving the final version of the strategic plan. This has led to greater board participation in the strategic planning process; whether it be determining and updating the organization's vision, values, and objectives, or contributing to improving market intelligence. As one director told *Corporate Board Member* magazine:

> We're much more involved than a few years ago. In the past we'd talk about strategy, but it always seemed that by the end of the meeting we were out of time and it didn't get enough attention. So we decided to put it at the beginning of the meeting, or to start talking about it at dinner the evening before the board meeting. In addition, each of the board members now has a business unit he's mentoring, so that we become more involved in that particular business and can summarize for the board what is happening in each of our major segments. We've gotten away from the old once-a-year dog-and-pony show where you just get mind-numbing slides that don't give you enough time to interact with the people. I feel pretty comfortable with our involvement in strategy planning now.

Another director noted:

> We all recognize as a board that it's very difficult to predict both the economy and the pace at which changes occur. We're probably 50% more involved than we were; we've done this by putting together special committees that look at strategic issues, and this didn't exist a year ago. Of course, you need to keep your nose in and fingers out. I've been on eight different public-company boards, and the best ones realize that the job is governance, not management. You should be a great resource to the management team, but you can't cross the line and start to manage.

In the end it is the role of management to devise a strategy that makes sense for long-term shareholder benefit, but the board can play an important role in evaluating the risk-reward ratio as well as provide a foil for constructive debate.

In order for the board to play that role, however, the makeup of the board must be appropriate. The qualities of a good director are, without a doubt, good listening skills, sound judgment, and a talent for asking the right questions rather than the tendency to think and act alone. In fact, 88 percent of directors in the NYSE Governance Services/RHR International Survey pointed to the quality of boardroom dialogue and debate—followed by the ability to ask tough questions of management and diversity of thought and experience among members—as most critical to boardroom success. Conversely, a lack of candor in the boardroom (77 percent) and a lack of mutual respect and collaborative culture (68 percent) were the lead answers given when directors were asked to name the factors most likely to undermine board effectiveness.

As noted above, diversity of thought and experience among members was one of the top three responses given when naming important attributes to board effectiveness. More than 60 percent of the directors we surveyed say diversity is a key factor, and 86 percent agree that a proactive approach to board diversity is a necessary building block to a great board. In summing up crucial board components, several directors reflected on the need for diverse backgrounds. One director pointed to the importance of "diversity of experience by directors who are actively engaged within the proper role of the board to provide oversight and perspective."

When asked to choose from a list of possible actions that could be instrumental in making a great board, 81 percent of director respondents chose a "regular, ongoing evaluation program for CEO/leadership succession" as the most significant contributor. Many of the directors we surveyed believe their board does a credible job in this area. Sixty-seven percent indicated their board does a very good job managing and evaluating the performance of the CEO; 30 percent said they do this job at least somewhat well. (Interestingly, when asked about US boards overall, these percentages were basically reversed: 33 percent said boards do this job very well, and 59 percent said they do it somewhat well.) Further, when asked to rate their board's effectiveness at aligning the CEO's performance with board expectations, two thirds (68 percent) pronounced themselves effective, and 28 percent said they were at least somewhat effective at doing so. Directors also increasingly understand the difference between long-term CEO succession planning and short-term or "disaster" succession planning, and the role that differentiation plays in their strategic thinking.

Of course, there's no "right" person to temporarily take the helm in a disaster scenario. Oftentimes, the outside chairman or lead director is designated for the role; sometimes it's the chief operating or financial officer. These are not long-term solutions, merely stopgaps to allow a board time to find the right, long-term solution. For example, in June 2008, the board of Wachovia Corp., the big Charlotte, North Carolina, banking company, ousted CEO Ken Thompson after the company reported massive losses on bad real estate loans. The search to replace him led a month later to Robert Steel, the former US Treasury undersecretary. In the interim, directors went with one of their own, Chairman Lanty Smith, an investor with a diverse business background, to run the show. "Having a short-term successor for an emergency gave us time," the board noted. As it turned out, it was time enough to determine Wachovia's next strategic turn, as later that year, the board sold Wachovia to Wells Fargo & Co.

"The good news is more and more directors are appreciating the importance of both CEO evaluations and succession," said T. K. Kerstetter, Chairman of NYSE Governance Services, Corporate Board Member. He notes that an effective CEO evaluation program requires leadership on the board's part and is being embraced more than ever before. Therefore, he says, it is important to establish a regular process for evaluating the CEO and discussing both the board's and the CEO's plans for the future. "Recruiting, compensating, cultivating, retaining, and planning for the succession of the CEO has always been one of the core responsibilities of the board, and boards that handle it well typically have a good foundation that allows them to be effective overall."

As to factors that could limit board effectiveness, a majority (53 percent) worry about a lack of independence from management, and 43 percent say ill-prepared directors could undermine success. With regard to the latter, a solid majority (59 percent) say US boards overall fail to do a good job of replacing directors who are not contributing value; 27 percent say this is a problem on their board. The effectiveness with which a board renews itself and manages its own succession is a key factor to ensure a healthy and self-sustaining board, which of course plays a critical factor in the board's ability to serve as a key strategic advisor to the management team.

6 Fostering a long-term perspective: using strategic simulations to prepare for uncertain futures

Nicole Monteforte, Senior Associate Booz Allen Hamilton

One thing a person cannot do, no matter how rigorous his analysis or heroic his imagination, is to draw up a list of things that would never occur to him.

Thomas Schelling,

University of Maryland economist, winner of the 2005 Nobel Memorial Prize in Economic Sciences for demonstrating how game theory applies to the interactions of people and nations

Commercial institutions face an unpredictable world with challenges ranging from bottom-line management, to insider threats, to cyberattacks. Continuous change and volatility are the primary constants of business, and one false move or moment of inaction can spell the difference between being "in" or "out" in the broader marketplace. For a company to survive—let alone lead—in this dynamic global space, it must do three things well:

1. Understand the forces at work in the marketplace, how they could affect the business, and what they mean for the future.
2. Provide top managers with experience competitors lack, which includes growing a cadre of top managers who can think and act strategically.
3. Grow the buy-in to act on this understanding and experience at an enterprise level.

Such understanding and experience must come from looking forward and responding to potential discontinuities and surprises with decisive action. This willingness to act, in turn comes from confidence in the assumptions and potential outcomes surrounding the situation the company faces and from buy-in from the full team of executives across the enterprise. Such understanding, experience, confidence, and enterprise-wide buy-in can only come from having lived through the crisis *before* it strikes. In his seminal work, *The Strategy of Conflict*, Thomas Schilling demonstrated how these dynamic variables can actually be used to predict future action—using game theory to predict the unpredictable. Since 2001, Booz Allen Hamilton has been leading industry in the application of world-class strategic simulations in the financial services sector and the broader commercial sector writ large. Adapted from our decades-long experience providing wargame and exercise support to US government clients, Booz Allen strategic simulations in the commercial sector offer our clients this ability to live the crisis *before* it strikes.

Case study (reputational risk at large, global financial institutions)

Understanding the past is vital to good judgment about the future. But straight-lining a successful past into a scenario of how the future may unfold, even with experts postulating events, has been the rocks and shoals on which many companies have run aground. Prior to 2008's financial crisis, many large financial institutions might have been forgiven for struggling to contemplate realities where issues like reputational or liquidity risk could cause entire businesses to fail. Yet in 2006 one such institution had the temerity to contemplate just that. What if reputational risk were a reality? And what would it take for our business to fail? Working with analysts from Booz Allen Hamilton's simulation team, this institution designed a *Senior Management Exercise* focused on operations in disrupted environments, with the goal of uncovering those unknown variables that could otherwise unhinge a firm's reputation in the marketplace if mishandled. While this particular simulation was not focused on mortgage-backed securities and some of the other variables that led to 2008's global decline, the experience nonetheless prepared this organization well to deal with issues like strategic communications, refined and battle-tested business continuity plans, and enterprise-wide consideration for line-of-business–specific decisions—lessons that no doubt served their enterprise well during the tumultuous months of 2008–2009.

Immediate benefits

Indeed, strategic simulations offer our clients a window into the future, with many potential benefits devoid of more traditional forms of analysis and strategic planning. Your indeterminable future must consider how competitors will react to your moves and each other's moves, and how the market will react to all of these moves. In turn, your strategy itself is likely to be multifaceted. With this uncertainty, how do we come to closure on a strategic direction? What unforeseen pitfalls lie in wait?

Faced with similarly complex and uncertain situations, many businesses have used "strategic simulations"—business wargames—to test and refine strategies. Every business in a complex environment faces the same dilemmas: It is difficult to plan for a future you cannot predict. You cannot really understand your competitors or your marketplace unless you can see the situation as they see it. You cannot succeed unless everyone on the team is working to the same goals and viewing the situation similarly. Strategic simulations create a dynamic "low-risk" environment, where your key leaders can come together, analyze alternatives under "pressure," and gain the benefit of this alternative perspective prior to facing those real decisions in the real world. Moreover, strategic simulations offer businesses the added benefit of creating a defined environment for a shared learning experience. It is an experience where participants come through on the other side not only knowing things about themselves and their colleagues they did not previously but also with the shared understanding and enterprise-wide buy-in on the *next step*—be it an acquisition, updated go-to-market strategy, or a more nuanced understanding of the threats that are ahead (think: cyberattack, hostile takeover, market corrections).

Strategic simulations bring the best minds in the company together to develop and test strategies in no-holds-barred interaction with "competitors" and in the face of "external forces" over which you have no control. It offers the following benefits:

- Team building and bonding as well as ownership of strategic lessons and the strategies developed over the course of the simulation.

- Direct acknowledgment and the potential to address those difficult-to-model but nonetheless critical variables in a fully interactive, rather than deterministic fashion.
- A methodology to challenge conventional wisdom and the freedom to break from "known truths" and other limiting paradigms.
- A forum to provide key training to managers around the dynamic aspects of strategic planning.
- "No-risk" exploration of strategies, prior to implementation—with the added benefit of providing an opportunity to internalize lessons learned and anticipated "speed bumps" among your core leadership before living them out in the real world.
- An articulated view of the full range and nature of potential outcomes (competitor capabilities and strategies, market dynamics, financial impacts).

Case study (preparing for the "next big thing" in the US automotive industry)

The automotive industry has been and remains a highly competitive market space in which every competitive edge gained, be it in clean technologies, luxury products, or safety, can be a differentiator in the competition for consumers. In the late 1990s and early 2000s big industry witnessed the rise of several newcomers driving innovation and capturing share that may have previously been taken for granted. The question became: How can we best strategize to prepare for the next decade? So in the early 2000s, teaming with Booz Allen Hamilton simulation experts, we were able to uniquely tailor a simulation designed to test competition in the US marketplace for passenger vehicles from 2005 to 2014. Analysis of relevant industry trends and competitor "profiles" were generated to be paired with a dynamic scenario pushing simulation participants many years out into the future to explore how market forces would both be shaped by and react to adopted company strategies. At the end of the simulation, the manufacturer in question not only had a validated set of assumptions around how their current strategies would be received but also a list of action items to carry forward, including diversification of markets beyond the core North American focus and a reduction in their product development cycle timeline, insights and actions that positioned them with the tools necessary to take market share and drive growth for the decade to come.

How it works

For years, many businesses used scenario planning to deal with future complexity, but taken alone, scenario planning is just "best guessing" at the future. To really understand what might happen, a scenario or a strategy must be played against realistic conditions before it is actually implemented. This can best be accomplished through a "competitive simulation" of the future. Competitive simulations allow strategies to be exposed to marketplace and adversary reactions, potential execution issues, and reactive modifications—in short, all the variables that would happen in real life.

A competitive simulation is a dynamic, time-compressed process, uniquely tailored to each of our client's problem sets to design a process to actually "live" through the future. The results are decided by human interactions and expert judgment, with financial implications of decisions often tracked by a model of the industry. Players live in the real world with the capabilities and constraints of the company they are playing. That world develops and changes as a result of decisions players make.

Using our time-tested multiphased process, the Booz Allen simulation team designs each effort to match a particular client's unique problem sets. From concept development, to design and testing, to execution and analysis, each phase of the Booz Allen design process is structured to ensure organizational inputs, test and validate key assumptions, and produce the most effective strategic simulation possible. These processes can be designed across a fully customizable time frame—understanding that shorter time frames often dictate certain elements—however, our decades of experience have taught us that an 8–16 week engagement often offers our clients the most rewarding experience.

Case study (managing integration and market share in the food processing industry)

Companies may choose to grow through many different ways, but those that choose to grow through acquisition often find a unique set of challenges when integrating capabilities, processes, and personnel. In the food processing industry, Booz Allen Hamilton simulation designers encountered a client in need of game-changing analysis to prepare for the future. The company in question had grown through aggressive acquisition strategies that had cobbled together a portfolio of more than 100 independent operating companies—though they were certain of the strength of products and capabilities they had to deliver to the market, the positive impacts of these acquisitions had yet to be realized. Working with the company, the Booz Allen simulation team designed an engagement that allowed the company to test the market, develop potential strategies, and reinvent internal processes. The simulation highlighted the real risk the company was facing from global competitors but also provided the CEO with a punch list of items that were then used to reinvent their investment strategy and internal processes, steps that have allowed them to grow into a global food company with broader market share and a more integrated portfolio.

Conclusion

The challenges facing today's financial institutions and the markets they operate are real, dynamic, and unprecedented in their scale and potential to disrupt. Moreover, yesterday's "ground truths" are being disproved as too shortsighted or worse yet, naïve, on almost a daily basis. In such environments, organizations require tools that can adapt with them and, more important, can help them peer around the corner to see what is coming next. The difference in this market between action and inaction, preparedness and flat-footedness, will determine which organizations thrive and which lag behind.

Strategic simulations offer our clients access to an alternative analytic framework to face these challenges head on, to prepare for their unknown futures, and to be positioned on the other side for success.

CHAPTER 7: Selections from *Corporate Board Member*

7A What directors think: a *Corporate Board Member*/ Spencer Stuart survey

Deborah Scally, Editor and Director of Research, and Kimberly Crowe, Managing Editor NYSE Governance Services

What kind of board does your company need to maintain a competitive edge? Industry and leadership experience are obviously important factors and most boards have added a financial expert thanks to Sarbanes-Oxley, but does your board have IT expertise? Social media savvy? How about an international perspective?

Given the meteoric rise in IT risk, it is likely your board either already has a director who is well versed in information technology and data security or is looking for one to help it better understand the company's IT risk profile. The same is true for the fast-growing realm of social media; its increased use as a competitive strategy in recent years has brought correspondingly greater risks. And if your company is contemplating expansion outside of the United States, bringing in a board member with international experience is a must. At the same time, more attention must be paid to the tricky arena of anticorruption and FCPA compliance, with its minefield of risk.

The results of the 2014 *Corporate Board Member*/Spencer Stuart What Directors Think survey, a long-running annual study based on the input of public company directors nationwide, reveal directors' views on rejuvenating the board, risk oversight, say-on-pay, and more. In many areas, this year's findings align with more than a decade of What Directors Think results and demonstrate that CEO succession and the desire for more time for strategic planning continue to be chief challenges for US public company boards.

In addition to the core areas of study, this year we posed a number of questions around board structure, turnover, and guidelines to better understand the methods and processes boards are employing to maintain their vibrancy and effectiveness. Interestingly, quite a few directors wrote in to comment that these latter issues, while topical, should never become a distraction from their primary responsibility of improving the bottom line.

For example, one director noted that while surveys typically ask about say-on-pay and regulatory issues, the board's focus should be squarely on enhancing shareholder value: "Shareholders want us to make money for them. . . . We work for those who invest in our companies to make a profit." Another offered a similar comment, saying, "A board's obligation is to further and enhance a company's revenue growth, profit potential, and shareholder benefit" rather than to be overly concerned with political correctness. This year's results support the fact that directors' commitment to shareholder interests remains paramount, but Stephen G. Kasnet, a survey respondent and chairman of Rubicon Ltd., maintains boards can find common ground with some of the so-called softer issues and those that have a direct line to profitability: "A well-informed board can and does establish goals and structures that meet the shareholders' and business's needs."

To provide context to the issues that surround corporate governance at the start of 2014, we have organized survey data into five categories: board composition and effectiveness, leadership challenges, executive compensation, risk management, and strategic planning. While compensation and succession are long-running themes, the results show there are new twists on risk oversight that undoubtedly reflect the current corporate environment, both technologically and globally.

Assessing board composition

For any given company, there must be both management and a governing body that are up to the task of meeting current challenges. And while many of the requisite skills are the same year after year, corporate challenges continue to evolve that require new blood and fresh approaches.

While the concept of "refreshment" is more readily applied to employees and management, there's a growing trend among investors and academics to apply it to boards as well. Shareholders want to ensure that the boards of the companies in which they own stock are capable of handling the leadership and governance demands of the current marketplace and that the highest standards of independence are being met. This viewpoint reflects the belief that today's corporate boards are one step further from the days when boards were often formed under the auspices of long-standing friendships or business favors—and stayed that way.

Today's board members are well aware they need to stay sharp. As John Bagalay, one of our respondents and an executive in residence at EuroUS Ventures, notes, "Failure to establish an orderly method of changing board composition creates two problems: one diplomatic and the other leadership refreshment." Two thirds of directors we surveyed agree, finding the need to periodically refresh the board with new blood as either important (51 percent) or critically important (16 percent), with another 26 percent saying that refreshing the board is at least somewhat important (Figure 1). Bagalay adds, "All companies need board members who come on without a predisposition to accept the way things are."

And the time has never been more appropriate for a jaundiced look at board composition. According to What Directors Think survey partner Spencer Stuart, among S&P 500 boards, retirement ages are being pushed back, and as a result, board members are becoming older and more entrenched. "While it sometimes makes sense for boards to ask experienced directors to remain on the board longer, they must also ensure they have the diversity of skill sets that are important in today's business world to define a forward-looking strategy and vision and manage key risks," says Julie Hembrock Daum, who leads the Spencer Stuart North American Board Practice.

Yet, one irony today is that adding younger board members to the ranks inadvertently means these new directors may one day end up with longer-than-average tenures. Along those lines, we asked directors whether it would create a problem

Figure 1

HOW IMPORTANT IS IT TO REFRESH THE BOARD PERIODICALLY?

CRITICALLY IMPORTANT
16%
IMPORTANT
51%
SOMEWHAT IMPORTANT
26%
NOT VERY IMPORTANT
6%

for a board member to serve as much as 30 years on one board. Respondents were split on this point, with 53 percent saying yes; 47 percent no. As one director noted, "I generally favor age limits, but [Warren] Buffett is causing me to rethink the issue. Who wouldn't want Buffett at 80-plus?" Another pointed out that proponents for age limits "seem to focus on the negative side of longevity but give little or no credence to the wisdom gained only through years of experience."

Jim Hunt, a survey respondent and retired Walt Disney World executive who sits on several boards including Brown & Brown Insurance, says, "A robust, specific board evaluation . . . of each board member, coupled with individual discussions with each member by the chairman/lead director, should provide for a company's board to be self-reflective and allow for change as needed." And in his mind, this type of well-executed evaluation negates the need for external regulatory pressure to manage board performance. "The fact that a great many boards are up for reelection annually allows for shareholders to give due consideration to board performance," he states, and thus evaluations can be handled without regulatory intervention.

Most boards have formal policies regarding ongoing board service and tenure. Just over half (53 percent) of directors reported that their boards employ a mandatory retirement age. In addition, 39 percent said their boards require a mandatory resignation submission in the event of a personal reputational event, such as a bankruptcy or arrest, and 28 percent require a mandatory resignation if a director fails to garner a majority vote. However, fully half of those surveyed said the latter is not required nor needed, which may indicate a preference by directors to evaluate each case individually rather than under blanket guidelines.

In addition to examining the methods boards are using to refresh their ranks, another important function is for boards to undertake a healthy self-evaluation to ensure all sitting members are contributing something unique and relevant to the whole. This is often an important step when there is a vacancy on the board. Dovetailing with this idea, the survey asked directors which attributes would be most important in selecting their board's next new member. Not surprisingly, financial and industry expertise were the top two choices, followed by CEO experience, knowledge of information technology, and global expertise. Close behind was the relatively new demand for directors with marketing and digital/social media experience.

Industry experience is often viewed as a compelling factor for selecting a board member, especially in terms of how a candidate could contribute to the competitive growth and strategy of the company. Tim Gentz, a survey respondent and chairman of Speed Commerce Inc., says to make his board stronger, "We need to enhance our industry knowledge both via education and by recruiting candidate(s) with industry experience, as we have recently changed our strategic direction."

With regard to leadership experience, the survey found a difference of opinion about the upside of having active CEOs serving on boards. One director said there is a need for more CEOs or COOs who are willing to sit on boards, explaining, "We now have too many professional board members who are getting education boxes checked through the NACD, etc., who don't have the experience of actually running an organization. They tend to be good on process and weak on leadership." But another director complained that "board members who are also CEOs and sit on multiple boards are cheating everyone—[they don't have] enough time to do any of it right."

"Active CEOs bring a wealth of relevant current business experience to the board," says Daum, "which is why they are frequently sought by boards looking to recruit a new director. They also tend to relate well to the company CEO and are well-equipped to build a strong working relationship with him/her," she adds. "But boards will want to be cognizant of the tradeoffs in adding a sitting CEO to their boardroom, among those, potentially less time to devote to company business in between meetings or when extra time is required—in a crisis, for example. Boards also will want to have a candid discussion about whether they are looking for a marquee name or someone who will actively contribute to the dialogue and deliver value," she explains.

Daum says the 2013 Spencer Stuart Board Index revealed that 23 percent of new directors were retired CEOs, COOs, chairmen, presidents, and vice chairmen, compared with just 16 percent in 2012. And, for the first time, fewer active CEOs than retired CEOs joined S&P 500 boards, 77 versus 79, "suggesting that more boards are comfortable that retired CEOs can make a similar contribution as sitting CEOs—who are more reticent these days to sit on incremental outside boards," she notes.

One area that *Corporate Board Member* has been actively tracking for the past several years involves initiatives to promote board diversity. Thought by many to have benefits above and beyond a perception of political correctness, board diversity has gained momentum in countries that have put their regulatory muscle behind such initiatives. Such regulations, however, have not gained a foothold in the United States, nor do most directors expect them to. Nearly 60 percent believe there will be no formal actions in the US in the next three years related to board diversity, though 38 percent believe we will see increased pressure on this front by investor activists.

As one director noted, progress toward more diverse boardrooms is likely to occur, but it will come about by more organic means. "Diversity cannot be achieved by mandatory selection of less experienced members; it has to come about naturally through societal changes. As more and more diversity enters the job markets, the pool of directors will allow for diversity." These views are telling in that directors themselves are a key component in how their future boards are shaped. Nearly two thirds (63 percent) of those surveyed, for example, said individual board member recommendations are the most successful source of new board members, followed by the use of search firms (22 percent).

For a closer look at the functions of the board and its members, the survey set out to ascertain how effective the board and its committees are in several key oversight areas. Directors are most confident in the audit committee's ability to accurately monitor financial reporting, followed by their ability to challenge management when appropriate, and the compensation committee's ability to properly align CEO compensation and performance. Rounding out the top six are the audit committee's ability to investigate internal fraud, the board's ability to develop and deliver the CEO's performance review, and the compensation committee's ability to properly set industry benchmarks for CEO compensation.

"For the 10-plus years we've been doing this survey, directors have been unwavering about their ability to monitor financial reporting. I truly believe that audit committees take great personal pride in their ability to perform this important task," says TK Kerstetter, chairman of *Corporate Board Member*. "What is equally interesting over those 11 years is how little has changed regarding the order of the duties they feel they oversee effectively."

Figure 2

WHICH ARE EFFECTIVE TOOLS TO ENCOURAGE BOARD REFRESHING?

BOARD EVALUATION
85%

AGE CEILING
49%

TERM LIMITS
25%

Ironically, despite the earlier finding noting that two thirds of directors believe it's important to refresh the board, they rated themselves least effective in terms of the nominating/governance committee's process to effectively encourage board turnover and to create a board that has a balance of needed skills and diversity. Other relative weaknesses noted by respondents include the full board's ability to complete a management succession plan and to monitor the organizational risk management plan to mitigate exposure. It's worth noting that two of the bottom four results in this category are related to board composition and turnover challenges, indicating many directors are attuned to the fact that these important areas need more attention in the future.

"Boards must ***have the diversity of skill sets*** that are important ***to define a forward-looking strategy and vision and manage key risks***."

Julie Hembrock Daum

Spencer Stuart North American Board Practice

"Spencer Stuart's research shows the number of new board appointees fell by 23 percent in the period between 2008 and 2012. While there was a 16 percent uptick in the number of new independent directors elected to S&P 500 boards during the 2013 proxy year (339 directors), boards continue to wrestle with the question of how to promote ongoing board renewal," Daum says. "In our experience, making board composition and performance an annual topic of board discussion is a good approach to ensuring the board has the right expertise and skills as the economic and competitive landscape changes."

In analyzing the methods used by boards to encourage healthy turnover, 85 percent of directors surveyed said board assessment/evaluation is an effective tool to encourage board refreshing. Boards use annual board evaluations to assess the effectiveness of the board as a whole as well as the contributions of individual directors, which can identify directors who are underperforming or whose skills no longer represent a good fit with the strategic direction of the business. Forty-nine percent cited the use of an age ceiling, and 24 percent chose term limits as a means to bring on new members (Figure 2).

"Whatever the tool, boards should ensure they are having a regular dialogue about whether the expertise and diversity of perspective around the table reflects the strategic vision for the organization," says Daum.

Finally, in the area of board performance and effectiveness, we surveyed directors' views on director education. Nearly three fourths of those surveyed (73 percent) said they receive reimbursement for attending an educational program they anticipate will make them a more effective director.

Choosing company leaders

Since this study's inception in 2002, succession planning has continually topped the list of challenges for boards, and this year was no exception: 10 percent of respondents said they were "poor" at this responsibility and another 26 percent said they were "adequate"—much lower than other dimensions measured. Why, year after year, is this so, we wondered? According to director Jim Hunt, boards continue to grapple with CEO succession planning because they sincerely want to "get it right."

Interestingly, it's long-term succession that they lack confidence in—not short-term. Fully 81 percent indicated that the company's succession plan would proceed without a hitch in the event their CEO was immediately unable to perform his or her duties. While these findings might seem at odds, they more likely reflect the distinction between an emergency plan and a successful, long-term succession plan. As Rubicon's Kasnet explains, "As a young company, we foresee little need for a directional change but are prepared for the potential of an abrupt change."

Speed Commerce's Gentz agrees. "I believe boards take this issue on with great vigor when they are faced with an imminent CEO change (planned or otherwise). However, when not faced with that urgency," he explains, "boards tend to 'theoretically' deal with the issue, knowing it is important but not wanting to delve into it in detail until necessary. Oftentimes this is to avoid creating concern for the incumbent."

The survey also sought to find out more about boards' ongoing processes to plan for succession within the ranks of rising senior management. Almost 60 percent indicated their board has some type of formal process to assess internal candidates, leaving nearly 4 in 10 that do not. In another finding, 68 percent indicated their company's method for benchmarking candidates against best-in-class talent is at least somewhat effective, nearly 20 percent admitted their efforts are not at all effective, and another 14 percent were unsure. On an encouraging note, nearly four fifths of those surveyed said their board reviews the company's CEO succession plan at least once a year, and another 14 percent said they do so whenever the need arises.

"By definition, internal candidates are not proven CEOs. To gain insights into whether a candidate is capable of moving into the role, boards need to embrace an assessment process that is fact based, rigorous, and forward looking. It's also important to not lose sight of how an organization's internal talent compares to the best-in-class talent externally," Daum explains. "Taking a look at external talent—through research, informal or formal introductions, or a search—can provide important insight when assessing the readiness of potential successors," she adds. "This process is critical to give the board a good sense of the relative strength of the internal candidates, as measured against the outside talent pool that would likely be considered for the role."

Another tough leadership decision boards have to face is whether to split the chairman/CEO role, an issue that was elevated following the financial crisis of 2008. In light of increasing investor pressure, it's not surprising that 69 percent agree or strongly agree that splitting these roles results in more favorable proxy advisory recommendations; likewise, 64 percent agree or strongly agree that doing so offers more independence of thought within board discussions, and 60 percent affirm that it establishes more effective CEO evaluations.

Figure 3

IF YOU WERE AN INCOMING CEO, WOULD YOU WANT THE PAST CEO SERVING AS CHAIRMAN?

YES
18%
NO
82%

However, external forces to persuade boards to split the roles are often met with just as many compelling internal reasons to combine them. In the end, boards need to feel comfortable they are doing the right thing for the company—and for the right reasons. Director John Bagalay, the EuroUS Ventures executive, says that in past CEO searches in which he has been engaged, many CEO candidates have told him they would not take the job unless they were also made chairman. "I have never acceded to that request. The insistence on having both positions is a clear indication that the candidate doesn't want an 'intrusive' board. The separation of the two positions is unwise only if it leads to board micromanagement." Bagalay believes that separation is essential in order to establish that the board has the right and responsibility to be certain that the company's business strategy is given a tough and challenging review.

Yet another thorny issue related to board leadership emerges when a CEO steps down and is subsequently offered the chairman's seat. Whether such appointments stem from personal board loyalty or a desire for continuity, the situation is far from ideal, governance experts say, because the perception of influence from a past CEO is usually too much to overcome. When we asked respondents if, as a hypothetical incoming CEO they would want the past CEO serving as chairman of the board, 82 percent resoundingly said no (Figure 3).

The common thread running through these issues involves board independence and effectiveness. While a good relationship must exist between the board and senior management to run a successful company, there must also exist a healthy separation for good decision-making at the board level. Kasnet's company has a separate board chair and CEO, along with a lead director who has fairly broad powers, and he says the system works, but he also says he would be against keeping a past CEO on the board if it became a disincentive for an incoming CEO. Hunt adds that while he has observed situations where a new CEO could and would benefit from the departing CEO either remaining in or stepping into the chairman role, he believes such matters are situational and require each board to undergo a considered review to deliver the best outcome for shareholders.

Setting executive compensation

Since 2010, every public company has been through some level of angst related to Dodd-Frank–imposed legislation requiring a shareholder advisory vote on executive pay. In year one, the fear of the unknown created the lion's share of work and worry, but most companies saw smoother roads in subsequent years. In this year's survey, we wanted to see how companies fared after the 2013 proxy season, especially in comparison to prior years. Forty-five percent of directors surveyed said their board spent more time on say-on-pay in 2013 than the previous year, and 24 percent acknowledged receiving tougher scrutiny from shareholders. On a positive note, fully 70 percent said their efforts to improve shareholder communications paid off and termed 2013's proxy season a smoother experience.

Figure 4

HAS SAY-ON-PAY RESULTED IN BETTER ALIGNMENT WITH SHAREHOLDERS' INTERESTS?

YES
21%

NO
17%

IT WASN'T OUT OF ALIGNMENT TO BEGIN WITH
62%

Interestingly, when we asked if three years of say-on-pay had resulted in making executive pay more aligned with shareholders' interests, only 21 percent of those surveyed agreed. Nearly two thirds (62 percent) said no, because, in their opinion, executive pay was not out of alignment in the first place (Figure 4).

As a follow-up, we offered several scenarios and asked which situation would warrant a board making changes to its executive compensation plan prior to the company's next say-on-pay vote. Not surprisingly, we found that relative company performance is the key. Fully 80 percent of those surveyed said if executive compensation were higher than peer level and the company was underperforming, that would be reason to make changes; 52 percent agreed even if compensation were in line with peers. A much smaller group (15 percent) said changes would be in order if compensation levels were higher than those of peers even if the company was hitting performance targets.

Wrapping up the compensation arena, we asked for opinions about the new SEC disclosure of CEO/median employee pay ratios: 70 percent worry that such disclosure will result in a misleading indicator, while nearly half believe it will be costly and difficult to accurately compile and report. Only 17 percent of those surveyed believe it will provide meaningful information to investors. One director echoed the comments of several others, saying, "Regulators (SEC, PCAOB, Dodd-Frank, etc.) are out of control with

Figure 5

WHAT WOULD IMPROVE YOUR BOARD'S ABILITY TO OVERSEE RISK?

MORE HIGHLIGHTS/FEWER DETAILS IN REPORTS
44%

BETTER UNDERSTANDING OF HOW TO OVERSEE RISK
39%

A SEPARATE RISK COMMITTEE
33%

MORE TIME TO DIGEST REPORTS
29%

MORE DETAIL IN REPORTS
11%

REPLACING ONE OR MORE BOARD MEMBERS
7%

new policies that are very costly and often do not improve governance." Another added, "Governance changes have become more publicized, but the end results have not dramatically changed overall operating results [which are] a function of operating efficiencies as well as good governance."

Managing risk

Of paramount importance year after year is the board's responsibility to oversee risk across the enterprise. As a demonstration that boards are fulfilling this role appropriately, 87 percent of those surveyed affirmed that new strategic objectives are reviewed by the full board to ensure they align with the company's risk appetite. But there is no denying the job is an overwhelming one. In terms of what would improve the board's ability to oversee risk, 44 percent of directors said getting management reports with more key highlights but fewer details would be helpful, while 29 percent said more lead time to digest those reports would be appreciated. However, some directors obviously feel overwhelmed and find the process burdensome and a distraction. As one director put it, there is "too much ritual risk management and too little emphasis on generating shareholder value."

Meanwhile, 33 percent said the ability to delegate risk to a separate committee that could keep closer tabs would be advantageous. Others, however, don't agree with this approach. "Risk oversight should rest with the full board," says Bagalay. "Every board member should understand and accept that corporate risk oversight is his or her special responsibility—that requires every board member to know and understand company strategy and the risks that go with it." Kasnet says that while his company established a risk management committee early on and its function has grown substantially, still "the subject is discussed in great detail regularly in board meetings."

Interestingly, nearly 40 percent of those surveyed agreed they could do a better job at risk oversight if they had a better understanding of how to do so (Figure 5). Hot spots crop up all the time, and even traditional risk areas are often murky. For example, 20 percent of respondents said they are not confident in directors' understanding of the many facets of IT risk, one of the most elusive new risk areas for companies today.

Figure 6

TOP FIVE TOPICS MOST RELEVANT TO YOUR NEXT BOARD MEETING

STRATEGIC PLANNING
81%
M&A
61%
CEO SUCCESSION
47%
GLOBAL STRATEGY
42%
IT STRATEGY
38%

Thinking strategically

In addition to overseeing compensation and risk and finding the right company leaders, board members must keep profitability and increasing shareholder value in their cross-hairs. Without meeting these goals, all the others hold little value. Therefore the board's role in shepherding strategic planning for future growth is imperative, particularly in an environment where competitive change happens quickly. Bagalay noted that this is another good reason for refreshing the board: "The danger of strategic direction stagnation dictates the need for orderly and predictable change in board composition." Another survey respondent agreed, saying, "Our board has put a strong focus on discussing our strategic plan with more regularity. We have a number of board members aging out over the next five years, which will create a nice opportunity to bring in fresh blood and some different skill sets."

Accordingly, 81 percent of directors we surveyed chose strategic planning as a top agenda item—the most popular response, followed by M&A opportunities (61 percent), succession (47 percent), global business strategy (42 percent), and IT strategy (38 percent) (Figure 6). One director who commented on the survey noted, "Boards need more experience from members who have private equity or other similar experience to assist the board in matters of M&A and activism. I believe this is a missing component of board composition."

"There is no question in my mind that boards have gotten significantly more effective at performing their duties over the last 10 years, even though we still see some repetitive negative trends associated with risk and CEO succession duties," Kerstetter of *Corporate Board Member* notes. "More and more, boards are understanding and embracing the need for effective board leadership, which should result in more confidence in boards' abilities to perform effectively in all areas of governance." In the end, he continues, overseeing risk and selecting/retaining the right CEO are two of the most fundamental duties a board of directors must administer. "My hope is that we will see that confidence reflected in future director opinion surveys."

Looking ahead

In all, directors this year appear to be laser-focused on ways they can help their companies grow and prosper in the year ahead and are working to better understand and come to grips with the battery of risk elements that continue to make the job more challenging. In doing so, they are on track to ensure that their boards are operating as effectively as possible and have the requisite skill sets to ask the right questions and stay ahead of the risk curve.

Corporate Board Member would like to thank Spencer Stuart for supporting and sponsoring this important annual research as well as to thank the nearly 600 directors who took the time to respond to our survey and to those who offered additional comments and perspectives to this year's findings. For a full copy of the results, visit www.boardmember.com/WDT2014.

7B Growing goodness, Annie's way

Deborah Scally, Editor and Director of Research NYSE Governance Services

For investors who nabbed the offering of 950,000 shares of common stock at $19 a share in March 2012, Annie's has certainly made good on its tagline "Growing Goodness." In the 18 months since its IPO, the Berkeley, California-based company, trading as BNNY on the NYSE big board, has performed extraordinarily well. In fact, it jumped 89 percent on its first day of trading, making it the best first-day IPO performance since LinkedIn the year before. Moreover, since its initial catapult, the stock has chugged steadily upward, closing at around $49 at the current time.

Annie's is one of the new breed of company whose mission reaches beyond its P&L, thus creating tremendous brand loyalty and positive messaging. Despite an unabashedly cute persona—its ubiquitous bunny logo can't help but draw a smile—Annie's performance is anything but lightweight. Boasting substantial investment and managerial talent behind the scenes for more than a decade, Annie's has successfully transformed itself from a quiet, niche organic and natural food company to a big league player.

Working hand-in-glove, CEO John M. Foraker and board chair Molly Ashby are largely responsible for this evolution. Bringing the gravitas of 16 years as JP Morgan Capital's chief investment strategist where, among other things, Ashby was a key member of the team that organized the $5.1 billion leveraged buyout of HCA Holdings, this mother of two has been instrumental in Annie's growth and progress since 2002. Ashby's interest in developing and funding companies she sees as worthwhile stems from the founding philosophy of her own investment management company, Solera Capital, which she launched in 1999 and serves as CEO. Simply stated, Solera's philosophy is to identify and invest in modern companies that bolster the values Ashby and her colleagues stand for: sustainability, diversity, and responsibility. Thus, two key ingredients—Solera's capital injection plus the untapped growth potential of the organic and natural food market—have created the perfect recipe for Annie's success. Over the course of its 10 years of ownership, Solera invested $81 million in Annie's, an investment that multiplied roughly six-fold at the time of the IPO in 2012. Today, Annie's enjoys a market capitalization of more than $830 million.

Since 2002, the Annie's team has worked to push its products out of the dusty organic and natural food shelf to take their rightful place in the mainstream market. To make this a reality, management and the board realized wider backing would be necessary, so for the last two years, Ashby has overseen a calm and ordered private-to-public transformation, facing head-on the opportunities as well as challenges that come with running a publicly-traded company. Shortly after the announcement of its positive Q1 2014 financial results, as well as an announcement the company was expanding its presence with family entrees, *Corporate Board Member* interviewed Ashby about her experiences and her perspective in the rearview mirror to offer proverbial food for thought to others who may be considering a similar path.

Molly, we'd like to talk about your experience navigating Annie's through its post-IPO first year, but it might help set the stage for you to tell us about your principal company, Solera Capital, and how it came to take a major stake in Annie's more than a decade ago.

Certainly. Solera is a growth investor, and its focus and mission is to identify and to work closely with companies in sectors we believe have really strong growth prospects—those that are well positioned for the long term. We bring a lot of capital, focus, and operating expertise into the building of our companies. So, by way of background, we have Annie's in the organic and natural sector, we also have a company, Latina, in the Latin space, an affordable luxury company called Calypso—all of which are in sectors we believe have exceptional, long-term prospects. We also built a consumer health-care company called The Little Clinic from two to more than 100 clinics before selling it to our partner The Kroger Co. in 2010.

Specifically, we made our acquisition of Annie's in 2002 because we loved the growth we saw in the organic and natural space. It was intriguing to us that there were few companies of size and scale in that space. We also believed that, while the growth itself was strong, there would be an acceleration of growth coming from the distribution of natural and organic [foods] in mainstream channels. What was also very important to us, as it is in all of our companies, was a very strong alignment with the founder and the leadership team as well as with the values and the mission of the company. At Solera, we're really hands on, we're operations focused, and we take long views on sectors, but we are centered on a mission and a core set of values that are really important to us. We just found outstanding alignment with Annie's on all those fronts.

So you first came aboard Annie's as a director in 2002 and then took over the chairmanship in 2004. Turning to the relationship you have with the leadership and company today, you and CEO John Foraker have both been there for more than a decade, yet the rest of the board members are relatively new by comparison. Was there a concerted effort to recraft the board to meet the challenges ahead as you looked at going public?

Yes. The long-term advanced planning for this kind of undertaking is really important, so as part of that process you determine what an optimal board of directors would look like—the experience, expertise, skill, etc. needed, because the requirements of a public company are different than those of a private company. We began a good, strong dialogue with several prospective board members with that in mind and began that process significantly ahead of the IPO.

How did you approach that task? That's a big undertaking, even outside of all the details related to the IPO mechanics, financing, regulations, and so forth.

Specifically, we looked at potential directors who had served on large, public companies because we knew Annie's was growing rapidly, and that experience would be tremendously valuable. We also looked for experience in specific functional areas, such as finance, audit, consumer products, and IT. We looked specifically at how the members would complement each other from a skill set standpoint, as well as generally. It was important that our directors had expertise that our management team would be able to draw on in important functional areas. So we were really building a matrix as we went along. And then, for us at Annie's, an extremely important overlay was strong alignment with our values, our mission, and our approach, which is what we look for in all our companies.

That's a lot of things to put in that matrix.

It is. And we are continually building and growing and developing our board, because we want the board to gel—to work well together, to have the right set of complementary skills, to be aligned on mission and values, and provide exceptional oversight and assistance to management.

I can appreciate the amount of effort that's gone into that thus far. How have you evaluated the board since the IPO?

A good public board is like a living, breathing organism. And so it's important to look at the evolving needs of the company and whether the board is positioned to address those needs. You need to be asking these questions: How are we doing? Do we have all the skills we need? Are we the right size? Have we got all the committee alignments right? There's an ongoing process of self-evaluation.

So in terms of laying the groundwork for the IPO, how early did you start?

It was more than a year. We knew if we wanted to seriously entertain going public, we needed to do a great deal of planning and have access to good advice. We gave ourselves lead time to make sure the company was ready and we had the right team in place—at both the board and management levels—and had all our processes lined up. John and I needed to ensure that our lawyers, accounting firms, prospective underwriters, and the organization, at a deep level, were all aligned on the requirements of being public and were starting to think through and create a really thoughtful timeline. You could perhaps do it quicker than a year, depending on the company, but for us it was more than a year. And during that period we continued to evaluate going public versus other strategies.

So as you stepped back and made those assessments, how did you really know when the time was right? What turned that light green?

We considered the readiness of governance, legal, the management team, and the depth of reporting capabilities within the company.

What good advice did you get that helped you and the Annie's team move through the transition from private to public?

One piece of excellent advice was to start behaving as if we were a public company before we were actually out in the public arena. This helped us refine the way we did things and made judgments about our degree of readiness.

So it sounds like you had a good process for gauging your readiness and laid your groundwork well in advance of the initial public offering. Were there any surprises this past year? Things that were perhaps either easier than you expected or more challenging?

I would say that you get a lot of good advice, but still the IPO experience is eye opening. Amassing the resources needed to be public—human resources, adviser teams, in-house teams, and systems and processes to communicate and engage thoroughly and thoughtfully with shareholders—is a big issue. We think of our shareholders as our public investment partners, so the resources, time, and focus we put into our relationships with our investors is huge. This is perhaps the single greatest distinction moving from the private to the public arena.

Indeed, and the tide can change quickly, and sometimes in reaction to external things that are not in your control.

Yes, management and the board need to work together to make sure enough thought, support, people, and resources are being applied in this area.

So touching on this important aspect of investor relations and shareholder activism, we've seen a groundswell of investor interest in recent years in corporate social responsibility, which is something that is ingrained in the fabric of Annie's and has been for years. Have you felt any tension thus far in trying to balance a philosophy of social responsibility and the pressure to meet investor performance expectations?

No, and I know [Annie's CEO] John Foraker and I share the same perspective here. We saw the public offering as a wonderful way to enable others to share in the growth of a business we felt really strongly about. We were able to do it because we had worked hard in preparation, and because John and I and the board all had confidence in the business and in the team's readiness. In addition, we felt very strongly that it was important for this kind of company to go public and to show that Annie's mission and values were truly enabling to the business. It was very important and powerful and energizing for us to think that if you could take this company public, you could really demonstrate that you can be true to your values and produce results that translate into long-term shareholder value.

It must be tremendously gratifying to feel that all those things are firing in sync.

Yes, and while we are proud that the IPO has been a success, John and I and the entire Annie's board hope and believe that our success shows that public shareholders appreciate how values can truly be enabling from a financial standpoint.
(From *Corporate Board Member*, 2013 4Q: 20–25.)

7C How sweet it is! One-on-one with Jim Nevels

Deborah Scally, Editor and Director of Research NYSE Governance Services

Describing his role at The Hershey Company as the "first among equals," Chairman Jim Nevels has a lot to smile about as he leads the board of one of the world's most respected confectionery empires. Nevels has a sweet job—literally. As chairman of The Hershey Company, Nevels oversees the governance of one of the best-known and beloved brands in the country. It's practically impossible to think of Hershey's mouthwatering chocolate and not grin. But that brand speaks to more than simply good taste. Hershey's long-standing tradition of philanthropy is in its genes—a side of the company Nevels has long been associated with through his day job at The Swarthmore Group, an institutional investment advisory firm, as well as his tenure on the board of directors of The Hershey Company. *Corporate Board Member* recently interviewed Nevels about what makes Hershey's culture, approach to business, and outlook so successful and unique.

Can you begin by sharing some background on The Hershey Company? It is certainly a unique corporate model in terms of its history and ownership structure.

The greatest confectionery company in the world, The Hershey Company was founded by a visionary and an extraordinary man named Milton Hershey more than a century ago in 1894. During the course of this incredible history, Mr. Hershey persevered and became a successful entrepreneur and a philanthropist who, with his wife in 1910, established a cost-free, private school for orphaned children, The Hershey Industrial School, now known as the Milton Hershey School. He left Milton Hershey Trust an established legacy that included a controlling interest in The Hershey Company. The Milton Hershey Trust has a 30 percent financial interest in the company, but by virtue of dual-class stock, voting control is held by Hershey Trust Company. The Hershey Company has had 13 CEOs, and the relationship with Hershey Trust Company has been very good. There is no divergence whatsoever between Hershey Trust Company, as the controlling shareholder, and all other shareholders, because Hershey Trust Company acts for the benefit of all shareholders.

How and when did you become involved with The Hershey Company?

My background as a lawyer and as an institutional asset manager of The Swarthmore Group, which I founded 21 years ago, were experiences that contributed to my invitation to join the board of directors of Hershey Trust Company in 2007. Then in 2008, I had the singular honor and humbling opportunity to be elected to the board of directors of The Hershey Company; and a year later, I was elected by the board to be its chairman, and I continue to serve as chairman today.

What have been the major business objectives during your chairmanship?

Since 2009, management of The Hershey Company and the board of directors have focused on three corporate objectives, the first of which is to strengthen and fortify North American operations. Historically, The Hershey Company has been a predominantly North American–centric company, and the goal is to focus on the core business, which is geographically North America. So that is the first outcome.

Second, in 2009 there was consensus between management and the board that a second matter of importance should be succession planning. Not just in respect to the C-suite, but succession planning stem to stern. There are employees in the manufacturing facilities who have long tenures with the company, and literally, when they leave the confines of a particular manufacturing facility, a tremendous amount of resources and assets are leaving the company as well. So how do you go about imbuing the culture of a company by means of succession planning? This is something that we've been working on very studiously.

The third matter is enhancing the company's international footprint. We have seen the market recognize the abilities of our extraordinarily capable CEO, J.P. Bilbrey, along with his global leadership team, and the roughly 13,000 employees that comprise our Hershey family. So in his tenure, we've seen dramatic growth, enhanced capacity, and capability.

At The Hershey Company we have the most advanced confectionery manufacturing facilities in the world, one of which produces 72 million Hershey Kisses 24/7! It's an incredible facility, and there is no doubt that Mr. Hershey would be extremely proud. So we are continuing to execute on the fundamentals, and we are doing so around an expansiveness of these three corporate objectives for which management and the board have reached a consensus.

Talk to us a little bit about the board culture at Hershey and the directors' working relationship with management.

Our CEO is a member of management who also serves on the company's board. The remaining nine directors are all independent directors.

The board dynamics are consensual. In terms of board leadership, I have a fundamental belief that consensus is ultimately desired, and 99 percent of the time, that's the way this board operates. I'm also a firm believer in allowing committees to do their work. We have a governance committee, an audit committee, a compensation and executive organization committee, and a finance and risk management committee. We also have a fundamental belief that every board member shares responsibility for good governance and corporate social responsibility. We don't have a separate committee to address corporate social issues; however, the company has made great contributions and accomplished some amazing things with respect to corporate social responsibilities, for which the board of directors and senior management are very proud.

Another key ingredient is the recognition of a line of equilibrium between governance and management. Let's assume we're standing at a chalkboard, and you draw a line across the middle of the chalkboard.

Above the line is governance; below the line is management. There are times when that horizontal line moves up and down and results in a situation where, in fact, management may be in the role of governance, and there are times when that line moves the other way, and the talents of the board are such that they can serve as able consiglieri or able advisers to management. But management has the final call and must execute the objectives and maintain good governance standards. So that is the perfect example of the collaboration above the line and below the line.

You once referred to the chairman's job as being a "first among equals." Can you tell us what you mean by that?

Certainly. What I mean by that is the chairman leads through serving and the chair is the prism through which the will of the board is reflected. This requires the chairman to be very studious about collaboration and consulting with the board on an ongoing, consistent basis. The chair is the living, breathing symbol of the board. "First among equals" means exactly that—that by virtue of the consent that is earned from the body politic called the board, and those constituent members, they consent to the position and the conduct of the chair. And if you take that point of view, the chair must reflect the body called the board. The chair doesn't have a super vote and cannot do things by fiat, but rather by persuasion. That's philosophically the way in which I believe the chair should interact with and lead the board.

What are some of the more interesting shareholder issues that the Hershey board has had to deal with?

Well, a few years ago I had the honor of taking a trip to Ghana, one of the cocoa-growing regions, the very genesis of the supply chain for the confectionery delight called "chocolate." It was very enlightening and interesting because we heard a lot about the issues of child labor and sustainability. Remember, this is a company in which roughly $180 million in dividends flow to the Milton Hershey School. So we have a very interesting juxtaposition in which the company takes care of children here in Hershey, but we never want to do so at the expense of children elsewhere. And, so that is one of those paradoxes of which we're very aware and which we take very seriously—it is in the fiber of this great company.

Remember, corporate social responsibility was practiced some 100 years ago when Milton Hershey started his philanthropy, so it's in our DNA. Our employees adopt a group home at the school, for example, and contribute in many other wonderful ways.

So back to the issues we have confronted, during the company's recent annual meeting of stockholders, the board was very placid, but also very dynamic in that there was tremendous focus on the progress of the company, its financial success, and also on what the company is doing with respect to corporate social responsibility. We were selected to be represented on the prestigious Dow Jones Sustainability Index in 2012. We were also ranked among America's 100 Best Corporate Citizens by *Corporate Responsibility Magazine* in 2013. In the 2012 *Newsweek* Green Rankings, we moved up 172 spots overall, and to No. 7 in the food and beverage peer set, up from No. 20 in 2011.

In addition, there's the *Bloomberg* Civic 50, where we were ranked No. 29 for the "most community-minded companies" in America. Hershey was the only confectionery company and the second-highest ranking CPG (consumer-packed goods) company on this year's list. Then there's the Carbon Disclosure Report, where we improved our carbon disclosure score from 67 in 2011 to 80 in 2012. With regard to our corporate social responsibility reporting, the latest full CSR report [issued in 2012] is available, and we've been lauded for the transparency level of that report. So the social issues are front of mind for Hershey, along with the maxim of "doing well by doing good," which was the mantra of our great founder that is instilled in all of us.

That is a lot of positive recognition in recent years. Did something internally at Hershey propel increased attention to social responsibility and sustainability issues?

I think these issues have fully evolved into front-of-mind issues with management and also within the priority of strengthening and fortifying North American operations. So they fall within that purview. Likewise they fall within the purview of increasing our international footprint. We must "do well by doing good" in all of our geographies.

Turning to the international priority you mentioned, what have been some of the challenges for Hershey, a company that has had a very rich, domestic history in Pennsylvania for so many years?

It is quite difficult, but we're doing it prudently and deliberately. Our CEO, J.P. Bilbrey, says it best: "We will do it at a measured pace." And that is precisely what we're doing. We've had the good fortune to acquire a company in Canada called Brookside Foods, and to date, the integration of this company has been successful. Our footprint in Mexico and into South America puts us in a wonderful position to be the candy company of the Americas from the Hudson Bay to the Straits of Magellan.

As you may know, this has been a very interesting period recently for us in that we introduced our first global brand, Lancaster (named after Mr. Hershey's hometown), which will be sold outside the United States, in China. The board made a historic trip last October and held a board meeting in Shanghai. In addition, we opened an international research and development center in Shanghai. This has been an incredible statement to both the enterprise and, quite frankly, the world, that the company is very serious about creating an international footprint.

I am sure these new global initiatives also introduce new risks as well. Has overseeing FCPA risk and compliance become a critical issue for the board?

You bet, and therein lies the other element. The board [made a good decision to establish] a finance and risk management committee in 2009, in which finance and risk management functions were separated from functions of the audit committee (given the bone-crushing workload that the audit committee bears). [This was especially prudent] given the liability, as well as the opportunity it provides to enhance the internal audit function as we expand abroad. When you look at all the work that audit has to do, enterprise risk is a very serious business and being attentive to those issues will keep a group of very talented people on the board rather occupied.

One of the hot topics from investors lately is the push toward having a separate CEO and chairman, which Hershey already has in place. Do you believe that is the proper structure as a standard of governance?

The Hershey Company has utilized both structures from time to time, and certain situations can dictate a separation of these positions. I frankly believe there is little difference between the role of the lead director and the non-executive chair. As to my personal opinion in respect to that, I have to answer: It depends. I think there are times that absolutely warrant the two (positions) being one person, and then I think there are other times when it does not, and in that regard, it will depend on the collective facts and circumstances. I will say this: When the CEO and chair roles are separate, it is the role and function to manage the board and to be the prism through which the board's views are reflected and to be a wise counselor to the CEO. That's essentially my role.

You mentioned that there have been 13 CEOs in Hershey's history. How does the board approach succession planning?

Succession planning is one of the corporate focus points that the board believes is very important. J.P. Bilbrey has been charged to move forward with this focus and has cultivated a number of potential successors internally. He is giving the board full view of how those people conduct themselves, though, of course, his successor may not be within the company today. He has been very studious about giving the board the opportunity to see the fulsome talent at this great company.

So you have put the responsibility to cultivate talent on him?

Yes, and the board's charge falls with its compensation and executive organization committee. And that's where the review of the organization falls. The very capable chairman of this committee, Robert Cavanaugh, has the longest tenure on the board, and he's also a graduate of the Milton Hershey School.

Jim, it sounds like you have an enlightened board and a relationship with management that is based on mutual respect. Add that to being in the business of making something that people love, and it must make this job an enjoyable endeavor.

Yes, and one of the things that is so unique about this company as a brand is this: As a student of business and as a lawyer, I oftentimes wondered when I looked at a balance sheet: "What does the term goodwill mean?" After serving on The Hershey Company board of directors, I now have a better understanding. It is that look on an individual's face when I say, "Hershey"—because invariably, they smile! Now *that's* goodwill.

Indeed! I'm smiling right now.

Right. This is really illustrative of what goodwill is, and it's also illustrative of our company's values, which encompasses goodwill to children, families, and (the public's) happiness. And we're all here—the board, J.P., the global leadership team, and the 13,000 dedicated employees—that's the reason we come to work.
(From *Corporate Board Member*, 2013 3Q: 34–42.)

7D A new frontier: one-on-one with Maggie Wilderotter

Deborah Scally, Editor and Director of Research NYSE Governance Services

Maggie Wilderotter, chairman and CEO of Frontier Communications Corp., has a full agenda for 2012. To start, she must oversee the telecom as it digests its 14-state acquisition of Verizon and do so amid headwinds that aren't likely to abate in the near future. But Wilderotter's moxie and endurance are firmly ingrained, and she has no intention of swaying off course. *Corporate Board Member* caught up with Wilderotter, also a director on the Procter & Gamble and Xerox boards, just moments before a Frontier board meeting and asked about the company's boardroom dynamic, her leadership style, succession planning, and what's in store in the months ahead.

To begin, let's talk about the relationship you have with the board at Frontier. How would you describe the boardroom dynamic? As both the chairman and CEO, what keys have you found to maintaining good communications with your lead director and the rest of the board?

It's a great question. I would say, first, when I think about the Frontier board and I think about the dynamic, it's a very healthy environment. The board is active. [Directors are] participatory. They are passionate about the business. They are diverse in who they are and their experience. So they bring a lot to the table. And we have structured our board meetings where it's about discussion and decision-making, not about download. So we don't spend a lot of time on PowerPoint presentations. If there's a thought-starter, it might be one or two slides, but that's it. So we take topics and we go deep in a discussion and debate environment from a board perspective to really help the company make better decisions. So I would say the dynamic is very healthy.

As for my communication style, I'm a very proactive communicator with our board in between meetings. I send out e-mails probably three or four times a month on different activities that are taking place within the company that are informative for the board to keep them abreast of what's happening, as well as any key critical updates on the business. I also usually reach out by phone once a quarter to each board member. And if I have a specific topic that we're going to discuss at the board meeting that I want them thinking about ahead of time, I'll do a personal phone call to each of them to sort of give them a framework of what I'm thinking about, so when we get together, there's good discussion and it's not cold for them.

It's interesting that you call each of them individually. Do you feel like that allows them to express a reaction or a view to you that perhaps they'd be less than willing to talk about in the full group?

Well, that could be, but that's not the reason for it. I just think that every board member processes information differently. I do it out of respect to give them all the opportunity, maybe not just for first reaction, but also to ask me questions that would give them better insight to have them think about it. That's really the whole genesis of that approach. And I don't just call two or three. I call all of them.

I assume that part of this approach is because you can put yourself in that position, since you are also a director sitting on the other side of that conversation on other public company boards?

Correct. Because I do sit on the Procter & Gamble and Xerox boards as well, I understand the role of the CEO versus the role of a board member. And as a CEO [sitting as a director on another board], you don't want to jump in and try to help the other CEO be the CEO. You want to make sure you maintain the right role based upon the position you're in.

I know when you appeared on *Corporate Board Member*'s [Oct. 20] webcast "This Week in the Boardroom," you mentioned Frontier's board mentoring program. Can you explain a little about how that works and why you think it's valuable?

We've had the program since 2005, so it's been in place a fairly long period of time. I look at it as part of succession planning for the company. I take the top 10 to 12 company officers and match them with different board members for a two-year rotation program. During that two-year window, the [matched] board member gets together three to four times a year with that senior executive, off cycle of a board meeting. It's usually for a meal, so it's more of a casual setting. It allows them to get to know each other, [for the director] to understand the senior leader's perspective and thoughts about the company, as well as what [the executive is] personally working on and what his or her career aspirations are. It lets the board member provide insights as to what's important to the board and where the company is headed strategically. Then when I do a succession plan review of our top people once a year with the board, each mentor on the board partners with me on each of those senior leaders to discuss the opportunities for that leader and the succession opportunities in the company.

That sounds like a very productive board development program.

It is. And I'm not involved in any of those [prior] discussions, so it's really between my senior leadership and the board members. And it's also nice because since we've had it in place for several years, we've actually rotated senior leaders through a couple different board members. So my goal over a five- to 10-year window is to get each board member to know, pretty intimately, three or four members of the senior leadership team. I think the board members enjoy it a lot, as do the senior leaders. It's a win-win all the way around.

Succession planning is always one of the most challenging aspects we hear about from board members. Does Frontier have any other initiatives in place with regard to succession planning and development?

Yes, I do a three- to four-hour session every year with my board strictly on succession planning where I take them through the top 20 people in the company. We call it "Two Great Candidates," in which I take them through the two successor candidates for each of those jobs in the company. So they get exposure throughout the rest of the year to the potential candidates for those jobs in addition to understanding the capabilities of the folks who are in those positions and their next steps as well.

We also wanted to talk a bit about the topic of boardroom diversity. It must feel good when you and your sister [Denise Morrison, CEO of Campbell Soup Co.] are characterized as role models who embody the best qualities of successful women today. How did your upbringing affect the business success you and your sister have enjoyed?

From an upbringing perspective, I think one of the great things our parents taught my sister and me was that if you get a great education and work hard for what you want, you can do anything you want to do. They built a lot of confidence for us at an early age, and I do think that is a big issue with a lot of women, because they don't come across self-confident. They often come across more deferential in how they portray themselves in the business world. And as we all know, our male counterparts don't know anything but confidence. So I think that is a big gift my folks gave Denise and me early on in our lives. In addition, my father brought the business world into the dining room every night, so we talked about what he was doing in business. He shared the different activities he did. He even took us to work with him in the 1970s before it was cool to do that.

What was his profession?

He worked for the telephone company—for AT&T and Cincinnati Bell.

Oh, how interesting for you, now that you are heading up a telecom yourself.

Yes, exactly! So he sort of opened up the business world to us so it wasn't a big mystery. And my mom was one of the top real estate agents in New Jersey. She worked part-time, but was very accomplished at what she did. So I think [we were motivated by the] combination of education, a focus on delivering results (we had to do business plans if we wanted to buy anything), and giving back to the community. We did a lot of community service work when we were kids, raising money for different charities. That gave us a good balance, I think, for being successful later in life in the C-suite and the boardroom.

On a broader scale, in your opinion, what else should corporate America be doing to further move the needle toward a more diverse executive suite and boardroom?

With regard to what companies can do to move diversity forward, I think it starts with the tone at the top. The CEO of the company has to make this a priority and not just talk about it, but put actions in place in those companies by putting women in senior roles and by taking risks and chances on up-and-coming women in the organization for high-profile positions. I also think the CEO has to make sure the pipeline is strong from the hiring of entry-level women and moving them up through mid-management and into senior-level roles, so you have a constant pipeline of diversity. And, I think CEOs also have to look at the makeup of their boards to make sure their boards are reflective of the customers they serve.

Right, and that makes perfect sense, but it does not yet reflect the vast majority of boardrooms across corporate America.

I sit on three public company boards, and all of them have four or more women. So they are very diverse boards. My board, in particular, is quite diverse, and I think when you get what I call a mass of two to three women on a board, it does change the dynamics in the boardroom for the better, because I do think that critical mass really helps bring more of a balanced approach to the decision-making.

Speaking of tough decision-making, I know you've been reporting quite a bit lately about Frontier's 2010 acquisition of Verizon's local wireline operations in 14 states in 2010. You've been saying that in general, the progress reports are very good, the integration is going very well, and your cost-saving synergies are right on track or even ahead of schedule. Is all of that still the case?

I think you've got to consider that we tripled the size of the company 15 months ago, so we are still swallowing the whale, as they say. We are making great progress. Every month, we improve the metrics of the company. Integration and cost synergies are ahead of plan. And we have said since the beginning that fourth quarter 2011 and into 2012 is when the revenue line would start to turn. As you implement different programs and you get broadband builds, what follows, usually at a six-month lag, is the building of the revenue side. I still feel very strongly that's the case—that we will see it turn, and it will continue to improve on a trend-line basis through 2012. And I think that's one of the big things the Street is still waiting to see. I think they feel very good that we've done a good job on integration, on synergies, but we haven't really proven the case on the revenue line yet. The ironic thing is, when you're in a market where there's a lot of volatility, like we are today, it's, in many ways, a fear-based market. So you don't get the same runway that you would get when the economy is good.

Undergoing something like this is a huge undertaking from the board's perspective to ensure that an acquisition of this magnitude meets, or exceeds, shareholders' expectations. What steps have you and the board taken to keep shareholders informed of the deal's progress and its performance, and can you share any challenges or lessons learned along the way for other boards that are considering an acquisition strategy in the year ahead?

My CFO and I are very proactive with our shareholders. Just in the last couple of weeks, I've spoken to all 20 of our top holders to keep them informed on how we're doing, and we attend a lot of conferences. We do a lot of outreach with our analysts as well as our investors. But I also think, and we remind them all the time of this, we're staying the course; we haven't changed the story. But there's an impatience, and there's a worry about whether the story will have the happy ending that everybody thinks it should have. In looking at this again, I think we probably should have focused more on some quick hits on the revenue side earlier, versus just building for the long-term foundation for revenue. Hindsight is always 20/20, but I think you have to recognize the dynamic of the market you're in, in addition to the dynamic of the company. Our board is very supportive of what we're doing. This was a big, courageous step for the board to take 15 months ago, because we had the option to sell the company at the time. So we chose the longer journey that would deliver more shareholder value. We still feel that way. There's been no change in our thinking from that perspective. But it's a journey. We said it would take through 2013 to get all of the integration done and to really get the company humming on all cylinders, and we are still, with our heads down, following that path.

But it's a difficult thing, isn't it, to take that courageous step and then tell your story, emphasizing that the benefits will show up in the long term?

Correct. And you want to build sustainable businesses. This is not short term. This is long term. We're a hundred-year-old company, so transforming every 25 years is not unusual for our industry. But as a CEO and as a board, you have to have thick skin. You're going to have to deal with noise in the system as you get there. And you talk about that esoterically, about the noise that you're going to get hit with, but it's not until you get the noise that you really realize what the noise is.

Well, from all indications, things appear to be moving ahead, and we wish you the best on that front. So in closing, what thoughts do you have about the upcoming proxy season for Frontier? Are there any particular issues you feel will "create noise" for your company this year? What is the Frontier board doing to prepare for its upcoming annual meeting?

I would say it's pretty much staying the course on a number of the governance issues that have already been on the table over the last year or so. I think the say-on-pay issue will continue to evolve.

I do think there is a lot more emphasis on the rigor the board goes through on executive compensation, and we will see more companies moving into performance-based comp. I think that's a trend we will continue to see, and it's one we're spending a lot of time on with our board, making sure you have not just base salary and annual bonus, but also long-term incentive compensation. That is becoming more the majority in terms of how executives get paid versus just short term. So I think that's a big issue.

I also think you'll continue to hear noise in the system about separating chairman and CEO roles, and the pros and cons of that. I don't think there's a consensus on whether you do it one way or the other. I think it's situational based on the company and the board. So, I'm not sure how much change we'll see this year, but there could be some changes with different companies on that subject as well. Other than that, we're not really hearing a lot in terms of shareholder proposals or upcoming issues that are happening on the governance front.

With regard to the chairman and CEO role separation issue, it appears to have worked well in your situation. I'm assuming Frontier's board has been very supportive of the current structure.

Yes, it has. We've been candid, and we've talked about it. And if there's a decision at some point to separate those roles, we will do it for the right reason, for shareholder value. I'm very active with our board, though it's not me who dictates the agenda; it's a collective agenda. I think the directors feel they have the right access and input to set the agenda and don't really need to change out the chairman leadership to change that dynamic. We also have a very active lead director who's proactive with me, and I am with him, so I think that makes a difference on the governance side. And I'll also say with both Procter & Gamble and Xerox, the CEO is also the chairman of those companies as well, and I don't foresee that being changed in either of those companies at this point.

(From *Corporate Board Member*, 2012 1Q: 28–34.)

PART II

THE COMPOSITION AND STRUCTURE OF THE BOARD

Electronic version of
this guide available at:
nyse.com/cgguide

8 Building a balanced board

Julie Hembrock Daum, North American Leader, Board Practice Spencer Stuart

A key function of a corporate board of directors is to shape and guide its company's strategy over the long term and encourage company management to take a similarly long view when thinking about market challenges and opportunities on the horizon. In our experience, the best boards regularly evaluate their company's strategy, in light of new market developments and competitive threats. But what about boards themselves?

Board composition lies at the heart of board effectiveness. Progressive boards should continually consider whether they have the optimum composition that reflects the strategic priorities of the business and the diversity of stakeholders. The need for careful planning of board succession is greater today in light of aging boards, pressure from rating agencies, governance watchdogs and regulators, and the demand for a broader set of skills to support changes in company strategies in a fast-changing world. All boards, from major corporations to nonprofit organizations, need to demonstrate their willingness to evolve if they are to remain relevant.

The composition of the board should be viewed as a strategic asset. Boards should regularly review their makeup in light of the company's strategic direction, identify the competencies that would be valuable to find in future directors and regularly infuse the board with fresh perspectives relevant to the organization's future.

Increased focus on director tenure

A growing board composition issue is director tenure. On one hand, independent director representation on S&P 500 boards continues to grow. In 2014, the *Spencer Stuart Board Index* found that 84 percent of S&P 500 directors were independent, compared with 80 percent a decade ago. On 58 percent of boards in 2014, the CEO was the only non-independent director, compared with just 39 percent of boards in 2004. While board independence appears to be increasing, some investors have become more vocal in questioning how director independence is defined and whether independence is compromised after many years on the board. In 2014, 16 percent of boards had an average director tenure of 11 or more years, and the average tenure of S&P 500 boards was 8.4 years.

Proxy advisory firms have begun to ask how long is too long when it comes to director tenure, and some governance activists are contemplating whether length of service should be factored into definitions of independence. Institutional Shareholder Services (ISS) announced in early 2014 that it will begin to take into consideration in its QuickScore rating whether a company has "excessive" director tenure of more than nine years. According to an ISS 2013–2014 policy survey, 74 percent of investors who responded indicated that long director tenure is problematic, including 15 percent who agreed that lengthy director tenure can diminish a director's ability to serve as an independent steward, 11 percent who agreed that lengthy director tenure can limit a board's opportunities to refresh its membership, and 48 percent who indicated that they share both of these concerns.

Critics of the ISS decision cite the benefits of having long-tenured directors on the board. Long-tenured directors can bring to board deliberations valuable experience, institutional knowledge, and an understanding of the company's strategy, operations, and culture. In many situations, directors with long ties to a company can be more confident and better prepared to challenge management because of their historical knowledge than a director with less history with the company.

Currently, there are no specific regulations or listing standards in the US that speak to director independence based on tenure. And, in fact, most US public companies do not have governance rules limiting tenure; only three percent of S&P 500 boards specified a term limit for directors in 2014. Several other countries have adopted regulations linking board tenure to independence, some requiring boards to explain why a director should be considered independent after a certain tenure and others setting tenure limits after which a director can no longer be considered independent.

In the absence of tenure or term limits, many US boards rely on mandatory retirement ages to promote turnover. Seventy-three percent of S&P 500 boards have established a mandatory retirement age for directors, compared with 79 percent in 2004. But the average retirement age has crept up in recent years, as boards have raised their mandatory retirement ages to allow experienced directors to serve longer; 92 percent of boards that have established a mandatory retirement age set it at 72 or older, versus 49 percent in 2004. At the same time, boards are recruiting more retired executives than in the past. In 2014, more than half of the newly elected directors were retired. As a result, boards are getting older and longer tenured. In a world that is increasingly global, rapidly changing, and more reliant on new and innovative technology, directors may not be as current.

Diversity considerations

Boards are increasingly recognizing that boards with a good mix of age, experience, and backgrounds tend to foster better debate and decision-making and less groupthink.

In recent years, female representation on boards in particular has been a growing area of focus. In addition to shareholder and government attention to the issue, recent research continues to highlight the benefits of gender diversity on boards. For example, the 2012 Credit Suisse Research Institute report *Gender Diversity and Corporate Performance* found that, during the six-year period ending in 2011, companies with at least some female representation had better share price performance, higher return on equity, and better average growth than companies with no women on their boards.

While women serve on US corporate boards in greater numbers than in the past, female representation on S&P 500 boards has fallen behind countries such as Norway, Finland, Sweden, and France as European governments have made diversification a priority. Women now account for 19 percent of independent directors of S&P 500 companies, according to the 2014 *Spencer Stuart Board Index*, up from 16 percent in 2009 and 16 percent in 2004. Two thirds of S&P 500 companies have two or more women on the board, compared with 45 percent in 2004. Yet still 5 percent have no women.

One of the most significant barriers to increasing female representation on boards is a perception that the pool of qualified female director candidates is limited. Our experience recruiting women to boards demonstrates that qualified women are available for board roles. Between 2007 and 2012, one third of the women we recruited for board roles were top corporate executives, including CEOs, chief operating officers, presidents, or chairwomen. Divisional business leaders and general managers represent another significant source of female director talent, as do finance leaders, bankers, and auditors. As companies seek greater integration of digital, social media, and e-commerce into their business models, women are proving to be an important source of director talent. Other sources include government leaders, academics, senior consulting partners, and functional leaders.

Increasing ethnic and racial diversity is another priority for many boards. In a 2014 survey of corporate secretaries as part of the *Spencer Stuart Board Index*, minorities, women, and sitting CEOs topped the list of the most desired profiles for director recruitment; 64 percent of respondents indicated that recruiting minority directors was a priority. However, recruitment of minority directors has not kept pace with demand. Among all directors for the top 200 companies of the S&P 500, 9 percent are African-American, 5 percent are Hispanic/Latino, 2 percent are Asian, and 8 percent are from outside the US.

Another consideration is whether to add an international business perspective to the board. For example, it can be valuable to have one or more directors from strategic markets or with working experience in those markets if the company is expanding its global footprint, building manufacturing or distribution capabilities overseas, or moving into a complex or particularly competitive market. International directors remain a small minority on US boards, accounting for just 8.1 percent of directors on the top 200 S&P 500 companies. Forty-five percent of those 200 companies do not have an international director.

It is important to point out that boards do not have to sacrifice critical skills or expertise to increase diversity, but they may have to broaden their approach to director recruitment and their perceptions about the ideal director. Boards often define the ideal board member as a current or former CEO or CFO, and women and minorities are still underrepresented in these ranks. In addition, some boards still look for director candidates within their own personal and professional networks, and these networks may include few women, minorities, or leaders from outside the US.

Succession planning for the board

In the past, boards had a tendency to replace a retiring director with an individual "who looks like the person who left" or allowed the chief executive officer to take the lead in filling board seats. Today, of course, boards no longer cede responsibility for director recruitment and succession planning to the CEO, yet they often address director succession only on an as-needed basis—when facing an impending vacancy.

This approach, however, may put boards at a disadvantage in this time when growth and innovation are top priorities for most organizations. Facing new global and competitive challenges, companies are transforming themselves through new product strategies, different product mixes, and expansion into new markets and geographies. In an ideal world, outside directors with relevant experience can serve as valuable advisers to the board and management about the company's market, geographic, and product directions, as well as providing a sounding board for management on the critical issues the company is likely to encounter. Wise boards will want to foresee where the company is headed in the future and have individuals on the board with the expertise to help the company move in that direction as efficiently as possible. Boards can accomplish this by vigorously managing director succession.

External forces, too, encourage a more proactive stance on board succession planning. Investors have become a potent voice in board governance, holding directors accountable for company performance and even challenging the nominations of directors. Institutional investors, on the whole, are looking for board directors who are independent from management and possess the relevant business and financial experience. Furthermore, boards that plan for director departures will be better positioned to recruit directors with the desired experience.

Director departures or retirements create openings that enable the board to expand or strengthen its skills in certain areas. Boards should take advantage of natural attrition to recruit directors who can add valuable perspectives about the company's strategic direction, bringing on, for instance, directors with experience in a particular market, industry, or business model.

Developing a skills matrix

As a starting point, the board should stay up to date on the timing of anticipated vacancies, including those due to directors' plans for retirement, term or age limits, and the needs of individual committees for specific expertise. In most cases, director departures are known well in advance, giving the board the opportunity to plan for specific board openings. Boards also should proactively review their composition periodically to ensure that they continue to have the right mix of expertise in light of the company's strategic direction.

When working with clients on this exercise, Spencer Stuart often uses a board profile matrix to examine the demographics and professional backgrounds of current board members and identify gaps or voids in the board's composition. As the board reviews topics such as the businesses in which the company competes, strategies to grow profitably, and competitive threats, it is natural to consider whether the board as a whole includes the expertise and skills that it will need to help the company deliver on its strategic vision. If skills gaps are identified, they can be used to help shape the search for new directors when vacancies occur or signal a need to expand the board. Increasingly, boards are sharing their thinking about board composition and how the qualifications, skills, and attributes of individual directors satisfy the defined set of skills for the board by including a skills matrix in the annual report.

The skills matrix should take into account regulatory and listing requirements, committee needs, the strategic direction of the business, and the appropriate diversity of perspectives.

Strategic considerations

Some boards are prioritizing new areas of expertise when recruiting and tapping nontraditional candidates, especially younger, active executives, to bolster their knowledge in disciplines such as digital or social media, certain areas of finance and emerging markets, or global business. We continue to see an increase in the number of new directors who are serving on an outside public board for the first time—39 percent of new directors were "first-time" directors in 2014, compared with 30 percent in 2012, as boards bring on younger executives with these capabilities.

Director independence requirements

According to NYSE Euronext guidelines, at least three quarters of the board members must be independent, and all members of the audit, human resources and compensation, and nominating and governance committees must be independent. Boards must affirmatively determine that directors who are classified as independent have no material relationship with the company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company. The nominating and governance committee is responsible for reviewing the qualifications and independence of directors and board committees on a periodic basis, as well as the composition of the board as a whole. This assessment should include members' qualifications as independent, as well as consideration of diversity, age, skills, and experience in the context of the needs of the board.

Committee needs

The matrix should also include consideration of the board's committee requirements. Knowledgeable, independent directors are needed to lead and serve as members of the audit, compensation and nomination, and governance committees. The chair, especially, must be current on the relevant governance issues and trends. Retired CEOs, chief operating officers, and chairs are a growing source of audit committee chairs, as are active and retired finance executives. Retired and active CEOs and COOs are often tapped to chair the compensation committee.

Diversity

One important category in the matrix is diversity. Rather than being considered an end in itself, diversity is increasingly considered an underlying criterion when potential directors are sought for skills or experience. More and more, boards recognize that having diverse perspectives on the board—in the areas of age, gender, race and ethnicity, and, in some cases, geographic knowledge—expands their views on issues, options, and solutions. The ideal board mix will vary depending on the needs of the company and could include directors with significant public company board experience, directors with relevant sector and geographic experience, and directors with international business experience.

Today, most boards start planning for vacancies at least 12 months in advance and, in cases when several retirements are on the horizon, boards think holistically about a multi-year process. The process begins with the board reviewing and confirming the desired expertise and qualifications for new directors, identifying potential director candidates, and reaching out to candidates well in advance to let them know the board's interest. It may be helpful to tap external resources at the point when specific vacancies are nearing. For example, through their work with boards and top executives, search consultants often know on a confidential basis the plans of many senior leaders. Particularly in the case of CEOs, who are often inundated with board invitations, it is valuable to understand their restrictions and preferences for outside board service, as well as their retirement plans. A search firm often has the ability to discreetly test executives' interest in a new board role and his or her future availability, and also to look globally at new, younger candidate pools such as executives with digital experience.

Role of director evaluation and director development in building a balanced board

A board can position itself to refresh and recruit directors with the desired experience by regularly reviewing its composition. The

Table 1 Developing a skills matrix

- Think holistically about director recruitment as opposed to one-off recruitments.
- Develop a matrix of the overall skills and experience required for the board based on an analysis of the skills and experience necessary to support strategy.
- Inventory the skills, contributions, and diversity of current board members to identify any gaps to be filled.
- Use a skills matrix to ensure the bases are covered when recruiting.
- Outline specific requirements for key committee chairs.

annual board evaluation is a natural platform for the full board to review its composition and discuss the expertise that it will need in the future. Through the evaluation, individual directors and the board as a whole can identify the areas of knowledge the board should possess in the coming years based on the company's strategic direction and the competitive landscape. From there, the board can evaluate whether it currently includes individuals with the relevant backgrounds and, if not, what skills or experience would be valuable to seek in new directors when vacancies occur. A growing number of boards conduct individual director assessments to understand the performance and contributions of each director to help improve individual performance and to encourage appropriate turnover.

Conclusion

Forward-looking boards elevate the task of planning for director succession. They engage in an ongoing review of the board's skill-sets relative to the company's strategy and direction and find opportunities to acquire the necessary capabilities and experience. As they become more proactive in this area, boards will ensure the board as a whole, and directors individually, have the energy, expertise, and experience to guide the organization as it addresses new challenges and market opportunities. In our experience, the most effective boards do the following:

- Carefully define the expertise that is important for the board—for example, industry or functional knowledge or international business experience.
- Cast a wide net for director candidates with the goal of identifying the best candidate—not just the ones known to board members.
- Have a good reason why each director belongs in the room. Be clear about the perspective or expertise the individual contributes.
- Keep an open mind about what a director should look like and the different ways directors can contribute. Boards can widen their net by looking at retired executives or senior business unit or functional leaders, who may not have the breadth of experience of a CEO but can bring valuable knowledge in specific areas.
- Establish a strong new director orientation program. All first-time directors benefit from an orientation and ongoing training that helps them quickly get up to speed on the business and the company's approach to governance.
- Understand your board's culture and assess candidates for their fit.
- Continuously review the board's skill-sets and performance relative to the company's strategy and direction to ensure that the board as a whole has the knowledge, experience, and skills to guide the management team as it addresses new challenges and market opportunities. In addition, this will ensure that every director is contributing. The annual board evaluation is a natural platform for the full board to review its composition and discuss the expertise that it will need in the future.

9 Corporate governance update: renewed focus on corporate director tenure

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The issue of director tenure recently has garnered significant attention both in the US and abroad. US public companies generally do not have specific term limits on director service, though some indicate in their by-laws a "mandatory" retirement age for directors—typically between 72 and 75—which can generally be waived by the board of directors. Importantly, there are no regulations or laws in the US under which a long tenure would, by itself, prevent a director from qualifying as independent.

Institutional Shareholder Services (ISS) and other shareholder activist groups, as well as some large institutional investors, are beginning to include director tenure in their checklists as an element of director independence and board composition. Yet even these groups acknowledge that there is no ideal term limit applicable to all directors, given the highly fact-specific context in which an individual director's tenure must be evaluated. In our view, director tenure is an issue that is best left to boards to address individually, both as to board policy, if any, and as to specific directors, should the need arise. Boards should and do engage in annual director evaluations and self-assessment, and shareholders are best served when they do not attempt to artificially constrain the board's ability to exercise its judgment and discretion in the best interests of the company. In addition, in much the same way boards consider chief executive officer (CEO) succession issues, boards are beginning to address director succession issues as well.

Director tenure in the US

According to executive recruiting firm Spencer Stuart, the average tenure of directors at S&P 500 companies in 2013 and 2012 was 8.6 years.[1] The average tenure of CEOs was close, at 7.2 years, in both 2013 and 2012.[2] ISS reports that the average tenure of S&P 1500 directors was 10.8 years in 2013, an increase from 10.3 years in 2012.[3] Very few US companies—only three percent of the S&P 500—have term limits for directors, none of which is less than 10 years.[4]

There appears to be a recent trend toward raising retirement ages and extending board service as valuable directors grow older. In the S&P 500, over the last 10 years, the percentage of boards with a mandatory retirement age of 70 has decreased from 51 percent to

11 percent, while the percentage of boards with a mandatory retirement age of 75 or greater has increased from three percent to 24 percent.[5] Meanwhile, the average age of independent directors in this group has increased from 60 to 63.[6] Board turnover was reported last year to be at a 10-year low; one source reports that 291 board seats turned over at S&P 500 companies in 2012, as compared to 401 in 2002.[7]

Despite these trends, boards are steadily becoming more diverse.[8] Long tenure is often cited as an obstacle to achieving board diversity,[9] yet current patterns of tenure and retirement have not prevented increases in gender and racial diversity on US boards. The number of women directors continues to rise; at S&P 500 companies, the percentage with at least one woman director has grown in the last decade from 85 percent to 93 percent, and the total percentage of women directors has increased from 13 percent to 18 percent.[10] Minority representation has also increased in this time frame, as has the percentage of independent directors of non-US origin.[11]

In the US and Canada, regulators have wisely refrained from adopting guidelines regarding director tenure. Long tenure on a corporate board historically has been understood—and demonstrated—to be an asset to board effectiveness and a feature that goes hand-in-hand with solid corporate performance and good management. Having a core group of long-term directors has been seen as beneficial to board dynamics as well as to the relationship between the board and management.[12] According to some estimates, new directors require between three and five years to acquire sufficient company-specific knowledge,[13] with more time required for directors of companies with complex operations and more intangible assets.[14] Long-serving outside directors thus are highly valued for their experience and organizational memory. Often, they have made important and useful industry connections over the course of their careers. Such directors frequently have gained a deep understanding of the relevant industry, and in board discussions they can offer historical context for consideration in corporate strategic decision-making. These resources are particularly valuable to a company whose business is highly complex or whose significant projects have unusually long-term horizons for completion.[15]

In recent years activists' attempts to micromanage the boardroom have begun to complicate the traditional view. Boards with many long-serving directors are now described as "entrenched" and deaf to shareholder concerns.[16] Critics posit that older directors—who are typically the longer-tenured directors—can no longer keep current with respect to industrial or technological developments and are unable to offer new insights into corporate issues; they fear that these directors may hold fossilized positions that are no longer relevant in the changing economic and business environment.[17] Some argue that extended board service can create a culture of undue deference to management, particularly in cases where the chief executive also has held the position for many years. While these may be valid concerns in isolated situations, it is often the case that older directors are among the savviest and most skilled board members, and that long-tenured directors may be in the best position to manage a powerful chief executive by virtue of their shared history and many years of building trust and collegiality together. Whether the advantages outweigh the disadvantages of long tenure for any given director on any particular board ultimately can be evaluated only by considering the specific circumstances. As with many other important elements of corporate governance, in matters of director tenure, one size does not fit all.

Director tenure abroad

A growing number of countries have adopted tenure-related guidelines or restrictions for independent directors.[18] With very few exceptions, the "comply-or-explain" model prevails, and the recommended maximum tenure for a corporate director is between nine and 12 years. The European Commission recommends that independent directors serve a maximum of three terms or 12 years.[19] In the UK, the UK Corporate Governance Code (formerly known as the Combined Code) provides that a board should explain, in its annual disclosures, its reasons for determining that a director who has served more than nine years qualifies as independent.[20] The average tenure of a UK director is less than five years.[21] In Hong Kong, an independent director is limited to a three-term, nine-year maximum tenure unless shareholders separately vote on a resolution permitting re-appointment, which should include the board's justification for determining his or her independence.[22] Singapore recommends "rigorous review" of the independence of a director who has served more than nine years, and the board is expected to explain any determination of independence in such case.[23] In France, the only country with a mandatory regime, directors may not be deemed independent after the end of a term in which they reach 12 years of service on the board.[24] The French rule creates an effective term limit, as longer-serving directors are not eligible for audit committee membership or other board roles left to independent directors.

In Australia, a recent move toward a recommended term limit was quashed by significant opposition. The Australia Stock Exchange (ASX) Governance Council, an advisory committee that includes business, shareholder, and industry groups, last year proposed a "comply-or-explain" guideline that ASX-listed companies' independent directors be limited to nine years of service. Reportedly, pressure from several of the country's largest companies resulted in the Council's dropping the tenure restriction in its final guidelines.[25] The final report incorporates references to tenure limits, recommending that one factor to be considered in assessing director independence is whether the individual "has been a director of the entity for such a period that his or her independence may have been compromised."[26] The commentary expands on this point: "The mere fact that a director has served on a board for a substantial period does not mean that he or she has become too close to management to be considered independent. However, the board should regularly assess whether that might be the case for any director who has served in that position for more than ten years."[27] According to one source, 21 percent of non-executive directors at the top 50 listed companies in Australia have directors who had served at least nine years.[28] The Australian episode demonstrates that strong opposition to director tenure limits still exists outside the US despite the increasing international popularity of such policies.

Academic studies

Academic researchers have examined the question of whether there is an optimal length of tenure for outside directors, with varying results. Studies from the 1980s through the 2000s have shown, for example, that longer tenure tends to increase director independence because it fosters camaraderie and improves the ability of directors to evaluate management without risking social isolation.[29] A 2010 study confirmed that companies with high average board tenure (roughly eight or more years) performed better than those companies with lower average board tenure, and that companies with diverse board tenure performed better than those with homogeneity in tenure.[30] A 2011 study, by contrast, examined a sample of S&P 1500 boards and found that long-serving directors (roughly six or more years)—as well as directors who served on many boards, older directors, and outside directors—were more likely to be associated with corporate governance problems at the companies they served.[31] One 2012 study found that boards with a higher proportion of long-serving outside directors were more effective in fulfilling their monitoring and advising responsibilities,[32] while another 2012 study found that having *inside* directors increased a board's effectiveness in monitoring real earnings management and financial reporting behavior, presumably due to their superior firm-specific knowledge and operational sophistication.[33] On the related topic of board turnover, a recent study of S&P 500 companies from 2003 to 2013 found that companies that replaced three or four directors over the three-year period outperformed their peers.[34] The study found further that two thirds of companies did not experience this optimal turnover and that the worst-performing companies had either no director changes at all or five or more changes during the three-year period.[35]

A 2013 study on director tenure by a professor from the INSEAD Business School has received significant attention. The study hypothesizes that there is a trade-off between independence and expertise for outside directors—a prejudgment that is widely disputed[36]—and examines the effect of tenure on the monitoring and advising capacities of the board.[37] After review of more than 2,000 companies, the author finds that the optimal average tenure for an outside director is between seven and 11 years, though industry- and company-specific factors create substantial variability.[38] He concludes that nine years is generally the optimal point at which a director has accumulated the benefits of firm-specific knowledge but has not yet accumulated the costs of entrenchment.[39] As a policy matter, however, he suggests that in light of the significant variations across industries and company characteristics, regulating director tenure with a single mandatory term limit would not be appropriate.[40]

Taken together, the academic studies show that conclusions about optimal director tenure are elusive. Common sense indicates that a board should use tenure benchmarks not as limits but as opportunities to evaluate the current mix of board composition, diversity, and experience.

Activists and term limits

Shareholder groups have begun to highlight the issue of director tenure. The Council of Institutional Investors (CII) last year announced a new policy calling for boards to evaluate director tenure when assessing director independence.[41] The statement accompanying the policy change suggested that long tenure can affect a director's "unbiased judgment" and asserted that "[e]xtended tenure can lead an outside director to start to think more like an insider."[42] Nonetheless, CII stopped short of endorsing a tenure limit, noting that "[r]equiring all directors to step down after a certain number of years could rob the board of critical expertise."[43]

Similarly, some large institutional investors have enhanced their focus on director tenure. State Street Global Advisors (SSgA), for example, announced a new policy in 2014 that sets forth specific guidance regarding factors that might lead SSgA to vote against certain directors at the companies in which it invests.[44] SSgA will consider "longer-than-average" director tenure, benchmarked against the applicable market, as well as whether any long-tenured directors serve on key committees, and whether the board in question is classified. SSgA sensibly has indicated that it will, at least initially, proactively and directly engage with board members on the issue of director tensure and board diversity before taking action to vote against director nominees.

Beginning in the 2013 proxy season, ISS offered a product called QuickScore, which uses specific governance factors and technical specifications to rate public company governance.[45] In 2014, company ratings (based on data that companies may review and correct) were released in February, and the scores were included in proxy research reports issued to institutional shareholders. ISS has stated that it will use corporate public disclosures to update ratings on a continual basis throughout the year. Director tenure will now factor into a company's rating: ISS views tenure of more than nine years as "excessive" by virtue of "potentially compromis[ing] a director's independence."[46] Having long-tenured directors thus may negatively affect a company's score.

While the factors ISS uses to produce a company's rating are public, the specific calculation methodology is not. There is no reason to believe that a rating generated by this new product will bear any relation to the actual quality of governance or financial performance of a particular company. The very name of the QuickScore metric alludes to the superficiality of its mechanically derived results, generated without regard to the fact-specific circumstances of a board of directors and the real-world needs of the company it supervises.

ISS's QuickScore is an outlier with respect to director tenure—not in terms of the nine-year limit, which may well have been determined by reference to the policies of some foreign countries and perhaps even to the 2013 study mentioned above, but in considering any longer service to be automatically detrimental. We are not aware of any country whose governance guidelines create a mandatory maximum of nine years for a corporate director. While various countries use the three-term, nine-year time frame as a benchmark, they recognize that boards may indeed have excellent reasons to extend a director's term well beyond that limit. Hence the flexibility of the "comply-or-explain" model, which requires a board to consider director tenure and communicate with its shareholders, yet still preserves the board's ability to make informed decisions for the company using its business judgment.

Outside of the QuickScore product, ISS itself recognizes the wisdom of a more reasonable approach. The ISS 2014 Proxy Voting Manual discusses the pros and cons of limiting director tenure and contains the following, eminently reasonable, language on director retirement age and term limits: Rather than impose a narrow rule on director tenure, shareholders gain much more by retaining the ability to evaluate and cast their vote on all director nominees once a year and by encouraging companies to perform periodic director evaluations.[47]

Accordingly, ISS offers the following proxy voting policy for US companies in 2014:

> "Vote against management and shareholder proposals to limit the tenure of outside directors through mandatory retirement ages. Vote against management proposals to limit the tenure of outside directors through term limits. However, scrutinize boards where the average tenure of all directors exceeds fifteen years for independence from management and for sufficient turnover to ensure that new perspectives are being added to the board."[48]

ISS endorses—rightly, in our view—a robust director-evaluation process, conducted annually by the corporate governance or nominating committee of the board.

Board judgment

It is unfortunate that the tenure of outside directors may become yet another point of controversy in shareholder activists' ongoing efforts to dictate ever more elaborate standards for director independence and board composition. There is no reason to believe that extended director service does, in and of itself, compromise director independence. Indeed, as the studies mentioned above suggest, factors ranging from industry-wide characteristics all the way to company-, board-, and candidate-specific elements can be meaningful in assessing appropriate director tenure. Term limits, like any bright-line rule, may offer superficial appeal, but the potential downside is that valuable directors may be forced off the board in circumstances that would be detrimental to the board, the company, and the shareholders.[49] Moreover, term limits can interfere with the development of effective collaboration among board members, a crucial element of a successful board and one that can be built only over a period of time. "In the end, creating a stellar Board of Directors is part science, part art."[50]

Many arguments both for and against long tenure are valid. The debate can best be resolved in individual cases by reference to the facts on the ground, and no arbiter is better positioned to determine the appropriate length of service of a director than the board as a whole. Companies and their shareholders should resist any pressure to establish term limits, a mandatory retirement age, or another mechanism that would constrain board discretion in evaluating the effectiveness and performance of individual directors. With annual evaluations and self-assessments, most boards monitor and manage their own performance quite effectively, and they should continue to have the latitude to determine the tenure of their directors in light of their conclusions regarding the needs of the company. As a general matter, the US is well served by directors' using their business judgment to act in an informed manner in furtherance of the best interests of the company and its shareholders, and the area of director tenure is no exception.

The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole. A version of this article originally appeared in the New York Law Journal on May 22, 2014.

Notes

[1] Spencer Stuart Board Index 2013, at 17.

[2] *See id*.

[3] ISS 2014 U.S. Proxy Voting Manual, at 37. *See also* Vipal Monga, "Board Directors Are Extending Their Tenures," CFO Journal, WSJonline, Apr. 1, 2014. An investigation by the Wall Street Journal found that 28 outside directors in the Russell 3000 had served on a single board for at least 40 years. *See* Joanne S. Lublin, "The 40-Year Club: America's Longest-Serving Directors," Wall St. J., July 16, 2013.

[4] *See* Spencer Stuart Board Index 2013, at 15. One oft-cited example of a US company with term limits is Target Corporation, which recently raised its directors' term limit from 15 to 20 years. *See* Target Corporate Governance Guidelines, § 24, November 2013, available at http://www.target.com.

[5] *See* Spencer Stuart Board Index 2013, at 6.

[6] *See id.*

[7] *See* Carol Hymowitz and Jeff Green, "Corporate Directors Get Older, Hold Their Seats Longer," Bloomberg Businessweek, May 23, 2013.

[8] As we have previously discussed, while diversity on US boards of directors has improved in recent years, significant additional improvement is both desirable and necessary. *See* David A. Katz and Laura A. McIntosh, "Developments Regarding Gender Diversity on Public Boards," N.Y.L.J., Oct. 31, 2013, available at http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.22908.13.pdf.

[9] *See,* eg, Kimberly Gladman and Michelle Lamb, "Director Tenure and Gender Diversity in the United States: A Scenario Analysis," GMI Ratings, June 2013, available at http://www.gmiratings.com.

[10] *See* Spencer Stuart Board Index 2013, at 6.

[11] *See id*. at 19-20.

[12] *See,* eg, Judy Canavan et al., "Board tenure: How long is too long?" Directors & Boards, Board Guidelines 2004, at 39, available at http://www.highbeam.com/doc/1G1-114244181.html.

[13] *See* Raymond K. Van Ness et al., "Board of Director Composition and Financial Performance in a Sarbanes-Oxley World," Academy of Business & Economics Journal 10 (5), 56-74 (2010), at 8, available at http://www.albany.edu/faculty/vanness/AA/ARTICLES/DirectorSOX.pdf.

[14] *See* Sterling Huang, "Zombie Boards: Board Tenure and Firm Performance," July 2013 Draft, at 30, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2302917.

[15] *See*, eg, BHP Billiton, Submission to the ASX Corporate Governance Council, Nov. 15, 2013 ("[W]e believe that particularly in a long-cycle business such as ours, governance is enhanced by having a balance of longer serving Directors. . . . Formulaic considerations of tenure should not override the other considerations of independence and the proven ability of Directors to be able to exercise independent judgement and act in the best interests of the Group and shareholders."), available at http://www.asx.com.au/documents/public-consultations/bhp_submission.pdf.

[16] *See*, eg, Hymowitz & Green, supra note 7.

[17] *See*, eg, Canavan et al., supra note 12.

[18] *See*, eg, Janet McFarland, "Countries Set out Rules on Directors' Tenure," theglobeandmail.com, Nov. 24, 2013, available at http://www.theglobeandmail.com/report-on-business/careers/management/board-games-2013/countries-set-out-rules-on-directors-tenure/article15574442/.

[19] *See* Official Journal of the European Union, Commission Recommendation of 15 February 2005, Annex II, "Profile of Independent Non-Executive or Supervisory Directors," Section 1(h), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF.

[20] The UK Corporate Governance Code B.1.1 (September 2012), available at http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.

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24 Afep-Medef Code, Corporate Governance Code of Listed Corporations Section 9.4 (June 2013), available at http://www.ecgi.org/codes/documents/afep_medef_code_revision_jun2013_en.pdf.

25 *See* Ross Kelly, "Australia Backs Away from Proposed Director-Tenure Cap," Asian Business News, Mar. 25, 2014.

26 ASX Governance Council, Corporate Governance Principles and Recommendations (Third Edition), Mar. 27, 2014, at 16, available at http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf.

27 *Id*. at 17.

28 *See* Kelly, *supra* note 25.

29 *See* Van Ness et al., *supra* note 13, at 8-9 (citing various studies).

30 *See id*. at 18.

31 *See* Greg Berberich and Flora Niu, "Director Busyness, Director Tenure and the Likelihood of Encountering Corporate Governance Problems," January 2011, at 5, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1742483.

32 *See* ISS Benchmark Policy Consultation, "Director Tenure (US and Canada)," 2014, available at http://www.issgovernance.com/file/files/Directortenure-USandCanada.pdf.

33 *See* Jeff Zeyun Chen et al., "Can Inside Directors Be Effective Monitors? – Evidence from Real Activities Manipulation," Aug. 24, 2012 Draft, available at http://business.gwu.edu/accountancy/workshops/files/katherine percent20gunny.pdf.

34 *See* George M. Anderson and David Chun, "How Much Board Turnover Is Best?" Harvard Business Review, April 2014, available at http://hbr.org/2014/04/how-much-board-turnover-is-best/ar/pr.

35 *See id*.

36 *See*, eg, Van Ness et al., *supra* note 13.

37 *See* Huang, *supra* note 14. The study examined 2009 data.

38 *See id*. at 30-32.

39 *See id*. at 4-5.

40 *See id*. at 7.

41 *See* Amy Borus, "More on CII's New Policies on Universal Proxy and Board Tenure," Council of Institutional Investors, Oct. 1, 2013, available at http://www.cii.org/article_content.asp?article=208.

42 *Id*.

43 *Id*.

44 *See* Rakhi Kumar, "Addressing the Need for Board Refreshment and Director Succession in Investee Companies," State Street Global Advisors, IQ Insights, 2014, available at http://ssga.co.nz/library/povw/733339 Addressing the Need for Board Refreshment. . . . in Investee_Companies_1_CCRI1399281503.pdf.

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46 *See* ISS's website at http://www.issgovernance.com/governance-solutions/investment-tools-data/quickscore.

47 ISS 2014 U.S. Proxy Voting Manual at 39.

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49 *See*, eg, Carnavan et al., *supra* at 41.

50 Amy Errett, "The Dream Team: What It Takes to Build an Effective Board of Directors," Maveron Features (2011), available at http://www.maveron.com/blog/2011/10/the-dream-team-what-it-takes-to-build-an-effective-board-of-directors/.

10 Conducting effective board and director evaluations

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High-performing boards typically conducted periodic self-evaluations as a method of driving continuous improvement long before evaluations were required. Since 2003, the NYSE has required all listed committees and their audit, compensation, and nominating committees to perform self-evaluations. The requirements are found in Listed Company Manual Section 303A.09 (board), 303A.07 (audit committee), 303A.05 (compensation committee), and 303A.04 (nominating committee).

After a decade of experience, boards are rejecting processes that take up hours of valuable time but are nothing more than "check-the-box" compliance exercises. Current trends in self-evaluation reflect three goals: (1) the boards want to identify ways to work more effectively to drive value creation; (2) they want to avoid litigation risk (usually without the need for cumbersome processes trying to gain attorney-client privilege); and (3) they want to complete the process quickly.

These trends mesh well with the needs of companies transitioning to publicly-traded status. Newly-public companies often are quickly evolving businesses where the board's focus on sustainable long-term value creation is critical. These companies are also deluged with new required processes, so they prefer a self-evaluation model that saves time and avoids administrative burden.

This chapter takes the reader through the major steps in planning and executing an effective board self-evaluation: evaluating key considerations, deciding upon design, selecting areas of focus, gathering data, interpreting data, reporting data, and following through. At the end of this chapter, there is an example, based on the model self-evaluation design that is the starting point at Global Governance Consulting for our newly-public clients.

Key considerations

No one self-evaluation method is right for every board. Further, a method that is right one year might be a bad choice the next year. Those executives and attorneys who provide governance support to the board will want to recommend one or two methods that would be best given the current circumstances. The following key considerations may influence the recommendation:

Board culture and personalities

Some considerations here include whether directors work with one another in a formal or informal manner and whether directors are comfortable discussing sensitive board dynamics with outsiders (such as a board-recruiting firm, outside counsel, or an outside governance expert) or with staff (such as the corporate secretary or the human resources executive).

Current industry environment

It is helpful to understand how the board experience stacks up against the boards of key competitors. Sometimes this information is already readily available, for example, from a recent board-recruiting project; at times when this evaluation has not been done for several years, it is useful to include it in the self-evaluation process. Effective leaders for such an exercise include board-recruiting firms and investment bankers.

Current company status

In calm times, when a company is reporting solid earnings in a stable industry, the board may prefer to handle the self-evaluation on its own or with the corporate secretary.

At times when the company is undergoing transformation, such as a period of rapid growth or moving to publicly-traded status, often a governance expert or motivational leader is the right facilitator for the self-evaluation.

And in those dark times when a company is beset with litigation while its industry is under heavy regulatory or societal pressure, the board may be most comfortable with outside counsel leading the self-evaluation and using an oral rather than a written process.

Current board status

If the board is facing change (for example, going public, facing upcoming retirements, or restructuring in connection with a merger), often a recruiting firm or governance expert is the best fit to lead the self-evaluation. These experts, or an investment banker, may be the best choice if there is external pressure for a change in board composition or leadership.

Staffing and support

If the board or management that supports the board, rather than an outside party, will facilitate the self-evaluation process, it is useful to consider the administrative burden of the process (for example, it takes more time to sift through written comments than to gather data through oral interviews). It is also important to clarify with outside facilitators whether their own team will schedule appointments and handle other tasks or will expect help from company personnel. This information allows advance planning to ensure that the optimal level of administrative support is in place.

Design decisions

Once the key considerations have been evaluated, the next step is to design the process. Design decisions include:

1. Will directors provide oral input? If yes, will they do this individually or in a group?
2. Will directors provide electronic or written input?
3. Will members of management who interact with the board provide input?
4. What topics will be covered, and in how much detail?
5. Will there be questions about the performance of individual directors in addition to questions about the collective performance of the board?
6. Who will facilitate—board leadership, the corporate secretary, or other member of management who supports the board; outside motivational leader; board recruiter; governance expert; other?
7. Will anyone beyond the facilitator (such as board leadership or members of management) have access to the raw data obtained or participate in analyzing the data?

8. Are comments anonymous?
9. Will results be reported in summary or will directors see the granular data for each question? Will there be a written report?
10. Who will participate when the board reviews the report and considers whether any actions are advisable based on the results? For example, will the facilitator meet with the board or will any members of management who are not also directors participate?
11. Who is responsible for follow-up to make sure any improvements identified in the self-evaluation are implemented? Sometimes the nominating committee chair is responsible for follow-up and implementation. A more effective practice is to assign responsibility for the follow-up based upon the content. For example, the audit committee might be asked to take the lead if an outcome of the self-evaluation was to increase focus on risk oversight, or the CFO might be asked to take the lead if an outcome of the self-evaluation was to provide director education on drivers of the stock price in the industry.
12. Will the same process be used for each committee as for the board? Sometimes a different process for one or more committees is advisable given current circumstances. For example, if a committee is newly formed, questions about meeting dynamics and information flow will be inapplicable. Unique questions for the committee can provide useful feedback for the committee chair and management in agenda planning.
13. Would a change of process be helpful, or would the continuity derived from using the same process as in prior years be useful?
14. What records will be retained when the process is completed? It is important that the general counsel is comfortable with the retention plan. Further, everyone who may create records of the self-evaluation should know in advance whether the records might be subject to discovery or litigation holds.

Gathering the data

Key items for gathering the data are: (1) being sure directors understand the process in advance; (2) honoring promises (for example, about the time asked of directors); and (3) being sure the input from directors is clearly understood. We believe oral interviews are the superior method to get the input with minimum administrative burden, and we find that the general counsel and outside counsel are often most comfortable with these interviews.

Analyzing the data

This step cannot be rushed. It is a mistake to look only at numerical scores, without also considering how the results fit with the company's current circumstance, the external environment, and, if available, the results from the prior year. It is important to consider the results in the context of the company's short- and long-term strategic goals. This careful approach best informs the board about how they might increase their effectiveness at driving value creation over the long term.

Reporting the data and determining focus areas

Oral or written reports can be equally effective. A concise reporting of overarching strengths and weaknesses, followed by board deliberations to choose one or two areas of focus, allows a board to hone in on continually improving their effectiveness at driving value creation.

Follow-up

This is a step that is often skipped. The easiest way to ensure that the agreed-upon focus areas are implemented is to assign someone to be responsible and to specify a time for completion, all at the same meeting where the focus areas are identified.

Sometimes the party is a board leader. For example, the responsible party for a focus area about better aligning the incentive pay opportunities to creation of shareholder value might be the compensation committee chair. A reasonable timeframe in that example might be to bring a recommendation to the board before the next award of incentive pay opportunities.

In other circumstances, the responsible party might be a member of management. For example, the corporate secretary might be the responsible party for better organizing the advance materials so that each director could easily find the information that he or she needs to prepare for a meeting. In that example, it would be reasonable to ask that this be implemented prior to the next meeting.

In still other cases, an outside party might be included in the action plan for a focus area. For example, one board determined that it was likely that the company and its shareholders would receive takeover offers as soon as the initial public offering was concluded. The focus area was to be well prepared to respond should there be one or more offers. The board asked the CFO and the general counsel to set up a special meeting with the investment bankers and outside counsel, where the likely scenarios could be discussed well in advance of the board facing an actual offer. In this case, the timeframe would be integrated into the schedule for the initial public offering.

A note about the evaluation of individuals

Several years ago, evaluating individual directors as well as the full board was in vogue. For some boards, this can be an effective tool in encouraging directors to contribute to their full potential. For other boards, this helps encourage the exit of those directors who are not adding value.

Unless there are special circumstances present, we believe the better process evaluates the work of the board as a group but does not include evaluations of individual directors. Boards work as a group rather than as individual performers. All critical decisions are determined by a vote of the group. Further, when the right questions are asked, the results will still include feedback about any individual director who may be getting in the way of the board's work.

The addition of individual evaluations includes the risk of an unintended consequence. Most directors are highly accomplished individuals used to delivering high performance. It is human nature to want to perform well if one is being personally graded. When individual evaluations are included, directors sometimes dilute their attention from their work as part of the board to focus instead on how they are being perceived as individuals.

Example of a model self-evaluation process for the newly-public company

This example follows a board through the entire self-evaluation process.

The governance committee selected an outside facilitator to lead the process. The facilitator was a governance professional with experience in the industry and in newly-public companies.

The facilitator first gathered background. He learned about the company's governance structure by reading the governance guidelines, committee charters, and director biographies. He learned about the company by reading SEC filings about the company, press releases, and analyst reports.

The facilitator next gathered the information to help him determine which issues should be covered by the self-evaluation. He had a short conversation with the general counsel, who is also the company secretary, about current board issues. He had a 20-minute conference call with the board chair and the nominating committee chair, who provided information about recent changes in board composition, strategic direction, and highlights of board strengths and challenges. He had a 15-minute conversation with the CEO, who is also a director. He asked the CEO for her view on strategic direction. He also asked the CEO to discuss the skills and experience the CEO needed from the board that were being well met by the current board, as well as any that might be added to fill in expertise that would help the CEO in achieving the long-term strategic plan.

Table 1 Topics for a public company's self-assessment

Board	Audit Committee	Compensation Committee	Nominating Committee
Skills/expertise Meeting dynamics Information flow Oversight of strategic matters	Skills/expertise Meeting dynamics Information flow Selection and interaction with independent auditor	Skills/expertise Meeting dynamics Information flow Executive compensation and stock ownership guidelines	Skills/expertise Meeting dynamics Information flow Director recruiting and orientation
Oversight/ encourage innovation	Oversight of internal audit matters	Process for succession planning and CEO performance evaluation	Board development, education, new director orientation
Oversight of HR matters (including CEO performance, succession planning)	Oversight of internal controls and other financial reporting matters	Executive stock ownership requirements	Oversight of shareholder engagement
Oversight of operational and quality matters	Oversight of risk matters and compliance systems		Process for board/ committee self-evaluation
Oversight of financial matters			Determining committee leadership and membership Director compensation and stock ownership requirements
Preparedness for crisis response			

Next, the facilitator recommended topics to be covered and anchored this recommendation with the client. Table 1 shows the topics initially recommended; the shaded topics were those actually covered by the self-assessment.

The facilitator interviewed each director about each of the topics to be covered for the board, as well as for the committees on which the director serves. During the interview, the director provided a numerical score for each question. The scores were:

5 = excellent
4 = good
3 = adequate
2 = could be better
1 = substantial improvement needed now

The directors were welcome, but not required, to provide comments to support the numerical score. Based on a particular director's input, the facilitator asked follow-up questions as needed. For example, one director provided many scores of two, but added few comments about why. The facilitator asked: "You gave relatively low scores across all the questions; can you help me understand what could be better?" The director's response was enlightening. He said: "As I think it through, our board flies through many, many issues. Some issues are important and other issues are not. We do not take the time to get down deep into the most important issues because we are so busy covering all the topics on the agenda. When I have suggested that some of these issues could be moved to routine reports or a consent agenda, the general counsel cuts me off, stating, 'now that the company is public, the board is required to cover the topic.' I have not pushed back on that advice, in part because no one else has spoken up about it. However, I do not think it is true. I have been on three other public company boards, and there we did not spend so much time on these procedural issues. In each case where I gave a low score, much of the problem comes from the board just skimming the issue rather than having a robust deep discussion."

After the interviews of each director were completed, the facilitator analyzed the results. The analysis of course included tabulating the granular results for each question. But his analysis went further. He also created a list of overarching strengths identified in self-evaluation. This is an important part of the process that is sometimes overlooked. If strengths are not identified, the strengths sometimes are inadvertently diluted in a scramble to complete a checklist of other, less important items that might be improved.

During the analysis, the facilitator also created a list of overarching opportunities where changes might make the board's future work more effective. This is also important, as opposed to just listing those issues with a lower score, which can mix minor concerns with critical issues.

The facilitator next drafted reports for the board and for each committee, showing the overarching strengths and opportunities, as well as the granular feedback. He sent the drafts to the general counsel and the chair of the nominating committee for review. They had no feedback or questions, so the reports became final. The facilitator then sent the reports to the board chair and the CEO for review. He also sent each committee's report to that committee's chair.

At the request of the board chair, the corporate secretary provided the report in the advance materials for the next meeting.

At the board meeting, the facilitator discussed the overarching strengths and opportunities. He answered questions from directors. The nominating committee chair then led the board in discussing the feedback and deciding upon two key areas for enhancing the board's work.

The first focus area was keeping strategic focus. The board decided to exercise tight oversight of the strategic progress over the next 24 months, when the proceeds of the initial public offering would be used to grow the business. To implement, the board asked the CEO to put recent developments into the context of the annual and five-year strategic goals during his operational report at each regular board meeting.

The second focus area was making sure the new public company requirements were met, but without taking too much time from the board's consideration of pressing strategic and business issues. They directed the corporate secretary to benchmark the use of consent agendas and other techniques to implement this focus item.

Conclusion

The boards of listed companies are required to perform annual self-evaluations. Designing the right process can assist your board in increasing the effectiveness of its work to drive value creation, without creating undue administrative burden.

11 Effectively structuring board committees

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Effectively structuring board committees is an important foundation for building and maintaining a strong board. Committees provide expertise to the board's work on critical topics. Committee meetings provide the time to take a deep dive on these critical topics. The committees also ensure that the work of the full board is well informed, by providing timely reports of their work.

At the newly public company, effectively structuring board committees is even more critical than at established companies. The newly public company is at a pivotal juncture as it invests the initial public offering (IPO) proceeds to grow the business. The company and the board are also grappling with many new listing requirements. If the committees handle these requirements expeditiously, it can save important time at full board meetings for oversight of business matters that are key to creating long-term value.

This chapter takes you through the main steps in effectively structuring board committees—identifying the committees and their function, naming excellent committee leadership, adding the optimal mix of committee members, carefully constructing the committee charter, and advance planning for agenda and calendar. Finally, it is important to periodically review and follow up, so that committees evolve as the company and external circumstances change.

What committees does the company need?

Listed companies are required to have three board committees: audit, compensation, and nominating/governance. I advise most clients to start with the recommended three committees and in 12 to 24 months revisit to establish whether other committees would be helpful.

In some industries, other committees may be required. For example, at certain types of banks or insurance companies there may be risks such as derivatives exposure and industry regulations that require a risk and/or investment committee. In other industries, additional committees may be practical. One example is the energy industry, where the products are necessities. There also are many safety and environmental concerns. As a result, it is often practical to add environmental and safety committees or a corporate responsibility committee. Another example is the pharmaceutical industry, in which two types of additional committees are often helpful: science committees (which oversee issues such as drug pipeline productivity, pipeline value, and product safety) and business oversight committees (which oversee compliance with complex regulations about manufacturing and marketing processes).

It is important to be practical if adding committees beyond the required three. Many times, companies rush to have extra committees related to current trends, such as risk or cybersecurity. Every committee takes extra director and management time. Every committee also uses up more full board time, on committee reporting, considering committee membership assignments, etc. As a result, when the matters are not critical to the company's business, it is better initially to pass on additional committees and cover the topics in a way that does not take so many board resources as an extra standing committee would.

Excellent committee leadership is crucial

Chairing board committees is an important role. The chair must control the agenda and the meeting so that all necessary business is completed.

High-performing chairs go a step beyond. They drive the committee's work in a manner that assists management in building long-term value. This works out differently in each committee. For an audit committee, that might mean making sure the way financial metrics are tracked allows management to measure return on investment for the IPO proceeds that will be plowed into growing the business. For a compensation committee, that might mean pushing for a compensation program that allows recruiting/retaining the leaders needed to steer the company through the transformation, in addition to employing shareholder-friendly performance metrics. For a nominating committee, that might mean driving a change in board composition so that board skills match long-range needs, given the company's strategic direction.

It is often the case that there is a comfort level with existing board members. Management knows them. Major investors (particularly private equity investors who may exit the stock gradually) know them. The comfort level can make it easy to keep existing committee chairs or, if existing chairs will not meet the independence requirement, to draw from other existing board members for the chair. But at least for the three key committees—audit, compensation, and nominating—it is also important to make sure the committee chairs have served on the same committees at other public companies, preferably as committee chairs. This experience is the foundation for delivering all that the company and the board will need from the committee.

One perceptive private equity firm I know starts recruiting new board members about a year before the planned IPO. They seek new members who meet many criteria:

- They are independent under SEC regulations and listing standards.
- They have experience on at least one of the three key committees at other public company boards.
- They have experience leading, as directors or management, companies in the post-IPO transformation.
- They have industry knowledge.

As you might imagine, nominees meeting such tough requirements are difficult to identify. The private equity firm uses a top recruiting firm, known for expertise in the industry, to be sure to identify the best candidates. The new directors have some time between their election and the IPO to get to know the company, the management team, and the other directors. Often, one or more of these new directors ends up as a committee chair from the IPO forward.

I believe that newly public companies with the strongest boards have the best chance at succeeding. And strong committee chairs are a lynchpin to building strong boards.

Ideal committee membership

In addition to a strong committee chair, it is important to revisit committee membership as a company prepares for the IPO. To begin with, counsel must review the independence requirements in SEC regulations and listing standards. However, there are other considerations beyond these requirements that merit attention.

First, management should think about what it will need from the committees to accomplish its vision for success. The CEO's thoughts are important. So are the thoughts of other leaders who will rely on the committees for their areas of responsibility. For example, the CFO and treasurer might want an audit or finance committee member with recent capital markets experience if they anticipate needing to issue debt to create the best capital structure. Or the internal audit executive might want an audit committee member who is familiar with the Sarbanes-Oxley Section 404 internal controls provisions, as well as with how other companies in the same industry handle those provisions.

Next, board leadership, including the chair or presiding director, the governance committee chair, and the chair of the applicable committee, should think about what the board needs from the committee.

Those considerations provide an outline for strengths needed on the committee. If existing committee members cover all of them, there is no further work. If not, then committee re-assignments, or recruiting one or more new directors who can be assigned to the committee, may be needed to create the right mix of skills and experience on a committee.

Tips for committee charters

It is important not to over-reach on required functions for a committee in its charter. I strongly recommend having the charter cover only what is required by SEC rules, listing standards and state corporation law for the committee in question.

Typically, the starting point for the charter comes from the law firm assisting with the IPO. Some law firms also add items the SEC staff wants a board committee to review, or items required to be disclosed, or items on a best practices checklist (ranging from organizations giving governance ratings, such as the Institutional Shareholder Services, to the National Association of Corporate Directors). These other items might be things the newly public committee should aspire to do. However, there are so many required items that I think it is most prudent to get a year or two of experience handling the requirements before building additional items into the charter. There is no prohibition from the committee undertaking these other items. However, leaving them out of the charter allows the committee to choose how to spend its time. Particularly, it gives the committee breathing space to make sure there is time to focus on keeping the business strong as the company grows by investing the IPO proceeds in its business.

Creating committee calendars and agenda

It is important to do advance work beyond the committee charters before the IPO, or as soon thereafter as possible.

The advance work will provide two benefits. First, it will ensure that as things become busy, the charter requirements and other tasks the committee has designated as important will not be overlooked. Second, it promotes the committee's focus on the bigger picture of all it will accomplish over time. The committee will avoid the trap of considering discrete tasks without putting them into perspective.

The advance work includes creating a 12–18 month calendar and rolling agenda for each committee. This makes it easy for the staff to help ensure that all requirements are met. It also makes it easy for committee members to understand how and when requirements will be met. This document should be included in the advance materials for every committee meeting and posted on the board portal, so that everyone can easily access it from time to time.

The advance work also includes benchmarking the use of consent agendas and other techniques to be sure the committees are not bogged down in the many public company requirements. It is important that the committee understands the requirements and oversees the work to meet the requirements. However, many committees report that hindsight shows they spent too much time on technical details presented by eager outside vendors and subject matter experts. The advance work allows much of the technical detail to be covered in advance material rather than during meetings. Sometimes opinions of counsel and accounting experts upon whom the committee may rely are helpful in this regard. The key here is to find a reasonable balance—the committee must feel comfortable that the requirements will be adequately addressed but still leave time to oversee business matters that are key to creating long-term value.

Review and follow-up

Often the annual self-evaluation is merely a mind-numbing checklist of the functions from the committee's charter—do you oversee the auditors, do you oversee financial reporting, do you oversee internal controls? While it is important to ensure that the committee's key functions are covered, these routine matters can be taken care of without too much time from committee members. Instead, the committee can use the self-evaluation to focus on ways to drive long-term value creation and to make the committee work more effective (see Chapter 10 for more details on effective self-evaluation processes).

An effective first step is to ask the corporate secretary to annotate the charter to show meeting dates where each charter requirement was covered with a brief description. Table 1 illustrates examples of such annotations for a charter requirement of the three key committees.

Table 1 Examples of charter requirement descriptions and annotations

Charter Requirement	When and How Satisfied	Comments
Audit Committee		
At least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues.	Sept. 2013 regular meeting—advance materials included an overview of the independent audit firm's quality processes, results of its own quality control review, a report of a peer review, and commentary from the PCAOB's review of the firm's work; also the results from a company survey of the finance, accounting, and tax teams' perception of the independent audit firm's quality processes; at the meeting the committee discussed these matters with the engagement partner and a partner from the firm's national office.	*The committee asked for benchmarking data about how other companies' audit committees handle this task in advance of the 2015 quality review.*

Table 1 Examples of charter requirement descriptions and annotations—continued

Charter Requirement	When and How Satisfied	Comments
Compensation Committee		
Make recommendations to the board regarding equity-based compensation plans that are subject to board approval.	Sept. 2013 regular meeting—review information from the committee's independent compensation consultant, management, and the company's compensation consultant regarding a proposed new stock option plan and recommend that the board approve the plan.	*The committee instructed that when future equity plans are presented for consideration, the anticipated reaction of each investor holding more than 5% of the outstanding shares be included with other evaluative data.*
Nominating Committee		
Oversee evaluation of the board and management.	Sept 2013 regular meeting—selected method of board self-evaluation based on alternatives together with benchmarking data provided by the corporate secretary. Selected method of management evaluation based on alternatives together with benchmarking data provided by the senior HR executive. October 2013 special telephone meeting—selected outside governance expert to facilitate the board self-evaluation and approved topics to be covered. December 2013 regular meeting—received results of the board self-evaluation at committee meeting and presented those results to the board.	*Board and committee liked the process and facilitator. Plan to use again next year, and to ask the facilitator to present the results at meetings of both the committee and the board.* *Next year, will ask executive recruiter who works with the board on succession planning to assist with the process for management evaluations.*

Table 1 Examples of charter requirement descriptions and annotations—continued

Charter Requirement	When and How Satisfied	Comments
Nominating Committee—continued		
	January 2014—joint meeting with the compensation committee, received CEO's self-evaluation and his initial evaluation of the other executive leadership team members; discussed those results and determined next steps February 2014—telephone meeting with the compensation committee, completed evaluation of management.	

Annotations like those in Table 1 allow the committee a quick way to verify that all requirements were met and to refresh itself about enhancements suggested during the year.

For newly public company committees, a self-evaluation process customized to take into account the company's opportunities and challenges will best position the committee to evolve and add value.

Conclusion

As a company goes public and reinvests the IPO proceeds into the business, having a strong board is important to building long-term value. Strong committees are the foundation for a strong board. It is worth the time to plan ahead, so that the right leadership and membership can be recruited. It is also important to focus upon committee structure and function. This will help avoid overcommitting with too many committees or too many nonrequired functions that can overwhelm a board. And most important, this will allow the committee to keep its focus on helping the board and management create long-term value.

12 Managing information flows among board and management

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Information is the lifeblood of the board. While non-executive directors should seek out current, complete, and accurate information about the companies on whose boards they serve—and many, in fact, do so—their knowledge of those companies is necessarily dependent upon information provided by management. Similarly, management cannot properly follow the mandates and views of the board of directors if those mandates and views are not communicated in an effective and timely manner. Thus, information flows among the board and management are critical to the proper functioning of both, as well as to the execution of a company's strategic plan and many other critical processes.

This chapter considers the factors and processes to be kept in mind in managing these information flows.

Information flows to the board

Let's start with the basics, noting that while the following discussion concentrates on materials for board and committee meetings, the same considerations apply to less formal information flows, which are discussed below.

The Goldilocks principle—moderation in all things

We all remember the story of Goldilocks, particularly that she always searched for an ideal midpoint. She disliked the bowls of porridge that were too hot or too cold, the beds that were too hard or too soft, and so on; instead, she sought out the bowl, bed, and so forth that was "just right." Managing information flows among management and the board should utilize the same principle: Determine what's "just right," based upon the specific facts and circumstances.

Quality of Information: Before addressing other aspects of information flow, it's critical to focus on the most important "just right"—namely, that the board and its committees receive full and fair information, including bad news as well as good news. Bearing in mind the earlier statement that boards are largely dependent upon the information provided by management, it's unconscionable—and dangerous—to sugar-coat information given to the board. We have all read (often in articles about scandals) of boards that were not informed about adverse developments. A very good if tragic example is the scandal that rocked Penn State a few years ago; according to published reports, management consistently opted not to tell the board of the allegations of sexual abuse and even of inquiries by the authorities. Examples in the corporate context abound as well.

Of course, the Goldilocks principle applies here as well—everything in moderation. But at a minimum, management needs to avoid even a soupçon of the "no bad news" approach. In fact, the first questions management (including the corporate secretary) should ask when something bad—or good—happens are, "do we need to tell the board, when do we tell them, and what do we tell them?"

Some examples:

- When preparing materials on acquisitions and similar corporate transactions, it's important to candidly discuss the risks of proceeding—and not proceeding—with the deal. Giving only the upside is simply not good policy. And if the upside (or downside) is based upon certain assumptions, be straightforward about the assumptions and how realistic they are. The same goes for timing, antitrust implications, and other aspects of the transaction.
- When informing the board about litigation brought by (and against) the company, it's important to be realistic about likely outcomes.

Just think about how not being realistic may play out in court:

> *Plaintiff's Counsel:* Director Jones, when the board considered the $50 billion merger with Red, Inc., what was said about the statement in the board materials that the acquisition would be accretive within the first year?
>
> *Director Jones:* Well, that was pretty impressive; it's not often the case. So the fact was noted during our discussion.
>
> *Plaintiff's Counsel:* In giving that projection, did anyone indicate that it was premised on 10% growth in GDP during that same first year? Or that the synergies resulting from the acquisition would be fully implemented within six months after closing?
>
> *Director Jones:* Well, er, I don't remember anyone saying that, and I also don't remember anything about those assumptions in the materials.
>
> *Plaintiff's Counsel:* How about the fact that Red is involved in a lawsuit challenging the patent protection on its principal product?
>
> *Director Jones:* Well, I know that the materials said that the lawsuit was entirely without merit. I guess that turned out to be wrong . . .

Amount of Information: Let's proceed to discuss the amount of information provided to the board. It may be tempting to give the board massive amounts of information to avoid omitting something that may be of significance. The thinking goes that you are protecting the directors against liability by making sure that they have every piece of potentially relevant information. However, think of Goldilocks: There is such a thing as too much information, and giving your directors everything that may possibly be of interest falls into this category. First, there is no assurance that the directors will find the important needles in massive haystacks of information. In fact, by giving them too much information, you may be forcing them to choose between reading it too quickly and thereby not absorbing it, and not reading any or all of what you've given them. In either case, you may be causing problems—not the least of which may be that your directors will not be prepared for discussions at board meetings (and the worst of which may be that your directors are found liable for not considering the appropriate information). Consider how furnishing masses of information might play out when a matter considered by the board is litigated:

> *Plaintiff's Counsel:* Director Jones, we note that the board received a 50-page memorandum, copies of the merger agreement and a number of ancillary documents, and a 60-page banker's "blue book" in connection with its review of the $50 billion merger with Red, Inc. Did you notice a footnote on page 42 of the memorandum pointing out that the assumptions underlying some of the anticipated synergies between your company and Red, Inc. had not been tested? How about the statement on page 25 of the banker's blue book that Red, Inc. had been sued based on allegations that its principal product was defective?
>
> *Director Jones:* Well, I read the materials, but I don't remember those two items. I'm sure I read them, but I just don't remember.
>
> *Plaintiff's Counsel:* Did any other members of the board ask about either of those two items when the merger was discussed and approved at the board meeting?
>
> *Director Jones*: I don't recall.

Instead, it is (or should be) management's task—often executed by the corporate secretary—to make sure that the information provided to the board is reasonable in amount and can be read and digested prior to the meeting (and it's acceptable to let the directors know that they are expected to do so). Even if the company's culture calls for the use of lengthy, highly detailed materials, that approach is unlikely to work for non-executive directors.

Timing of Delivery: Again, the Goldilocks principle applies—avoid giving your directors information too early or too late. It may seem desirable to get them information as soon as it is ready, to assure that they will have "all the time in the world" to review and consider it. However, this runs the risk that they will forget some of it by the time the meeting rolls around. Also, giving information too soon may result in the failure to update the information as more details become available or in the directors missing that critical new factoid. The risks associated with giving your directors information too late seem obvious; they may not be able to review it on time, or they may read it too hurriedly, possibly overlooking key details. And think about how late delivery of materials might play out when a matter considered by the board is litigated:

> *Plaintiff's Counsel:* Director Jones, we note that the board received a 20-page memorandum and other materials in connection with its review of the $50 billion merger with Red, Inc. Frankly, it looks like these materials were very carefully prepared; they are neither too long nor too short—in fact, they look just right. However, when did the board receive these materials?
>
> *Director Jones:* I believe we received them a couple of hours before the board meeting got underway.
>
> *Plaintiff's Counsel:* You mean two hours before the board meeting at which the board was asked to approve, and in fact did approve, the merger with Red, Inc.?
>
> *Director Jones:* Umm . . . yes.
>
> *Plaintiff's Counsel:* Were you able to read the materials, much less carefully consider them?
>
> *Director Jones:* Well, it was tight. I'm glad I took that speed-reading course last year. . .

Good governance does not involve a one-size-fits-all approach, but delivery of materials five to seven days prior to a meeting is generally regarded as appropriate.

Provide good road signs for your directors

Have you ever noticed that road signs seem to be made by people who already know how to get there? You see a road sign that says "I-95 Ahead," so you stay on the road on the assumption that there will be an entrance ramp or another sign that tells you how to get on I-95—but it never happens. Don't you wish that road signs could follow a consistent format and actually do what they're supposed to do?

The same concerns apply to the information you provide to your board. If every document your board receives follows its own unique approach, you are making your directors' jobs harder—without any commensurate benefit. Why not make it easier for them, as illustrated by the following?

- Format—Materials furnished to the board should follow the same format; that way, directors will know where to find what it is they're looking for or what you want them to see. If directors know that the request for authorization—that is, the specifics of what the board is being asked to approve—appears in the same place in every memo or slide presentation (preferably in a prominent place on the first page), it will guide their reading. The same goes for any glossary or list of acronyms (see details below). If tables continue on several pages, make sure that the header row appears at the top of each page, and try to avoid having rows split across two pages. These are small tips that can make a director's job much less arduous, increasing the likelihood that he or she will read—and absorb—the document in question. And if your board members are reading materials on a tablet or computer, you should consider avoiding double-column formats; while there are studies indicating that double-column formatting is easier to read, that's not necessarily true when you're reading something on a screen.
- Technical Terms—Where technical terms must be used, provide a glossary. Don't assume that your directors know common acronyms in your industry or your company; in fact, it's likely that some of your directors serve on other boards where the same acronym means something entirely different. Therefore, include acronyms in your glossary or explain them in some other manner—and not on the last page, either.
- Readability—It should go without saying that anything going to the board should be carefully proofread. However, write in plain English rather than legalese and make the materials easier to follow through use of shorter paragraphs, bullet points, and other tools to focus the directors on what is important.

Informal communications to the board

The Goldilocks principle and the other approaches to board agendas and other formal communications discussed above should be considered in dealing with periodic, less formal communications as well.

Of course, the first decision is when to engage in informal communications with the board and/or a committee. As suggested above, this decision should be guided by the following questions:

- Do we need to tell the board?
- When do we tell the board?
- What do we tell the board?

In considering whether and when to engage in informal communications with the board, remember that sending something to the board on a too-frequent basis may be a bit like the boy who cried wolf; if you're constantly sending materials to the board, it may be hard for directors to distinguish between routine matters that might better be collected for distribution on a regular basis (for instance, on a weekly or biweekly basis) and materials that truly require their attention. There's no sure way of knowing this, but it can be very helpful to ask directors for their candid views as to how often they want to receive routine updates on various matters.

Once a decision is made to communicate with the board, the Goldilocks principle continues to apply. Specifically, as is the case with formal board and committee materials, it's important that distributions between board meetings need to be moderate in length and tenor and that format and similar factors can make informal materials useful and informative.

The same can be said for content—different directors and boards may want to see different things. Some boards may want to receive analyst reports on the company as they are published; others are content to wait for a weekly or biweekly summary. The best way to gauge what your directors may want to see is to ask them.

Information flows to management

Because of the very nature of board–management relations, communications from the board to management are far more likely to be informal than formal. However, the same rules apply as those outlined above, with a few extra wrinkles.

First, clarity of tone is very important. Management can be sensitive to board criticism, and if a communication comes across as harsh or insulting rather than constructive, relations between the two groups can be seriously impacted. Depending upon the circumstances, it may be desirable to have a second director review the communication before it is sent, in case the drafter is unaware of how the communication will come across to the management team.

Second, while clarity of substance should be a given in all communications, it is particularly important when the board is giving directions to management. Management may be timid about questioning the board's directions, so rather than ask for clarification, management may implement what it perceives to be the board's direction only to find out that the board meant something else entirely.

Third—and this surely applies to all communications in both directions—the board and individual directors may want to think twice before putting anything in writing. If the board is not represented by its own counsel, it should consider consulting with the company's general counsel or outside counsel to determine whether a particular communication may be discoverable; too often, boards assume that their communications are confidential without realizing that confidential communications will generally be available to plaintiffs and others unless some type of legal privilege can be claimed—and that it is very difficult to sustain a claim of privilege.

13 Recruiting and onboarding directors

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The composition of the board is critical to the health and effectiveness of every listed company. The ideal board comprises a diverse group of directors from widely varying backgrounds offering complementary skills and who work well as a team. The makeup of the board sends out important signals to the market about the direction in which the company is heading. More so than ever, each new director appointment carries significant weight and is closely scrutinized by everyone from shareholders and analysts to employees and the media.

The ability to recruit the right directors and integrate them successfully is one of the clearest indicators of a high-functioning, effective board. The task of selecting and appointing new director candidates falls to the governance committee, which in many instances will engage the services of an executive search firm to assist with the identification, assessment, and referencing of candidates. After appointment, the corporate secretary will assume responsibility for devising and implementing a tailored onboarding program to bring the new director up to speed on key topics, ranging from the board's structure, governance, and responsibilities to the company's strategic objectives, financial reporting, and relationships with investors and management.

Linking board composition to business strategy

We suggest that boards begin assessing the need for any specialized skill or experience by considering the company's strategy for the next several years and then taking stock of the skills currently on the board (including directors who will be cycling off the board in the near future). Does the board as currently constituted give the company its best shot at success in supporting the strategy? Would additional, and perhaps different, skills significantly enhance the board's ability to do its job?

Boards need to anticipate their own needs by adhering to a rigorous process of regularly evaluating the collective skills and experience on the board against what is required by the company's strategy. It is easy to fall into the trap of "fighting the last war" rather than focusing on the vision for the company several years out. The result of this careful evaluation may be a decision to add experience in areas such as finance, risk, technology, or digital/social media or bringing in someone with knowledge and expertise in a specific geography. In any case, it is useful to think holistically about director recruitment rather than making one-off appointments in a vacuum.

The recruitment process and the role of the search firm

Having the right expertise in the boardroom is paramount. The natural turnover of directors provides opportunities to refresh the board with new and needed skills as the economic and competitive landscape changes—and to increase the diversity of perspectives. When approached thoughtfully, ongoing board renewal can improve board effectiveness.

Many boards use annual board evaluations to assess the effectiveness of the board overall as well as the contributions of individual directors, which can identify directors who are underperforming or whose skills no longer represent a good fit with the strategic direction of the business. These evaluations can yield opportunities to refresh the board.

The vast majority of board departures are known about well in advance, giving the CEO and governance committee enough time to consider carefully what kind of profile the successor should have and what kind of expertise will enhance the board and further align it with the strategic vision of the business.

If the committee decides to engage an executive search firm, both parties will discuss the selection criteria and produce a statement of director specifications summarizing key client requirements and preferences. The search firm will then conduct a broad-based identification of candidates who meet the criteria, assessing their suitability, screening them for any potential conflicts of interest or existing board schedule conflicts, and submitting a report to the nominating committee. The committee will narrow the list of potential candidates to a short list of priority candidates and, after further consideration and conducting due diligence, the top candidates will be approached.

Recruiting directors with complementary skill sets

Every board should be greater than the sum of its parts. There is a distinction between individual expertise and collective capability, and a key part of the recruiting process is assessing how well candidates will be able to work alongside existing directors. The importance of board culture and dynamics cannot be underestimated. Wherever possible, board members should have the opportunity to meet finalist candidates before they are appointed.

No board needs one individual with experience in all aspects of the business, but directors as a group need to be able to deal with any and all aspects of the business. A well-balanced board will comprise directors who bring specific experiences, skills, and perspectives, and yet who are capable of contributing to board decisions on topics that may fall outside their sphere of expertise. In other words, they need to have sufficient financial and business acumen that they will not be left behind in any aspect of board debate.

The governance committee must consciously construct a board that is strong and has the right mix of perspectives. One effective strategy is to think in terms of a skills matrix. Each square of the matrix reflects a "must-have" or "nice-to-have" skill or experience, such as prior board experience, audit or compensation committee experience, or specialized expertise in a particular industry or in areas such as international business, marketing, technology, digital/social media, or finance. The matrix will of course vary depending on the nature of the business, its strategy, and its current situation.

Adding diversity to the board

Diversity takes many forms, and the relevant mix of perspectives sought by a board will vary depending on factors such as the scale of the business and demographic considerations (eg customer base and geographic footprint). While not an end in itself, boards are increasingly recognizing that including diverse perspectives on the board is important. This is borne out by results of a corporate governance survey published in the *Spencer Stuart Board Index*. We asked about the profiles that are most desired by boards when recruiting new directors. Minorities, women, and active CEOs/COOs topped the list in 2014, cited by 64 percent, 71 percent, and 60 percent of respondents, respectively, which is consistent with our own director searches. Other profiles that are in high demand are executives with financial expertise (45 percent), international experience (55 percent), and specific industry expertise (51 percent) and retired CEOs/COOs (40 percent)—or some combination of these backgrounds.

Adding international directors to the board can be a sensible step if the company has made a strategic decision to extend its global footprint, build manufacturing and distribution capabilities overseas, or move into a particularly competitive or complex market. But this is easier said than done. Despite the increasing importance of global markets to US businesses, international directors remain a small minority on the boards of leading companies. Indeed, 45 percent of US boards do not have an international director.

We regard the inclusion of international directors on boards as important for two reasons:

- Providing market intelligence and entrée: Directors with knowledge of business culture, business dynamics, regulations, and key influencers can pave the way for operating in critical countries or regions.
- Expanding the board's perspective: International directors may add something to the board that is harder to quantify than specific market know-how but potentially is of even greater value—creating a more open and diverse mind-set on the board and enhancing the board's deliberation and problem-solving skills.

There are a number of dimensions to consider when thinking about adding international representation to the board. Differing time zones, languages, customs, and cultural nuances can present seemingly insurmountable hurdles, but boards that are truly motivated to add an international dimension find ways to overcome these obstacles. For example, a board that demonstrates a commitment to being global—by having board meetings and director site visits outside the US, for example—will be more likely to attract an international director.

Having an international director who works and lives abroad is not the only way to add a more global dimension to the board. Some boards expand the search for an international director to include executives who were raised, were educated, or have worked abroad but now live in the US.

Sometimes, it can be helpful if the diversity of perspective sought by a board extends to having board directors who may be viewed as counter to the company's prevailing culture, particularly when it comes to risk. Boards may also specifically seek a candidate who can serve as a countervoice to the rest of the board and who has the courage to swim against the tide when there's momentum for something, whether it's a new product or innovation or a merger or acquisition opportunity.

Recruiting directors to serve on committees

A key aspect of developing the right mix of skills on the board is populating committees with appropriate technical expertise. The audit committee needs financial expertise and a solid understanding of risk; the compensation committee needs strong directors who can develop a performance-based CEO compensation scheme acceptable to shareholders and create effective communication around it; the nomination committee may need experience in handling CEO succession issues; the risk committee requires a knowledge of the stress tests and other measurement tools that can provide a fair picture of the company's major risks, and usually needs directors with a background in the company's industry.

Attracting the best candidates

Recruiting new independent directors today can be difficult and time-consuming. The desire for specialized expertise and diversity in the boardroom has increased competition for some candidates. At the same time, many directors are accepting fewer board assignments than they did in the past, and more companies have restrictions on how many additional outside board roles a director may accept. As a result, directors frequently are more discriminating about which boards to join.

Experienced directors want to serve on well-managed boards that make a difference to the performance of the company. They want to work with smart, engaged directors and be comfortable with the CEO's leadership capabilities and character. Finally, they want to serve on boards that allow them to learn and build new skills. When they find board opportunities that offer these professional and personal rewards, they are willing to accept a new director role—despite the time pressures and demands.

Boards can improve their chances of attracting directors with the most relevant experience by understanding the motivations and concerns of director candidates and the company's perceived strengths and weaknesses. Here are a few lessons from the front line of director recruiting:

- Assume that there will be good competitors for a candidate's time, whether it is another board opportunity or another interest.
- Understand your board's "value proposition," based on where the company is strategically, the kinds of issues that come to the board, the composition of the board, and the strength of the management team.
- Define the board dynamic and chemistry and promote an environment that encourages active participation by every director and is respectful of differing views. The chair or lead director plays an important role in creating this environment and getting contributions from everyone around the board table.
- Make board service a rewarding experience for directors. Tap into the expertise and brain power of directors by structuring board meetings in a way that gives directors the opportunity to engage with one another, rather than having a series of presentations. CEOs gain additional benefit when they develop one-on-one relationships with individual directors.

Where boards are finding new directors

In recent years, it has become harder to recruit active CEOs, the most desired candidate pool for corporate boards because of their broad-based leadership, management, and governance experience and current business knowledge. As the time demands of the CEO's role and board service have increased, many CEOs (54 percent of S&P 500 CEOs in 2014) are electing not to serve on any outside boards. As CEOs have reduced their outside board commitments, boards increasingly are tapping retired CEOs and other senior leaders and, for audit committee roles, CFOs and other finance executives. In 2004, just 13 percent of audit chairs were financial executives—CFOs, treasurers, and public accounting executives—compared with 37 percent a decade later.

Many current directors are scaling back on their commitments, focusing on only one or two boards instead of several. In response, boards have increased their director retirement age to allow experienced directors to stay on longer. The average retirement age for S&P 500 company boards is now 72, and 30 percent of boards have a retirement age of 75 or older. On the whole, independent directors are older than they were a decade ago. The average age of all directors is now nearly 63, versus 60 in 2003, and just over half of the 2014 cohort of newly elected directors are retired.

While the representation of retired executives on boards has increased, we are seeing a countervailing trend as well. Some boards are prioritizing new areas of expertise, recruiting nontraditional candidates, especially younger, active executives, who can bolster the collective knowledge of areas such as digital or social media, since most sitting directors are of a generation that did not grow up with these technologies. In addition, management teams desire directors who understand the current business environment.

Recruiting a first-time director

When openings exist, boards still tend to prioritize prior governance experience when recruiting new directors. Nevertheless, executives or other professionals with no prior public company board experience are a growing source of new directors for boards needing to add specific skills or knowledge. S&P 500 boards appointed 145 first-time directors in the 2014 proxy year, representing 39 percent of all new directors.

First-time directors tend to be senior executives who have already had some exposure to the board, such as CEOs, CFOs, or executive committee members who have run large divisions of multinational companies. First-time directors will usually be familiar with the industry the company operates in, although people with strong finance experience may be tapped to join a board in a sector that is new to them.

Board candidates from outside the business world are often at a disadvantage because they may not have managed a profit center or developed a sufficient level of expertise that will enable them to contribute to board decision-making over complex financial matters. Having a good grasp of financials is one selection criterion on which few boards will compromise.

First-time directors should be able to demonstrate good judgment and intellectual agility and be comfortable dealing with complexity. They need to be able to bring analysis and logical reasoning to bear on a new, ambiguous, or fast-changing situation in order to reach a sound decision. Prospective directors who can work with complexity in an unfamiliar environment are the ones most likely to learn and adapt to the challenges faced in the boardroom.

One of the most common difficulties for first-time directors, especially senior executives, is adjusting to a more detached, supervisory role, focusing on the strategic rather than the operational agenda, and understanding the distinction between governance and management. There are new conventions and protocols to learn, and some first-time directors take longer than others to make the mental switch between executive and non-executive ways of thinking and behaving. Chairs need to be sensitive to the challenges in making this transition and provide advice to the new director on the nuances involved.

Director onboarding

Chairs and boards have a responsibility to ensure that all directors, not just those joining a board for the first time, are given proper support so that they can get up to speed as quickly as possible. Whereas historically some boards may have tolerated new directors taking a back seat and observing proceedings for a year or so before making an active contribution, few directors have that luxury today. A thorough yet tailored program is therefore critically important.

Ideally, a new director without previous board experience will participate in a general director training program, which can offer the opportunity to become more familiar with the role of the board and individual directors, important governance regulations and listing requirements, and the governance issues affecting the boardroom today.

Director induction programs are usually run by corporate secretaries, sometimes with input from the chief human resources officer. If the new board member has had some prior general training in the role of a director, the induction can focus on the company, its products, services, and key players, the wider business context, and the culture of the board and how it operates. The best examples typically take several days and involve presentations by the heads of all the company's functions and divisions, such that new board members feel fully immersed in the business and know where to go for additional information.

Unfortunately, the quality of board induction programs is variable, and some companies do not even provide them. It is not enough for the CFO and general counsel simply to run through the core finance and governance issues; the new director should ideally spend some time at company headquarters with senior executives from each of the main functions (eg investor relations, human resources, audit, information technology). New board directors should be encouraged to make site visits to see as much of the company's operations on the ground as they reasonably can. Boards also may contemplate having an informal mentor program that pairs a new director with a more experienced director who can provide perspective on boardroom activities and dynamics or help with meeting preparation, explain aspects of board papers, and debrief and act as a sounding board between meetings.

In addition to the initial induction program, many boards offer "top-up" training or attendance at seminars run by law or accountancy firms. Corporate secretaries generally provide important information on changes to legislation, accounting rules, and governance codes in board packs.

Conclusion

Multiple forces have converged to make board service more complex and challenging today. Directors are taking on fewer board positions than in the past, conducting more thorough due diligence into each opportunity, aware that they will have to grapple with a range of pressures—from new regulatory requirements and shareholder activism to intense scrutiny and a growing board agenda. With fewer CEOs willing to serve on outside boards, nominating committees are casting their nets wider. Recruiting directors from the broadest possible talent pool will pay dividends, providing the board has a clear vision for creating a diverse, coherent, and well-balanced entity in which each individual appointment supports the company in achieving its strategic objectives.

14 Should I serve as a member of the board of directors of a newly public company?

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In recent years, there has been a significant increase in the number of companies conducting initial public offerings in the US, particularly in the technology and life sciences industries. Although most of these companies have boards of directors that are composed of members with some experiences serving on the board of directors of a public company, many of these companies have at least a few members of the board of directors that have little or no such experience.

Serving as a member of the board of directors of a public company can be rewarding for a variety of reasons, including the ability to maintain existing or develop new professional skills and networks. In addition, serving on the board of directors of a newly public company provides opportunities to participate in the overall strategic planning and oversight of an enterprise, oftentimes with companies that are at the forefront of new technologies or industries. Serving on a board of directors, however, also comes with a litany of responsibilities and risks, including a substantial time commitment, fiduciary duties to stockholders, a wide variety of other legal obligations, and potential liability exposure.

Before joining a board of directors, a potential director should first seek to determine if the company represents the right opportunity to achieve his or her goals without representing disproportionate risk. In addition, the prospective member should consider whether he or she meets the various requirements for membership, particularly as an independent member of the board of directors, under both stock exchange and Securities and Exchange Commission (SEC) rules. The prospective member should then consider the substantial time commitment, legal obligations, restrictions, and potential liabilities that come with serving on the board of directors of a public company.

Questions to consider before joining

- How is the company's business performing, what are its prospects, and what do investors think of its prospects?
- Does the company have a history of regulatory or legal disputes? Does the company have a history of disputes with investors?

- What is the "tone at the top"? Does the company appear to have a substantial commitment to compliance, good governance, and ethical behavior?
- Does the existing board of directors currently work well together?
- Is the board of directors dominated by a few members, or are the views and opinions of others welcomed?
- How committed is the company to supporting good information flow to the board of directors?
- What is the scope of insurance coverage and indemnification available?
- How well do I understand the company's business and industry?

Are you qualified to join?

Public companies typically must have a board of directors composed of at least a majority of independent members. These independence standards are required by the rules of stock exchanges as well as by the US securities laws. In addition, investor advisory firms and many institutional investors focus on additional attributes when making determinations about whether to support a company's proposed board of directors composition at stockholder meetings.

Stock exchange rules

A majority of the members of the board of directors of a public company must be "independent" under applicable stock exchange rules. The NYSE requires the board of directors to make an affirmative determination of independence, citing a range of considerations such as commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships. However a member cannot be considered independent if:

- the director is, or has been within the last three years, an employee, or an immediate family member is, or has been within the last three years, an executive officer
- the director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $120,000 in direct compensation
- (1) the director is a current partner or employee of the company's internal or external auditor; (2) the director has an immediate family member who is a current partner of such a firm; (3) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (4) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time
- the director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee
- the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million or two percent of such other company's consolidated gross revenues.

In the technology and life sciences industries, the last requirement of the list above can be an unexpected potential pitfall, as it is often the case that directors with the desired industry knowledge may also serve as executive officers with which the company does business.

For persons serving on the compensation committee of a board of directors, the board of directors must also consider additional independence factors, including the source of any fees paid to the director and whether the director is otherwise affiliated with the company or any subsidiary or affiliate.

Additional requirements for audit committee members

The NYSE requires that audit committee members be financially literate. The SEC also has additional, more stringent requirements for members of an audit committee, including that audit committee members may not receive additional compensation from the issuer, or be "affiliated" with the issuer (holding less than 10 percent of an issuer's securities, individually or through an affiliated fund, is a safe harbor to this definition). Issuers are also required to disclose whether they have an "audit committee financial expert" serving on the audit committee.

An audit committee financial expert is a person who has the following attributes:

- an understanding of generally accepted accounting principles and financial statements
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves
- experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities
- an understanding of internal controls and procedures for financial reporting
- an understanding of audit committee functions.

This experience must generally have been gained through education and experience as a financial officer, controller, or auditor, actively supervising, overseeing, or assessing such persons.

While it is not required that a public company have an "audit committee financial expert" serving on its audit committee, most issuers prefer to have at least one such member, and therefore qualifying as an audit committee financial expert would be an attractive attribute in a proposed board member.

No loans

Public companies are prohibited from extending or maintaining (or arranging for the extending or maintaining) loans to directors. While most companies are mindful of this restriction, to the extent there is any pre-existing arrangement in place, such as outstanding debt for stock purchases or other forms of debt, it must be eliminated prior to a potential candidate joining the board of directors.

Are you able to commit the requisite time?

Board membership involves a very significant time commitment. In addition to the substantial time a director must spend learning about and understanding a company's business and its industry, there are a number of additional factors to consider in making a realistic assessment of the time commitment that will be required.

Frequency of regular meetings

While many private companies have regular meetings of the board of directors, public companies will typically have more frequent and longer meetings, as well as regular meetings of committees of the board of directors. These include the stock exchange requirement that nonmanagement directors must meet separately on a regular basis without management. Additionally, the board of directors and its committees will often meet on an ad hoc basis with relatively short notice.

Each year, a public company must disclose the number of board and committee meetings held and identify the members who did not attend at least 75 percent of those meetings. While poor attendance impacts the ability of a member to fully perform his or her duties, it may also attract recommendations to withhold a vote for re-election from investor advisory services such as ISS.

Additional workload for committee members

For many newly public companies, recently added members of the board of directors are often asked to serve on at least one if not more of the committees of the board of directors in order to ensure they are composed of independent members.

Because of its unique role in overseeing all aspects of a company's financial systems and reporting and risk management, the audit committee is typically a very time-intensive committee, with a larger number of meetings and more information to review in preparation for meetings. Compensation committee membership also increasingly requires a more substantial time commitment, as a result of the increased public and regulatory focus on executive compensation.

Other committee duties

Over time, companies may face unusual events or emergencies that would require frequent meetings of existing committees or the formation of special committees. These events might include internal investigations related to accounting irregularities or whistle-blower complaints, proxy contests, acquisitions, or other unusual transactions. These occurrences will often involve numerous and lengthy meetings over a potentially indeterminate period of time.

Travel

Prospective members of the board of directors should also factor in travel required to attend meetings. While many companies in the high technology and life sciences industries are geographically concentrated, this is not always the case, with companies also holding meetings at a variety of locations.

Conflicts with other board memberships

If an audit committee member serves on the audit committees of more than three public companies, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve. In addition, investment advisory firms such as ISS will recommend votes against a member who serves on more than six public company boards.

Fiduciary duties

Members of a board of directors have fiduciary duties to the company's stockholders, in the form of a duty of care and a duty of loyalty. In most circumstances, directors will have the benefit of a legal standard that is referred to as "the business judgment rule," and this means that courts will not interfere with managerial decisions of the directors and a court will presume that the board acted with appropriate diligence, in good faith, and in the honest belief that they are acting in the best interests of the stockholders.

Duty of care

Directors have a duty to act on an informed basis, after due consideration of relevant information and appropriate deliberation. To meet their duty of care, directors should regularly attend meetings and prepare in advance of meetings by reading materials, asking questions of management, requesting additional information as needed, consulting with advisers, and requesting expert advice as needed.

Duty of loyalty

Directors have a duty to act in good faith in the best interests of the company and not their personal interest. Transactions in which the director might have a personal interest are not prohibited, but they require consideration and approval by disinterested members of the board of directors after full disclosure of the transaction. The classic example that brings into question the duty of loyalty is when a director either appears on both sides of a transaction or receives a personal benefit not shared by all stockholders. Without the approval of disinterested members of the board of directors, the transaction could be voidable under state corporate law, or may require the director to prove that the transaction was fair to the company. Most public companies have a "related party transaction" policy or other similar approval process for these types of transactions. However, the director should not assume that the company is aware of a director's interest in a transaction.

Disclosure of personal information

As a director, a variety of information will become publicly available. The reporting company will be required to provide detailed biographical information about each director, including work experience over the past five years, other board memberships, age, and involvement in bankruptcies and other legal or government proceedings. Many companies also disclose educational background of members of the board of directors as well. A relatively new disclosure requirement is that companies must discuss the "specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director . . . in light of the registrant's business and structure." The reporting company will also be required to provide detailed disclosure of directors' stock ownership and compensation.

This information is usually obtained by the company having the director complete a lengthy and detailed questionnaire (commonly referred to as a "D&O Questionnaire"). As a further matter of diligence, many companies will also conduct background checks of potential members of the board of directors, with any significant discrepancies being cause to withdraw the invitation to join the board.

Significant restrictions on how directors may transact in company securities and discuss information regarding the company

Section 16

Section 16 of the Securities Exchange Act of 1934 requires directors of public companies to file reports concerning their holdings and transactions in a reporting company's registered equity securities. Section 16 also imposes penalties for "short-swing" trading for any purchases and sales (at a profit) within a six-month period.

Section 16(a) requires all directors to file reports (Forms 3, 4, and 5) with the SEC disclosing any direct or indirect economic interests in the securities and any transactions in those securities. These reports, which are available to the public, enable the SEC and the public, including plaintiffs' attorneys, to examine trading by company insiders, such as directors and officers and large stockholders.

A public company must also disclose the name and the number of late and omitted filings in its annual proxy statement or Form 10-K. The SEC may take action and seek to impose substantial fines for each failure to make the necessary filings. This penalty is separate from the potential loss of profits from the stock transactions. If a person is a habitual violator, the SEC can temporarily or permanently prevent him or her from serving as an officer or director of a public company.

Section 16(b) requires disgorgements of profits on sales of these securities if the director has made a purchase within six months before or makes such a purchase within six months after the sale. A "purchase" or a "sale" would not be deemed to occur in most transactions with an issuer such as option grants or exercises. Rather, open market purchases and sales in the market will typically be the source of matching transactions for Section 16. However, it does not matter if the sale follows the purchase or the purchase follows the sale. These profits, which are often referred to as "short-swing profits," are computed by matching purchases and sales (whether or not they involved the same shares or certificates) so as to maximize liability. Thus, short-swing profits may exceed actual gains in certain circumstances. There is no reimbursement or indemnification for these disgorged funds.

Rule 144

Under Rule 144 of the Securities Act, directors and other affiliates cannot publicly resell securities on the open market that have not been held for at least six months. Once an affiliate has held the securities for at least six months, Rule 144 permits sale of the securities if the affiliate complies with all of the following requirements.

- *Adequate public information*. "Adequate public information" about a company must have been available for a period of time prior to the sale. This requirement is generally not met until 90 days after the company completes its initial public offering. This requirement is satisfied so long as a company has filed all of the required SEC reports during the preceding 12 months.
- *Manner of sale*. Securities can be sold under Rule 144 by an affiliate only in a normal broker's transaction in which the buyer is not solicited, in transactions directly with a "market maker," or in so-called "riskless principal transactions." To ensure that the broker is experienced in dealing with Rule 144 sales and properly executes the transaction, the use of a full-service broker is usually recommended.
- *Volume limitations*. An affiliate's sales under Rule 144 during any three-month period are limited to a volume of shares not exceeding the greater of (1) one percent of the outstanding shares of the class being sold, or (2) the average weekly reported trading volume in such securities during the four calendar weeks before filing of the Rule 144 notice of sale.
- *Filing of notice*. If a stockholder uses Rule 144 to sell more than 5,000 shares or to sell shares having an aggregate sales price of more than $50,000 during any three-month period, the stockholder must, at the time of the sale, file three copies of a Form 144 notice with the SEC (and one copy with any stock exchange on which the stock is listed). The selling broker will generally help you complete and file Form 144.

Insider trading

It is illegal to trade in company securities while in the possession of material nonpublic information concerning the company, and it can also be illegal to tip or disclose material nonpublic information to outsiders. Persons violating insider trading or tipping rules may be required to disgorge the profit made or the loss avoided by trading, pay the loss suffered by the persons who purchased securities from or sold securities to the insider tipper, pay civil penalties of up to three times the profit made or loss avoided, pay a criminal penalty of up to $1 million, and serve a jail term of up to 10 years.

Information is "material" if it would be expected to affect the investment decisions of a reasonable stockholder or investor. Both positive and negative information may be material. While it is not possible to identify all information that would be deemed "material," the following information would ordinarily be considered material:

- financial performance, such as quarterly and year-end earnings
- operational metrics, such as customer counts and associated retention or attrition rates
- potential mergers, acquisitions, or dispositions
- developments regarding customers, suppliers, or partners, such as the acquisition or loss of a significant contract
- stock splits, public or private securities, and/or debt offerings
- significant management changes
- introduction of key new products and services.

Many companies have implemented insider trading policies that only permit directors to sell during specific "trading windows." These windows are often closed for a period of time prior to the end of a fiscal quarter and then re-open after the announcement of earnings. However, for newly public, high-growth companies, these trading windows may be closed at other times, such as for potential acquisitions or other significant transactions. As a result, directors may find it difficult to sell any securities of the company at the desired times.

Regulation Fair Disclosure (FD)

Regulation FD prohibits directors (among other company personnel) from disclosing any material nonpublic information about a company privately to certain persons (typically stock market professionals, such as analysts, or stockholders likely to trade on such information). The SEC has taken enforcement action against companies and individuals for violations of this prohibition.

Directors will need to be mindful as to what information they discuss with brokers, research analysts, investment fund managers, or other securities industry participants. Even statements such as "things look good" or "the company is doing well" could be seen as conveying material information. In addition, many companies have strict communications policies that prohibit public disclosure of information regarding the company outside of controlled processes.

Other sources of liability under securities laws

Under US securities laws, directors (and certain other company personnel) potentially face liability in connection with public offerings of securities and in connection with a company's ongoing public reporting. Directors will sign the company's annual reports on Form 10-K, and if the company registers additional securities for public sale, directors will also sign those registration statements.

Sections 11 and 12 of the Securities Act impose liability for the making of materially false or misleading statements (or material omissions) in registration statements and prospectuses. These are the documents that are used to make public offerings of securities (as opposed to the periodic reports filed by companies on a quarterly and annual basis, for example). Plaintiffs do not have to prove intent or reliance, just that they purchased securities pursuant to a materially false or misleading registration statement or prospectus. Sections 11 and 12 allow for an affirmative defense for directors, placing the burden of proof on the defendant to show he or she did not know, and in the exercise of reasonable care could not have known, about the misstatement or omission.

In addition to potential liability in connection with offerings of securities, directors potentially could face claims as a result of a company's statements in its periodic reports it files with the SEC, such as current reports on Form 8-K, quarterly reports on Form 10-Q, or annual reports on Form 10-K.

In addition, directors could face liability under Section 10(b), which prohibits conduct deemed to be a "scheme to defraud" investors. Liability under Section 10(b) of the Securities Exchange Act typically takes the form of class action lawsuits following drops in stock price. Typically, only the company and its senior officers are held accountable under Section 10(b). In rare instances outside directors may also be liable, for example, by signing off on misleading press releases, or if there were sales of stock by such directors in advance of a stock price drop.

Additional pitfalls

Proxy contests/activist stockholders

If a company has been underperforming, whether through a depressed stock price or lack of growth, activist investors, such as hedge funds or other similar entities, will often launch a campaign for a company to pursue ways to increase stockholder value. Often these campaigns take the form of proxy contests, where an activist stockholder would propose an alternate slate of directors for election at a board meeting. As part of these concepts, there will often be a lengthy and very public campaign by the activist, alleging that the board was not effective, was not properly performing its duties, and was no longer appropriate to be overseeing the company. These contests are time consuming and can damage members of the board of directors' reputations among investors, even if they were otherwise acting appropriately.

Majority voting/withhold campaigns

In recent years, investor advisory firms such as ISS and Glass-Lewis have recommended that stockholders withhold votes for re-election of members of the board of directors for a number of reasons, including if companies maintain corporate governance practices that they find undesirable, or if the company's compensation practices exceeded their guidelines or for otherwise having policies or taken actions outside of their recommended standards. When coupled with a structure that requires that members of the board of directors receive a majority of votes cast for re-election (known as "majority voting"), a board member that did not receive the requisite votes (even though they were legally sufficient for re-election) could be forced to resign the position. These "withhold" campaigns can similarly be time consuming and damaging to members of the board of directors' reputations.

How you can mitigate liability

10b5-1 trading plans

The SEC enacted Rule 10b5-1 to provide an affirmative defense to a charge that stock sale was based on insider information. As a result, many directors may choose to enter into what is known as a "10b5-1" trading plan, which is often a written plan with a broker for the broker to sell a certain number of shares at a set price (or based on a formula) on specified dates over several months or quarters. The director would not retain any ability to influence the timing of sales or the amount of shares to be transacted. Furthermore, the director may not enter into a trading plan when in possession of material nonpublic information.

While such a plan can provide a defense to insider trading allegations, it does reduce flexibility, since the director effectively puts the number of shares to be sold into the hands of a third party. Additionally, if a plan is in place, trades outside of the plan are often discouraged.

D&O insurance

Many states' corporate laws allow corporations to purchase and maintain insurance on behalf of directors, officers, and employees, whether or not the corporation would have the power to indemnify such person. The primary types of coverage are known as Side A, Side B, and Side C, with Side A and Side B being most relevant to the director.

Under the so-called "Coverage A," "Side A," or "Natural Person Insured" clause, individual directors are covered for a "loss" arising from a "claim" against the director or officer for any alleged "wrongful act" during the policy period, except when and to the extent the company has indemnified the officer or director. Insureds are typically entitled to advancement of defense costs while a claim is pending.

Under the so-called "Coverage B," "Side B," or "Corporate Reimbursement" clause, the policy pays the "loss" of the company arising from "claim" made against a director for any alleged or actual "wrongful act" during the policy period, to the extent the company has indemnified the director or officer for the loss.

Side B coverage typically requires the company to make indemnification payments up to the retention (or deductible) amount before the carrier is obligated to pay. Typically, when a director or officer must defend against a claim, he or she requests indemnification based on an indemnification contract and/or the company's charter documents. The company agrees to advance defense costs upon execution of an undertaking by the officer or director to repay those costs if the director is subsequently found not to be entitled to indemnification.

Side A may be triggered, rather than Side B, when the company is insolvent and cannot pay indemnification. Another trigger is payment to settle a derivative action.

These policies typically contain numerous exclusions, such as if the insured had knowledge of a fact or circumstance likely to give rise to a claim but failed to disclose it in the insurance application, criminal fines, and penalties, among many others. Therefore, a director should review with outside experts the terms of the policy.

Charter provisions and indemnification agreements

Most newly public companies will have included provisions in their certificate of incorporation and/or by-laws providing for indemnification of officers to the fullest extent permitted by law. They will also often have indemnification agreements and may make indemnification and advancement of fees mandatory. Many states' corporate laws will permit a corporation to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee, or agent of the corporation.

This indemnification will often cover all expenses, including attorneys' fees, judgments, fines, and amounts paid in settlement. In many instances, a corporation may also be permitted to pay expenses (including attorneys' fees) in advance of the final disposition of the action, suit, or proceeding, so long as the director agrees to repay amounts advanced if it is ultimately determined that the person is not entitled to be indemnified.

As is the case with directors and officers liability insurance policies, indemnification provisions contained in a company's certificate of incorporation and by-laws and the terms of indemnification agreements can be complex, and the director should consult with an expert in this area before joining a board of directors.

Conclusion

For a board member new to serving on public company boards, the time commitment and scrutiny of board process has increased substantially in recent years. There are numerous pitfalls and potential liabilities for doing so. However, by following some relatively simple guidelines, these may hopefully be avoided:

- be active, engaged, questioning, and informed
- require that corporate governance and compliance procedures are in place, reviewed periodically, and scrupulously adhered to
- take prompt steps to address any regulatory or reporting issues
- monitor potential conflicts of interest involving directors or officers
- require that information presented to the board is accurate, thorough, and timely
- increase time commitments for board business, for example by scheduling committee meetings for the day preceding board meetings instead of the same day; review board packages in advance of meetings
- use independent advisers such as experienced outside counsel and compensation specialists
- scrutinize indemnification and insurance provisions
- be aware of your obligations under securities laws
- attend director education programs on a regular basis
- when the company is offering securities to the public, carefully read the disclosure documents, ask questions, and request briefings from management and auditors and seek advice of outside counsel with experience in these transactions
- consider a trading plan for transacting in the company's securities
- inquire of management as to how the company is performing and request regular business updates.

PART III

KEY CHALLENGES FOR BOARDS AND MANAGEMENT

Electronic version of this guide available at: nyse.com/cgguide

15 Succession planning: strategies for building the pipeline

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At any company, one of the most important responsibilities of the board and of the CEO is ensuring an uninterrupted flow of capable management. Boards and CEOs that do not make succession planning a priority can put at risk their company's ability to carry out its strategy or to respond to new competitive threats, potentially shaking the confidence of both the organization itself and the financial markets. The risks of complacency or poor planning are steep when it comes to talent development and succession, especially as succession has become a growing concern for investors.

Successors and succession plans rarely just emerge. They are a product of the board's commitment to thoughtful, diligent planning and a willingness to hold the CEO accountable for the process. Boards that embrace this process work with the CEO to ensure that senior executives receive the appropriate developmental opportunities, including exposure to the board and potentially to outside board experiences, and push to meet a broad range of top executives.

A rigorous succession planning process

The NYSE Corporate Governance Guidelines state that listed companies must adopt and disclose corporate governance guidelines around management succession: "Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO." In practice, boards must balance the need to provide appropriate information about the CEO succession process to fulfill their fiduciary and legal obligations with the need to protect sensitive internal information about potential candidates from being made public.

In our experience, a credible and sustainable CEO succession planning process involves the following:

- Preparing over time for an orderly, well-executed handover that proceeds from a robust management development process.

- Developing contingency plans to deal with other succession scenarios, for example, a death, health crisis, or other personal reason, that force a sudden CEO transition, or performance problems requiring an accelerated succession.
- Driving agreement about the long-term strategic direction of the company and developing CEO selection criteria based on the future needs of the business. A very precise and thoughtful profile should be the compass that guides the board in making tough decisions throughout the process.
- Defining the respective roles of the board, the committee, the CEO, and the management team in succession planning, and establishing the mechanisms to make succession planning an ongoing and real-time process.
- Assessing potential internal candidates based on the defined selection criteria, understanding their strengths and development needs, and then creating development plans to close any gaps. It is important that internal candidates feel good about this process.
- Gaining an understanding of the talent marketplace and how internal candidates compare to external talent benchmarks.
- Ensuring the CEO and chief human resources officer are overseeing an active and effective C-suite succession program so that all senior executives accumulate the experience and skill sets they need to be effective.
- Regularly reviewing the succession plan and adjusting when necessary.

The value of starting early

When should succession planning begin? While somewhat counterintuitive, ideally, the process should start early in a CEO's tenure. Starting early and creating a normal cadence around executive development and long-term C-suite succession planning increases the chances that strong internal candidates will be identified, assessed, and ready when a transition is near. Boards that wait too long to begin the succession planning process may find that there is not enough time to address the developmental needs of candidates with high potential. Starting early also allows directors to have more interactions with potential candidates over time, so they can observe patterns of performance and behavior and gain deeper insights into candidates' succession readiness. Finally, when C-suite succession is an established process—rather than a response to an imminent transition—it can minimize the emotion and drama from the process because it is business as usual.

Tie the profile of the future CEO to the strategic direction of the business

The foundation for CEO succession planning is the strategic direction of the business, from which the profile and selection criteria for the future CEO can be developed. Getting this right is critical because the CEO criteria provide a road map for internal candidate development plans and a framework for selecting from among finalist candidates.

A potential pitfall for the succession planning process is basing criteria for the next CEO on a strategy that is too rooted in the present or relies on status quo assumptions, rather than a view of where the company needs to be in five to 10 years. When this happens, the criteria for the next CEO may not be tied to the specific strategic, organizational, and operational levers that the next CEO will need to employ, potentially impeding the development of internal candidates with these capabilities. Very simply, if you don't know where you want to take the company, it's hard to evaluate who is the right person for the company's next phase—some executives are skilled at growing a company; some are experienced in turnarounds; some are perfect for maintaining the company's current course.

Wise boards agree on strategic issues up front, since these decisions will influence the kind of future leader or leaders the company will need, and push themselves to go beyond generalities. They identify the very specific effect the next CEO needs to have on the business and define the skills that it will take to accomplish that. These could include invigorating the innovation pipeline, applying disciplined cost management, pursuing specific growth targets in emerging markets, or building new organizational capabilities to drive organic growth.

In addition, boards should consider the question of cultural fit. If the organization's culture is viewed as a valuable asset, then—all things being equal—the board should favor a profile that fits into the culture. In other cases, the culture of the company can be an impediment to its success. A culture that is too invested in its own ways of doing business and not learning and changing in a dynamic market may require transformational change. In these cases, the board will give more weight to the capabilities needed to transform the culture.

Agreeing on a future-looking strategy that informs the criteria for the next CEO is a critical step that helps make the process go smoothly. It also helps boards avoid the trap of choosing an executive who mimics the incumbent's strengths.

Adopt best-in-class assessment approaches

By definition, potential internal candidates for the CEO role are not proven CEOs, so how can boards gain better insights into their ability to succeed in a role that is dramatically different in scope and complexity? Unless boards are diligent, evaluations of succession candidates tend to be relative to the roles executives are in today rather than mapped to the future. To gain the insights they need to understand the capabilities of their company's executives and make the discerning judgments about their readiness for the top role, boards need to embrace an assessment process that is fact-based, rigorous, and forward-looking.

A board's ability to choose a CEO successor requires a frank view of executives' readiness, including an understanding of their development needs based on the future direction of the company and the likelihood of their being able to close any gaps in a reasonable amount of time. Boards should understand candidates' track records delivering against the same strategic and operational levers that the next CEO will be required to pull, drilling down into the specific contributions individuals have made in the businesses they have run. In addition, boards should strive to gain an understanding of an executive's potential to stretch into the CEO role.

Executives' analytical capabilities, social intelligence, and self-awareness are all skills that speak to their ability to succeed in more complex and demanding contexts. CEOs must operate amid greater ambiguity and complexity than in their previous roles, so understanding whether executives have the skills to navigate these challenges is critical. Assessing candidates' business judgment and self-awareness also can shed light on which executives will be best able to learn, develop, and adapt as CEO. This is no small consideration in an environment in which the one thing boards can be sure of is that the collection of issues and challenges facing the business when the new CEO is named will be different six months later.

A careful review of individuals' competencies, including the observations of others who can validate their performance in current and past roles, can reveal whether candidates have the relevant experience and identify potential gaps. Gaps may include a lack of specific knowledge or experience, traditional "hard skills," such as experience with regulators or financiers, or a deficiency in certain "soft skills"—behavioral skills such as the ability to navigate complex interactions or to influence, motivate, and create followers, among others. Boards also will want to consider whether the culture of the company needs to evolve, and how aligned individual candidate profiles are with the desired company culture.

An additional component of candidate assessment is benchmarking internal executives against executives outside the organization. Companies that are strong producers of executive talent sometimes lose a sense of how their leaders compare to the best-in-class talent externally or overlook how the world has shifted around them. Taking a look at external talent—through research, informal or formal introductions or an executive search—can provide additional insight when assessing the readiness of potential successors. Ideally, benchmarking should happen in tandem with internal assessment, so that the results of the internal assessments and external benchmarking can be compared simultaneously. This process is critical to giving the board a good sense of the relative strength of the internal candidates, as measured against outside talent who have proven themselves as skilled in the operational areas that will be critical for the company's future success and have demonstrated the values and behaviors that align with the ideal company culture.

Planning for other succession scenarios

History has proven that unplanned leadership vacancies occur, so preparing for the succession of the CEO over the long term is not sufficient. The unexpected can happen: Illness, death, unanticipated family demands, or poor performance can end a CEO's tenure. A CEO may decide, due to illness or for other personal reasons, to leave earlier than planned, or be recruited away for a new career opportunity. It's critical, then, that boards stay vigilant in reviewing the company's succession readiness.

As part of ongoing succession planning, boards should plan for an emergency situation requiring a sudden change in leadership. This plan could involve internal executives who are far enough along in their CEO readiness, a current board director, or a retired CEO as potential candidates to immediately step in as acting CEO on an interim basis. Boards also should discuss accelerated succession scenarios, which can be implemented if the board begins to have concerns about the performance of the CEO or its own relationship with the CEO.

The board and the CEO should establish together a strategy in advance and define the procedures that will take effect if an emergency occurs. The chairman of the board or of the committee responsible should know the potential candidates who are willing to take on management responsibility in an emergency or which board member may be able to step in.

Creating a succession committee

Succession planning is arguably one of the more interesting responsibilities of the board—and a task that many board members are eager to be a part of. It also can be one of the most intensive board responsibilities, depending on where the board is in the process, requiring significant work between meetings. While the entire board should be involved at critical touch points throughout the succession planning process, a smaller succession planning, nominating, or personnel committee—that includes only directors who are the most qualified and who have the necessary time—can steer the process for the board and handle the granular work associated with assessment and benchmarking.

In our experience, the ideal size of this group is three or four directors. The lead director or non-executive chair is often included in this group, and it can be helpful to include two board members who have the expertise of being former CEOs, but who are not active CEOs, given the time commitment. It is even better when at least one of these former CEOs also chairs another committee such as the nominating, governance, or compensation committee. However, boards may want to avoid assigning the audit committee chair to this task because of the time commitment for that role. The succession planning group often may include the company's current CEO acting in an "of counsel" capacity.

As this committee takes ownership of many of the details of succession planning, it should keep the rest of the board up to date and ensure its continued buy-in throughout the process. This should happen at the beginning to ensure that the board understands the process; upon the development of the key selection criteria for the position; at the review of the assessment summary of internal candidates; and upon the review of the benchmarking information on external executives.

The CEO's role in succession planning

At the most basic level, the CEO's role is straightforward: driving management succession at senior levels, including the early identification of any inside CEO contenders, ensuring that the organization is developing succession-ready executives, and serving in an of counsel role to the board. The CEO is in the best position to make sure directors have the insight they need by working closely with the chief human resources officer (CHRO) to ensure the company has a robust, forward-looking approach to executive talent development.

The CEO should make sure that the CHRO is thinking about development plans for potential internal candidates with a forward-looking lens, assessing individuals based on the future requirements of the business, and translating those requirements into specific developmental opportunities. The CEO and board can benefit from bringing in outside assessment expertise when evaluating how the internal team stacks up against the requirements and external benchmarks, particularly when the business may require a change in strategic direction.

As the time for a transition nears and the process turns toward the board's selection of finalist candidates and potentially a search, the CEO's participation diminishes.

Developing a robust pipeline: the board's role in broader C-suite succession

While the board should be deeply involved in succession planning for the CEO role, less agreement exists among experienced directors about how involved the board should be in influencing talent decisions further down in the executive team. At a minimum, the board should be confident that the CEO has a strong team and that the organization has an effective succession planning process in place for other key executive roles.

Many boards monitor the succession planning for the top 10 or 12 positions in the company, making sure development plans are in place for these executives, that they are given challenging assignments or new roles, and that they gain exposure to the non-executive directors, for example, by presenting during strategy meetings.

At a broader level, boards want to be confident in the succession pipeline, ensuring that the CEO is focused on developing a succession-ready team and that directors have the insights about potential CEO contenders they will need to provide the necessary developmental assignments and, ultimately, to choose a successor. This ideally is a broad-based effort that incorporates up-to-date profiles for all the senior team positions, regular assessments and benchmarking, and thoughtful developmental assignments.

This does not mean that directors must become talent managers. It does require boards to take responsibility for ensuring that the right processes for talent management are in place and that they have the appropriate knowledge of potential leadership. Directors should get to know the senior leadership through presentations in the boardroom and regular meetings outside of it. Boards should plan on a deep-dive talent review at least once annually, which includes having the CEO and top HR executive lead a discussion about forward-looking leadership requirements against which talent can be evaluated. By being involved on an ongoing basis, the board can observe patterns of performance and develop a more nuanced point of view on executives' strengths and weaknesses.

Conclusion

Succession planning works best when it is viewed as a critical, ongoing board responsibility closely tied to management development. Among companies that do it best, succession planning is not focused solely on selecting the next CEO but instead involves a top-down and bottom-up approach to developing management talent for all key positions. These companies tend to share several common characteristics:

- They have strong boards that stay deeply involved in the succession planning process with the CEO on a continual basis.
- They continually expose their top management team to the board.
- They encourage "next-generation" CEOs to gain exposure to the media, the investment community, and, sometimes, outside board service opportunities.
- They view succession planning as an ongoing process that is linked to the strategic planning process to ensure a fit between where the business is going and the skills of likely successors.
- They minimize the human drama in the succession process by creating conditions for a predictable outcome.
- They periodically calibrate likely internal candidates for CEO against comparable outside leaders.
- They develop a "succession culture" in which all levels of the organization plan for the inevitability of change by ensuring that top executives and high-potential leaders throughout the organization are given the proper tools, exposure, and training to develop into contenders for advancement.

16 Communications strategies

Matthew Sherman, President and Partner Joele Frank

Boards of directors and management teams are now routinely challenged—both privately and publicly—by investors, sell-side analysts, industry experts, regulators, and others. They are finding that their decisions are increasingly being scrutinized—from executive compensation, corporate governance practices, and capital allocation to the ability to develop and implement strategic plans. Boards and management teams that are perceived to be lax or indifferent in addressing these issues often face public opposition and proxy challenges by activist investors. Notably, traditional institutional investors are no longer sitting on the sidelines: they are increasingly supporting activist activity—and in some cases, instigating it.

The best defense is often a good offense. This begins with execution and shareholder returns. Ensuring that the investment community understands and supports a company's strategy is also an important element. Board engagement and strategic investor communications can help foster this understanding. While engagement and advance preparation will not prevent shareholder activism, it can significantly influence the outcome when a proxy contest occurs.

Communications in peacetime

The traditional role of a board of directors has been to set strategy and to hold management accountable for executing that strategy. But the role of the board has evolved.

The expectation for regular dialogue between the executive management team and shareholders, which has long been "best practice" in investor relations, today has been extended to directors as well. Investors expect directors to be knowledgeable about the business, engaged in the strategy, and accessible to answer questions and share points of view on the company, its peers, and the industry landscape.

Externally, the board has an unmatched degree of authority and credibility. It can reinforce and support the management team, while at the same time holding them accountable for performance. Accordingly, when speaking with investors, they must strike a balance so as to not undermine management. Ensuring that management remains the primary spokespersons with shareholders, particularly outside of a proxy contest, will help achieve this balance. Director/investor communications should largely occur around normal course events where management is present, such as investor days, or in select investor roadshow meetings when a director's presence can help support the company's investment rationale or an investor relationship. Director accessibility and outreach should also be considered when shareholders are questioning board-level matters, such as company leadership, executive compensation or governance policies outside of management's purview.

At smaller companies with fewer resources, directors may take on a more active communications posture to augment the executive management team. At organizations where the chair and CEO roles are combined, a strong independent lead director can be an influential counterweight.

Directors can be important ambassadors to the investment community. Providing shareholders with access to a director reinforces that a company (1) has an active and engaged board, (2) is committed to sound governance policies and practices, and (3) takes seriously the views of its shareholders. Such director/shareholder relationships can also be important in establishing trust and a strong base of supportive shareholders. Indeed, if a company first undertakes serious outreach to the investment community when a proxy contest is underway or imminent, it is likely to be too late to establish the relationships and credibility needed to mount a formidable defense.

When identifying targets for investor/director meetings, it is important to consider not just an institution's portfolio managers with whom management regularly interacts but also that institution's governance/proxy advisory boards. Often in a proxy contest, these governance bodies, sometimes in conjunction with and sometimes instead of the portfolio managers, are the ones who control the voting of an institution's shares. While establishing a relationship in advance may not be determinative in a vote, it can help create a climate of greater receptivity and trust.

Before any meeting with investors—activist or otherwise—board members should be informed and prepared. Directors must be armed with details about management's prior engagement with the shareholder, the shareholder's investment focus and history with the company, as well as any public or private statements that the shareholder has made about the company. Directors are encouraged to run through mock Q&As and other role-playing exercises to prepare for investor meetings and ensure that directors know how far they can go on key topics.

The current landscape

Shareholder activism has become a prolific, well-organized force. Once the domain of a few celebrity-like names and gadflies, activism today is mainstream, dominating headlines and dedicated columns in financial media such as *The Wall Street Journal* and the *Financial Times*, and even mainstream news and pop culture outlets, such as *Time* and *Vanity Fair*. The level of media interest in activism has grown with the dollars invested. Activism has become its own asset class. Assets held by activist hedge funds totaled more than $100 billion in 2013 compared with $66 billion at the end of 2012. And in the first quarter of this year, activist strategies saw $3.5 billion in new capital inflows according to data from Hedge Fund Research.

At the same time activists have become more sophisticated and nuanced in their approach. They are establishing teams of advisers that mirror those established by companies, including legal counsel, financial adviser, investor relations/public relations adviser, proxy solicitor, and operations consultants. Slates of directors put forth by shareholder activists no longer comprise representatives of that fund and their "friends and family." Activist slates now include reputable current and former senior public company executives with relevant industry experience and credible track records at other publicly traded companies. While a handful of activists continue to seek headlines over substance, a number of activists today prepare and publish extensive white papers with specific suggestions for a company's strategy. Although activists' assumptions are sometimes flawed, their conclusions unrealistic, and their proposals not always in the best interests of the company and all shareholders, the extent of analysis and data activists put forward in these white papers demonstrates that they are taking these matters seriously and devoting considerable time, energy, and resources to their efforts.

As shareholder activists have refined their approach, the balance of power has shifted in their favor. Between 2009 and 2012, of the proxy fights that advanced to a vote, activists won 37 percent of the time. In 2013, that percentage rose to 60 percent and has already increased to 68 percent in 2014 with numerous meetings yet to be held.

Even when a situation does not advance to a shareholder vote, activists are increasingly gaining concessions, such as board representation, corporate governance changes, capital return, and other measures, through settlements. Of the 90 proxy campaigns launched in 2013, only 30 went to shareholder vote. The majority of campaigns were either settled (36) or withdrawn (24).

Notably, a company's size and performance are no longer a defense. Mega-cap companies such as Apple, Microsoft, and Procter & Gamble have all been targeted by activist investors and have implemented changes as a result.

What created the pendulum swing? Why do shareholders believe they need a "watchdog" on their boards? Why are companies settling? While some may debate the triggers behind the lack of shareholders' confidence in companies and their boards of directors, a few contributors to this shift are incontrovertible. Institutional investors, such as mutual funds and pension funds, are more supportive of activists than ever before. For example, T. Rowe Price, an institutional investor with $614 billion in assets under management, supported Carl Icahn's opposition to the buyout of Dell last year. California State Teachers' Retirement System, which manages $176 billion, joined Relational Investors in its 2013 campaign to split the Timken Company into separate businesses. Earlier, Ontario Teachers Pension Plan, with over $140 billion under management, joined with JANA Partners to advocate a break-up of McGraw Hill. Some traditional long institutional investors are even working with activists behind the scenes, asking them to get involved. *The New York Times* reported that "institutional investors even have an informal term for this: R.F.A., or request for activist."[1]

Activists also typically receive support from proxy advisory firms, such as ISS and Glass Lewis. ISS can influence between 20 percent and 30 percent of a vote; Glass Lewis, while somewhat less influential, still makes headlines with its voting recommendations.

Communications in the face of a challenge

The pace and urgency of communications increases markedly when an activist challenge emerges. The rhetoric tends to heat up and events unfold under rapid fire because a proxy fight, much like a political campaign, is a battle for votes and support. In any contested situation, the management team and board of directors will be subject to greater scrutiny by investors and the media.

Directors should be prepared to be publicly challenged and criticized. In such an environment it is difficult to resist the urge to set the record straight when confronted with falsehoods and slights. But discipline and coordination are vital when everything potentially can be used against the company by the activist.

There is no "one-size-fits-all" approach to conducting and winning a proxy fight. All actions and words must be developed and tailored to the specific circumstances, often in real time. That said, a few communications principles will serve a company well in almost any circumstances:

- *Do not be defensive*. Actions and communications should present the company and its directors as open-minded and receptive to the view of its shareholders.
- *Take the high road*. Avoid personal attacks. Shareholders do not like to see the company or its directors or management team attack other shareholders.
- *Stay aligned*. In a proxy fight, directors and senior management play critical roles in communications efforts. Both should be seen as aligned and supportive of the overall corporate strategy and direction. Collective judgment should determine when and how to deal directly with challenges.
- *Harmonize messages and spokespeople*. Spokespeople should be limited and messages consistent. Responses, even by board members, should be coordinated with the company and its advisers.
- *Be timely*. As much as possible, the company should respond in a swift manner to ensure its messages are communicated to key constituencies—including the investment and analyst community, employees, customers, and partners—during the same news cycle. While the media inherently favors the activist, responding in the same news cycle will help balance the story. Some boards choose to establish subcommittees for communications to help ensure an efficient approval process for communications during a proxy fight.

While disciplined and aligned messages are important, so too is the forum in which they are delivered.

Large group, public meetings should be avoided. These kinds of meetings can be usurped by an activist in an effort to disseminate its own messages and embarrass the company. Instead, we emphasize targeted, one-on-one or small group meetings with investors and sell-side analysts, which offer the greatest amount of control.

In these meetings, investors will be assessing subjective characteristics of the directors and management as well as objective metrics about the company's performance. Are the directors and executives confident or evasive? What is their reaction to provocative statements and how willing do they appear to consider differing ideas on capital returns, mergers/acquisitions, strategic alternatives, and so forth? Are there divisions among the management and board? Does the leadership have command of the facts of company performance, an understanding of macro industry trends, and a strategic vision?

What to do before a proxy contest

Advance preparation can significantly increase the chances of a favorable outcome in a proxy contest. We recommend several steps that all companies should take:

1. *Establish core team*: Identify a team that can manage rapid responses in a campaign scenario. Core team should include key members of senior management, legal counsel, financial advisers, investor relations/public relations adviser, and a proxy solicitor. Assign roles and decision rights ahead of a campaign and conduct regular update calls so the team is primed for action.
2. *Assess/address vulnerabilities*: Be candid about the company's strategic and operational weaknesses. Review operational and financial results, stock price performance, and other key issues including leadership, capital allocation, and broader market and industry developments. Review and consider enhancing the company's governance structure and policies as well as any structural defenses. Work with legal, financial, and communications advisers to develop a "defense white paper," which can often identify key vulnerabilities that can be addressed before they are raised publicly by an activist. This "opposition research"—similar to the approach used in political campaigns—can be invaluable in mounting an effective and credible defense.

3. *Review and refine investment rationale and governance messages*: Activist investors launch multipronged attacks that typically include criticism of a company's strategy, performance (actual and as compared to peers), capital allocation, shareholder returns, and corporate governance. Corporate messages should be reviewed to ensure that they accurately reflect the company's track record and goals in these areas.
4. *Identify appropriate board member(s) for investor engagement and train as needed*: As noted above, in addition to a regular dialogue between management and investors, companies are increasingly identifying independent director(s) to meet with select shareholders prior to an activist attack. As appropriate, conduct training with selected directors to ensure they are comfortable discussing the details of the company's operations as well as have familiarity with "best practice" guidelines for talking to shareholders, including an activist.
5. *Review/expand director bios*: In a proxy campaign, individual directors may become targets of attacks. The tenure, experience, independence, and stock ownership of a company's board are scrutinized—by the activists themselves as well as by other shareholders and proxy advisory firms. With this in mind, review the bios of current directors and identify opportunities to enhance the listed credentials to make clear the relevant skills and expertise that these directors provide. In a contest, new perspectives and diversity of experience can be as important as experience within a company's industry. To the extent new directors are contemplated, consider expertise that is both diverse and relevant to the company's strategies and goals, not just its industry.
6. *Renew/refresh investor relationships*: As discussed, establishing a relationship in advance may not be determinative in a vote but it can help create a climate of greater receptivity and trust.
7. *Identify third parties*: In addition to current investors, companies should identify potential supportive third parties such as sell-side and industry analysts, academics, customers, and business partners. Politicians, regulators, and business and trade organizations are also potential sources of support. Traditional shareholder advocates and corporate governance "gurus" can wield significant influence in a contentious proxy campaign. Ideally, these potential advocates should be cultivated long before their support is needed.
8. *Review/correct ISS evaluations*: ISS issues voting recommendations, which consider ISS issued governance scores and related reports, for approximately 39,000 companies in 115 countries each year. It is not uncommon to find mistakes or outdated information reflected in these scores and reports. Although ISS has a separate team focused on reviewing and opining on proxy contests and other matters, ISS governance scores are often cited by activists in their attacks and relied upon by other shareholders in forming a view on a company's record. Working with the company's proxy solicitor, companies should review governance reports to ensure accuracy and, if needed, that appropriate corrections are made and scores updated.

Conclusion: don't wait to engage

Shareholder activism is here to stay. Whether a company is facing good times or bad, it would be a mistake for any company to begin preparing for a fight only after one is threatened or, worse yet, has already begun. As a matter of course, directors and management should engage with their shareholders regularly to ensure that the company understands the expectations of the investment community and that the investment community understands the company's businesses, vision, and plan for value creation.

At the end of the day, the management team is in charge of the company's operations and responsible for implementing and executing the corporate strategy. That said, strategically utilizing a board member in a company's investor relations program can help build a track record of open and transparent communications with shareholders. This, in turn, can provide a board and management team with critical insights into its investor base, bolster that company's credibility, and in certain instances, head off any interest or approach from an activist investor.

For companies today, strategic communications and selective director engagement are important tools that should be deployed pre-emptively to deter or defeat the rising tide of shareholder activism.

Notes

1 de la Merced, Michael and Gelles, David. "New Alliances in Battle for Corporate Control." *The New York Times* Mar. 18, 2014.

17 Reputation, analytics, and corporate strategy

Chris Foster, Vice President, and Jason Kemp, Principal Booz Allen Hamilton

We live in a world of increasing transparency and high-velocity communications. Information not only travels faster, it travels everywhere. The rapid convergences of cloud, social, and mobile technologies have created a new generation of empowered information consumers.

In today's interconnected consumer economy, the notion that a company's reputation can be "managed" as a simple commodity or unidimensional artifact is dangerously outdated. In a fully networked global culture, every morsel of information—no matter how trivial or seemingly innocuous—has the potential to go viral in a heartbeat. Reputations that took decades to build can be destroyed in mere moments.

Reputation strategy is the solution to reputation volatility

Reputation is a complex set of perceptions, beliefs, and expectations held by all of an organization's stakeholders. It is the sum of their opinions, based largely on what they see, read, hear, and experience.

Reputation is an outcome of organizational behavior, values, decisions, and actions. Unlike traditional tangible assets, it is both multidimensional and fluid. Although invisible, reputation can be integrated into business planning and operationally embedded into organizational approaches across business units and geographies to positively affect a company's valuation, sales, employee morale, performance, partnerships, and a host of other critical areas.

Reputation can be leveraged for strategic advantage through insights gained from the scientific application of real-time big-data analytics and multidisciplinary approaches that we have developed, tested, and implemented over years of working with government defense, intelligence, and cybersecurity agencies. Our portfolio of analytics and processes enables us to understand attitudes, opinions, and behaviors and to create predictive models that anticipate behavior, actions, and response to content.

Building reputation is not an entirely new idea. But the application of scientific methods incorporating advanced analytics brings new capabilities for prediction and optimization that reveal new opportunities and genuine advantages.

More than just a technique for managing reputation, reputation strategy is derived from a carefully orchestrated set of scientific processes that create and sustain competitive advantage in a turbulent world.

Reputation is not monolithic; it is assembled from thousands of data points across stakeholder groups and markets. Thus, reputation is complex and cannot be simplified to a single score or index. A forward-thinking organization will take deliberate steps to monitor and analyze data that might impact its reputation. More important, it will take proactive steps to build its reputation on a solid foundation, one brick at a time.

Brand does not equal reputation

Great companies discern the critical difference between brand and reputation. Let's take a moment to examine this difference, because it is vitally important. As consumers, our impression of a brand is usually formed by our direct experiences with a company's products or services. A company's reputation, however, is formed by a collective belief system about quality or character. These beliefs are typically formed from hearing or reading the opinions of other people—friends, experts, and even total strangers—which today are relayed across an ever-widening array of media platforms and channels.

Indeed, the difference between brand and reputation is huge and not yet fully appreciated. Before the era of 24/7 media, reputational damage could be managed and mitigated by skillful public relations teams or corporate communications executives. In the rapidly evolving global information landscape, however, stakeholders have greater access to information and can easily uncover actions, behaviors, decisions, or values that are incongruous with communications of the organization. Today, news travels faster and farther than ever before, and communications professionals need the support of additional capabilities and tools to be effective.

Until fairly recently, the downside risk of confusing brand and reputation, or not understanding how the mechanics of brand management and reputation strategy differ, was relatively minor. However, the Internet, the Web, broadband networks, and handheld mobile devices have changed all of that. Now, the risks are higher, and the downsides are considerably steeper.

Table 1 A good reputation

- *creates trust* in an organization's products or services
- *provides access* to policy and decision makers
- *attracts and retains* the best employees
- *drives credibility* with outside partners
- serves as a *critical success factor* for investors.

Reputation exists in a complex ecosystem

Reputation cannot be judged, described, or distinguished at a glance. Multiple streams of data from multiple sources must be collected, integrated, analyzed, evaluated, and harvested for insight that can be used to develop meaningful responses to changes or shifts in reputation. Since reputation is built from an aggregate of components, different approaches are required for different companies and different markets.

Reputation strategy is composed of multiple action steps and processes based on environmental factors, as well as factors within an organization's sphere of influence

(Figure 1). Through the application of reputation strategy, scalable, repeatable, reliable, and predictable actions can be taken.

Every organization has a unique set of attributes that can be classified into those that could affect existing value or those that could generate new value. This allows organizations to address risks and issues, as well as proactively identify and address opportunities.

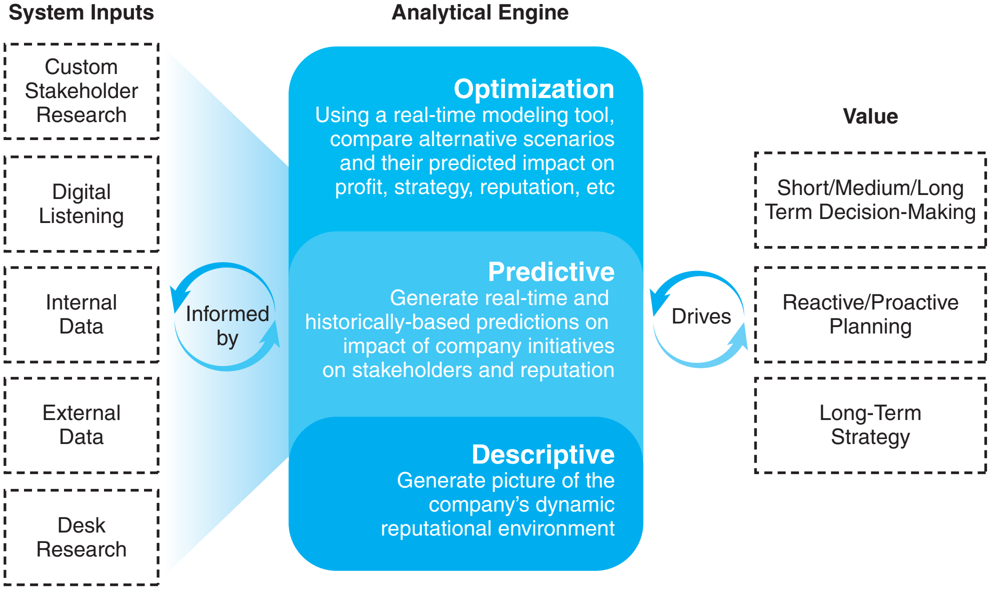
For example, reputation can be leveraged to create business advantages in supply chain relationships, executive talent recruiting, sales, sourcing, finance, and other functional areas of the modern enterprise.

In a recent engagement with a global firm, we integrated multiple types of data into a single model, making it possible for our client to recognize how each issue contributed to reputation and what impacted reputation across stakeholders.

Based on our analysis, we identified activities that should be created, sustained, or eliminated in order to support reputation goals. With a comprehensive understanding of the factors or "drivers" underlying the company's reputation, we helped them devise a workable strategy for influencing it.

Figure 1 Reputation ecosystem

Figure 2 Reputation analytics engine



Prediction is key to better outcomes

Big-data and real-time analytics create essential capabilities for modeling, comparing, and predicting outcomes of reputational issues. Recently our experts generated real-time predictive indicators of reputational impact for a client and tested multiple scenarios for how to address the situation based on our Reputation Analytics Engine (Figure 2). We also created a reporting framework that helped our client understand their reputation globally and develop strategies for protecting and enhancing their reputation over time.

Over the course of the engagement, we performed research, data integration, data/driver analysis (predictive and descriptive), strategy development, and change management analysis. The results of our work provided visibility into resource allocation and critical insights that informed future situations.

We took the following action steps:

- We developed an early warning system to let our client know which stakeholders in what markets would be impacted by specific aspects of their reputation.
- We customized and delivered our Global Reputation and Business Intelligence Model to:
  - integrate the wide range of data streams we identified and integrated so our client could understand stakeholder relationships and their causes.
  - align program initiatives with corporate strategic objectives to indicate impact and assist with strategic planning and efficacy analysis.

The engagement reinforced and solidified our belief that successful implementation of data analytics involves various departments and functional areas of the modern enterprise working in close collaboration. It includes departments like information technology, communications, operations, and human resources and functions like data science, business strategy, and subject matter experts. The key word is "collaboration." Experience shows that the total is always more than the sum of its parts.

Addressing reputational challenges successfully requires:

- building a system to enable reputation to be used as a strategic advantage with consumers, governments, and employees
- monitoring, evaluating, analyzing, and responding appropriately in real time
- predicting where and how communications have an effect on reputation (eg crisis life cycle, regressive analysis)
- learning how to allocate resources appropriately to gain maximum reputation strategic advantage.

While it is possible to outsource certain components of reputation strategy, companies should also consider developing their own internal expertise and experience. In addition to helping firms create and implement successful reputation strategies, we also train in-house staff to handle reputational issues as they arise and to address ongoing programs for protecting and enhancing reputation at the highest possible levels.

It is also crucial that the processes and techniques of reputation strategy be practiced and repeated over time. Truly effective reputation strategy requires multiple iterative processes and cycles.

New tools for extracting value from streams of data

The rise of big data and data science has given us new tools and techniques for extracting value from information, revealing hidden patterns, and uncovering fresh insights. New database technologies and advanced analytics solutions enable us to blend knowledge and expertise from multiple industries, improving business outcomes and driving faster cycles of innovation in hypercompetitive markets.

In today's communications environment, big data acts like an accelerant. Issues that took years or months to unfold now spin wildly out of control in hours or minutes. Clipping newspaper articles, holding focus groups, taking surveys—those kinds of tactics worked fine in an age when there were only three major television networks and essentially one national telephone company.

Events happen much more quickly now; news travels much faster. As a result, opinions are formed more quickly, and reputations can be damaged or destroyed within days or hours.

Given the dynamics of today's interconnected global culture, reputation strategy requires a blend of business intelligence, big-data analytics, predictive modeling, and forecasting capabilities. Traditional reputation management tools and approaches are often inadequate for dealing with modern-day challenges.

Reputation strategy is a combination of business acumen and scientific expertise. It should be used as an ongoing strategy to propel and protect business objectives, but it cannot be conjured up or jerry-built at the last moment or in the face of a crisis. It must be staffed and fully functioning *before* the crisis. Waiting until the emergency arises virtually guarantees a bad outcome.

Reputation is not a momentary phenomenon

Reputation building is a long-term strategic endeavor. It is an integrated set of ongoing processes, not an individual program or campaign or one-shot initiative.

Moreover, reputation is not a singular event or state. Reputation has multiple states and forms. It changes over time—sometimes slowly, sometimes with breathtaking speed. Building a reputation that is strong, resilient, and anti-fragile requires top-down leadership, executive sponsorship, and buy-in at all levels of the enterprise. It requires written policies, training, incentives, and discipline. The concept of *reputation as a strategy* must be woven into the culture of the organization.

In great progressive companies, reputation is an integral part of the cultural DNA. It isn't an afterthought; it's top of mind.

Don't try this at home

Reputation strategy isn't a "do-it-yourself" or "back-of-the-envelope" affair. In modern markets, reputation strategy is a genuine competitive advantage. Smart organizations will set aside the time and devote the resources necessary for creating and sustaining practical reputation strategies. They will invest in the people, processes, and technologies required for bringing those strategies up to speed and making them work, effectively and reliably.

We take an integrated approach to understanding and operationalizing reputation strategy—we use research and real-time data to help our clients obtain an understanding of their reputation and to inform the development of strategies for protecting and enhancing their reputation—and business—over time.

Reputation strategy is a set of scientific multidisciplinary processes aligned to generate insight, guide better business decisions, and create measurable value for the modern enterprise. It must be integrated into business planning and operationally embedded into organizational approaches across business units and geographies, with the proper executive sponsorship to promote the strategy. Ultimately, accountability sits at the highest level of the organization such as the CEO and board to increase awareness of the strategy and keep employees at all levels engaged.

Net takeaway

Reputation is a key strategic asset that provides tangible value to organizations through:

- creating trust in the organization's products and services
- providing access to policy and decision makers
- attracting and retaining the best employees
- driving credibility with outside partners
- serving as a critical success factors for investors.

Reputation must be protected and enhanced through authentic organizational values, decisions, behaviors, and actions, which requires a clear and evidence-based reputation strategy. Our portfolio of analytics and processes enables us to understand attitudes, opinions, and behaviors and to create predictive models that anticipate behavior, actions, and response to content.

18 Managing technological change

Jim Newfrock, Vice President, and Samitha Amarasiri, Principal Booz Allen Hamilton

Technology is a powerful force enabling efficient corporate enterprise growth when properly employed. The pace of "new" continues to accelerate, posing both new opportunity and possibly massive disruption within our established systems and data. As in the case with other change elements—environmental, political, legislative—savvy corporate boards will have the pulse on emerging technology and a view as to when is the ideal timing to drive adoption for maximum benefit without wasting limited capital. Following are seven questions proactive directors should consider when "talking tech" with their management teams.

How old is your daily use technology?

No kidding, what's the oldest system we have in production? What's the average life of the tech environment across all sources (eg hardware, software, apps, storage)? How old are the most mission critical? A strategy based on "sweating the asset" can be attractive because extending the useful life of existing investment can help to meet quarterly numbers or fund necessary resources to deal with new compliance issues and regulations. This, however, is a limited life strategy—the longer one puts off refactoring of information technology (IT) systems to current standards, the harder it is to make the change without breaking the "as is." Fragility and outages become more common as new systems built around the edge of the existing core simply don't integrate.

To do's:

- Build a true baseline. This goes beyond the fixed asset registry—software build components are some of the most compromising features of legacy and can be masked in financial reporting. Ongoing feature additions may be capitalized, but that is not the same as refactoring. Painting over the wood doesn't undo underlying decay.
- Consider appropriate allocation to staying current, neither too fast nor too slow—maximize the value of investments but

avoid overaging that puts the company at risk and creates a future bubble cost of replacements.

Are you mired in "yesteryear's" data management strategies?

Historically, information technology systems were grown in purpose built silos. Enterprise Resource Planning (ERP) management systems made inroads on integration but never encompassed the entire suite of applications. For those systems and industries not encompassed in the ERP, data continued to grow and proliferate in a much more ad hoc manner. Organizations have responded with data warehouse initiatives to further aggregate data, but not all yield the expected payoffs. The limitation of relational databases such as Oracle and Sybase require forethought in determining the exact type of analysis to be performed in order to organize and design the informational store. This becomes an expensive task in iterative build and design as the business continues to evolve the type and variety of questions to be answered. When the individual business lines reach the limitation point of an existing relational database, frequently they spin up brand new operational data stores for point analysis and further complicate information flows in the attempt to access all the information. Better methods and technologies exist, but, for many, there's significant inertia in the entrenched "as is" in part simply because it is what they know and understand.

To do's:

- Ask about initiatives to incorporate new techniques, like NoSQL, Hadoop, metadata tagging. If you're not hearing about these, your teams are probably not evolving your infrastructure.
- If initiatives like the above exist, inquire about plans to use them to accelerate the rollout of new solutions and reduce overall cost.
- On the development front, ask whether the approach is iterative in nature and how it will scale from targeted to full enterprise use case. Ensure that your enterprise is thinking about and making use of the new data management tools, but resist funding large platforms devoid of a specific set of measurable business needs.
- Ask to be briefed on the chief information officer (CIO) or chief technology officer (CTO)'s portfolio of projects and the segmentation into Exchange Transfer Load (ETL) traditional database treatment and those which might benefit from the NoSQL/Hadoop approach.

Is your security architecture in the medieval age?

Most boards are aware of both the potential exposure in allowing external access to their enterprises and the business friction created by trying to maintain a "closed shop." It is rare to find a corporation today with no Web presence and some semblance of e-services and communications channels. Simple firewalls and demilitarized zones are inadequate to protect against more sophisticated attacks—the old model of castle walls and a moat with select access to the "courtyard only" offers minimal protection in today's operating environment. The layered protection approach employed to protect traditional data structures—known as a "defense in depth" strategy—can be quite successful. However, with data being ubiquitous, a new set of techniques must be added. This might include the establishment of multiple security zones—"inner walls"—and greater attention to the underlying building blocks in your infrastructure and applications. Possibly of even more importance is the emerging concept of Attribute Based Access Control (ABAC), which could replace the present proliferation of Role Based Access Control (RBAC). RBAC security is largely "manual" and results in independent role definitions per application. Fluid organizational changes and new product alignments can cause role hierarchy models to rapidly become obsolete. In contrast, ABAC models derive access based on both rules and accurately tagged data and thus provide fine-grained entitlements ad hoc for authorized access and actions. ABAC rules use contextual information to make decisions without the overhead of traditional RBAC systems. Improvements in access to and use of the underlying data move beyond external/internal definition, and exploding role definitions, and become more adaptable and self-maintaining. For analytic application of the new data tools, security can be extended into the data itself through cell level security (eg Hadoop, Accumulo). Ultimately, emphasis needs to evolve including protecting the "king/queen behind a castle moat" and securing the data wherever it travels.

To do's:

- Well-advised boards should ensure first and foremost that there is an accountable officer responsible for the corporation's security. Good information security doesn't "just happen"—it takes leadership, focus, and consistency.
- Make sure the organization does not ignore today's more sophisticated risks. As in the case with other risk and change, a realistic picture needs to be drawn of the current situation, what's at risk, the honest probability of an issue, and finally, a quantified risk adjusted return in moving to next-generation security architecture.
- Encourage a holistic security architecture beyond inside/outside, authorized/not authorized; zones, attributes, and cellular security are all examples of new approaches that further secure the data.

Are your mobile and cloud initiatives a part of the business or floating untethered?

The power of mobile devices to transform businesses, to extend reach, and to allow "real-time" updates are profound. In tandem with cloud or virtualized data storage, truly the ability to have information access to products and services is nearly limitless. Unfortunately, too many technology initiatives in this space result in glitzy experiments or point use of what could be truly transformational change. Boards should be aware of spend and posture in this area. Cloud and mobile should both be done at a scale that can move the needle on performance. Be wary of mobile initiatives that are restricted only to the use of very small customer sets or only external users. Similarly, cloud initiatives for very select use cases are going to deliver only a fraction of the potential. While experimentation is valuable in the short run, the bigger payoff may be in truly changing how internal staff work and external customers access your enterprise. Boards should expect a more encompassing road map for mobile and cloud and steer clear of "me too" strategies that seek to use technology for a sense of "in vogue." Notional application will yield notional results.

To do's:

- As with new data technologies, ask when and where the organization is applying mobile and cloud strategies. Don't let antiquated security concerns stall broader application. The issues are solvable.
- Recognize that not all clouds are equal. A reputable, well-secured provider is fundamentally different from a "free" cloud storage offering.
- If the strategy presented is niche, consider it a starting point. Encourage business and technology teams to show the longer-term road map and think beyond simple inclusion of a new technology. Thoughtfully applied, cloud and mobile can be transformational.

Have you established a "Magna Carta" of data governance?

With the explosion of data, new techniques, and data management strategies, there is enormous value in the data embedded within the organization and accessible beyond the organization. As data availability increases, there will be a huge push for new insights, new growth ideas, and options to reduce cost and improve compliance, even while issues around consent, access, and ethical use will become more pronounced. For regulated entities, the concept of a chief data officer is catching hold and typically focuses on maintaining the integrity and compliance rules around the data. The convergence of the organization around data needs a strategy and organizational governance approach to match its culture and needs. For example, while the appropriate consents for use might be in place, has your team considered customer perception and are you comfortable with both the process and the decision? Data use will continue to evolve, and like research integrity in academia and drug development, appropriate oversight and governance of the methods, results, and publication must be carefully managed. Above and beyond this, increased access to data and use of canned tools opens up the risk of data error and mismanagement. While there's much to be gained through broader use of analytics, the potential for poor context or inappropriate computation increases.

To do's:

- Establish a data use governance/oversight committee. Don't assume that private information collected for one purpose can be freely applied to a new purpose.
- Test and monitor the access, use, and approach to research. As your data becomes more accessible through the use of a new data management strategy, the potential for amateur statisticians to miscalculate increases. Where analytics are high stakes, appropriate method is necessary. Increase integrity by ensuring that the mathematicians and the programmers are working collaboratively. Understand the "who" behind new analytics.

Has your organization produced an IT strategy or are you just being served appetizers?

Too often technology information comes to the board in bite-size chunks. The themes we've discussed thus far may all emerge as point discussions or presentations. Beyond discussing specific application of new technology, boards should also look to understand how they fit into an overall plan. Do you get a sense for the top-down view of technology needs and path forward when reviewing the strategy? A balanced strategy will have projects both tactical and strategic considering both risk reduction and growth. Many IT strategies assume and are based on evolutionary progression of technology. In today's environment, organizations need to make provision for the power of disruptive technologies. Left to meander, an IT strategy can damp out disruptive technology, and this may not be in the best interest of the company.

To do's:

- Ensure an IT strategy that is linked to the business initiatives, leverages new ideas, and is aligned with the pace of the business. Strategy needs to stay fresh and show progress. If the initiatives presented are aging without measurable progress, you may need to encourage more frequent metrics.
- Major milestones should demonstrate the impact of new technology and the business benefit and not merely highlight functional releases or increased deployment
- Objective vetting of a strategy can be impactful. Consider how to appropriately test against external views, to ensure reliability and that leading-edge, paradigm-shifting ideas are incorporated.

Is your staff ready for all this change?

While we watch our children jump into new technology and figure it out quickly, applying technology in the workplace takes more than just providing a slick consumer-like application and design interface. Training, process integration, planning for adoption, and the inevitable cultural change that comes with process and role change all impact the staff, their morale, and their support for adoption. Organizations need to actively manage technology adoption. As boards consider large potential change—technology and other—it is important to evaluate the human factor.

To do's:

- Ensure that the impact of new technology is carefully assessed and that process, training, and communication are planned for within project budgets in major new technology adoption. This will be particularly necessary for broad-reaching use of mobile or increased access to data. Business accountability in managing transition to new application access paradigms—from RBAC to ABAC, for example—also require thoughtful participation from departmental and functional managers.
- Board awareness, endorsement, and communication can play a key role in change readiness. The impact of staff knowing the importance the board places on technology or other encompassing change can have significant impact in their attitude and support for any transformational initiative.

19 Capital structure, leverage, and capital allocation[1]

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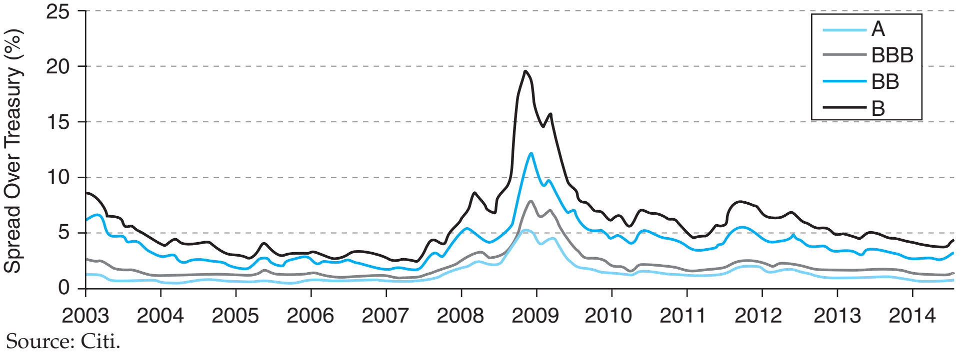
Effective financial strategy involves taking a comprehensive view of capital structure, funding liquidity, risk management, capital allocation, and distribution policy. Each of these elements of financial policy has important linkages to one another, and the optimal strategy involves taking an integrated view to develop a financial plan that maximizes the company's valuation. While the optimal solution for any company will be uniquely influenced by the company's long-term strategic and financial goals, each of these facets of corporate financial policy involves some common considerations that should be addressed in the context of the company's competitive opportunity and growth prospects within its industry.

Designing an optimal capital structure

The starting point for capital structure analysis often begins with an assessment of the optimal debt-equity mix on the company's balance sheet. Relative to equity, debt is a cheaper and more tax-efficient form of capital. However, high leverage ratios increase the probability of financial distress. An optimal capital structure entails choosing a leverage ratio that balances the cost advantages of debt financing against the risk of incurring financial distress and the costs associated with a weak credit profile. Financial distress costs can vary substantially across industries as well as over the economic cycle. In the aftermath of the financial crisis of 2007–2008, financing costs rose by three times relative to the historical average over the past decade (see Figure 1).

Figure 1 Dramatic rise in financing costs post-2008



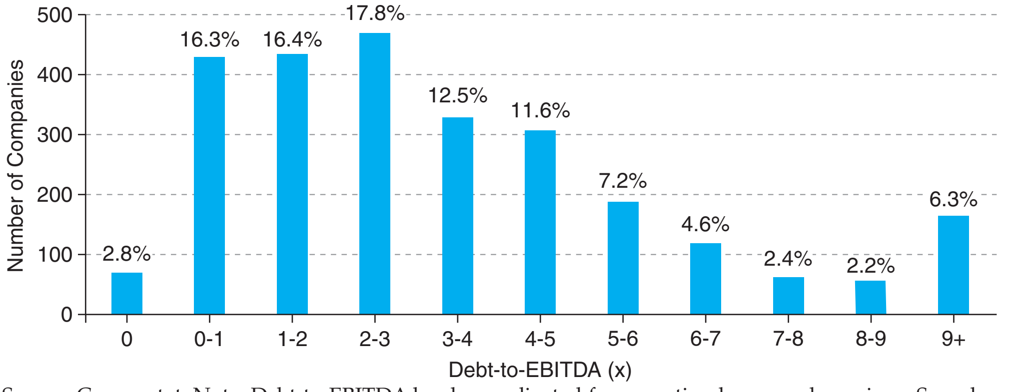
Source: Citi.

Beyond these cost-benefit trade-offs, an optimal capital structure also incorporates several other considerations. Among these, the flexibility afforded by the capital structure to pursue strategic investments either in the form of capital expenditures, research and development, or acquisitions tends to be an important factor that leads many companies to limit the amount of leverage on the balance sheet. For example, a buyer may find it more advantageous to finance an acquisition with cash from new debt issuance rather than a stock-financed transaction since it could enhance their competitive position as a bidder. As a result, it is not uncommon for companies that anticipate substantial growth through future acquisitions to be more conservative in their leverage choices so that they retain available "dry powder" for acquisition financing needs. Companies anticipating substantial acquisition driven growth often appear to target a capital structure that is more conservative than what strictly quantitative models would suggest.

Though flexibility to pursue an acquisition strategy is often a paramount consideration, evaluating how much flexibility to retain is a complex task, leading some companies to be potentially overconservative in their capital structure choices. Some companies may refrain from pursuing an acquisition if it endangers their credit rating, implying that this flexibility option is not frequently exercised. However, this behavior could sometimes be suboptimal. Even in the context of a ratings downgrade, strategically important transactions can be value additive if the buyer ensures adequate access to liquidity and an appropriate path to deleveraging.[2] In these situations, the ultimate outcome depends on the buyer's ability to manage rating agency concerns about management's willingness to take risk and view of financial policy going forward.

Access to capital markets through cycles is another important factor in capital structure choice. Despite substantial current market liquidity, the availability and access to debt capital can vary over time as interest rates, investor risk aversion, and market dynamics affect the amount of issuance capacity at various ratings. This is particularly relevant for lower rated, speculative grade issuers that face more constrained market access in periods of limited market liquidity. Thus, companies requiring regular and uninterrupted access to debt markets tend to find leverage ratios supportive of a credit rating at or near investment grade to be more desirable. (See Figure 2.)

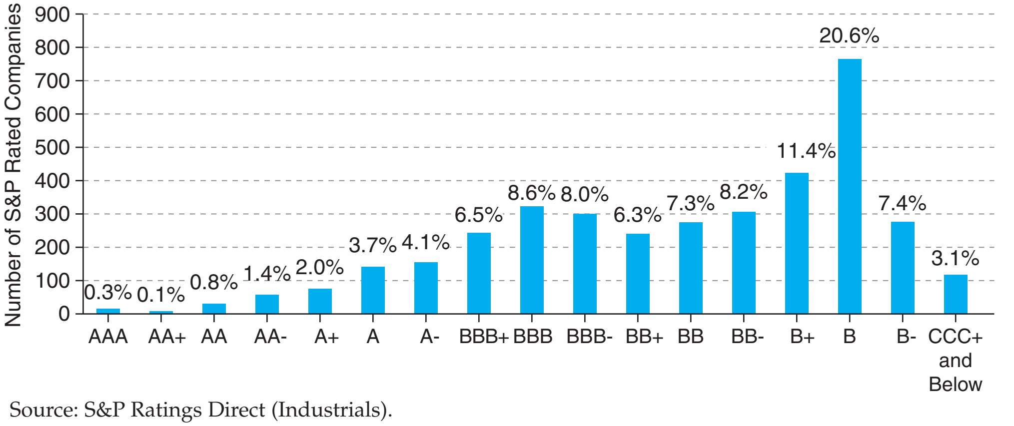
Figure 2 Leverage ratios across NYSE, AMEX, and NASDAQ



Source: Compustat. Note: Debt-to-EBITDA has been adjusted for operating leases and pensions. Sample includes all nonfinancial US common stocks traded on the NYSE, AMEX, and NASDAQ as of August 1, 2014.

For these reasons, it is common for companies to frame their capital structure decision in terms of a target credit profile rather than a target leverage ratio. While credit ratings are closely correlated with leverage ratios, they also tend to be correlated with other important company attributes such as the size and scale of operations, the stability and visibility of earnings, the nature and cyclicality of the sector, as well as management's commitment to a conservative or aggressive financial policy. In particular, company size tends to have a substantial impact on ratings. Issuers with a larger asset or revenue base that is well diversified across geographies, customers, and business segments tend to have higher and more resilient ratings than their smaller peers. Consequently, two companies in the same industry can have very different rating outcomes even though their leverage ratios may appear similar. The wide dispersion in credit ratings across companies is not simply driven by differences in leverage alone. (See Figure 3.)

Figure 3 Wide dispersion in credit ratings



Source: S&P Ratings Direct (Industrials).

From a ratings perspective, an important consideration is whether a company should target an investment grade or a speculative grade rating. An investment grade rating affords greater access to broader capital markets and provides additional flexibility in selecting among financing alternatives. Unlike investment grade debt, speculative grade issuance generally involves greater use of protective covenants. Only in recent years have covenant-lite loans emerged as a more flexible funding alternative for issuers pursuing leveraged transactions.

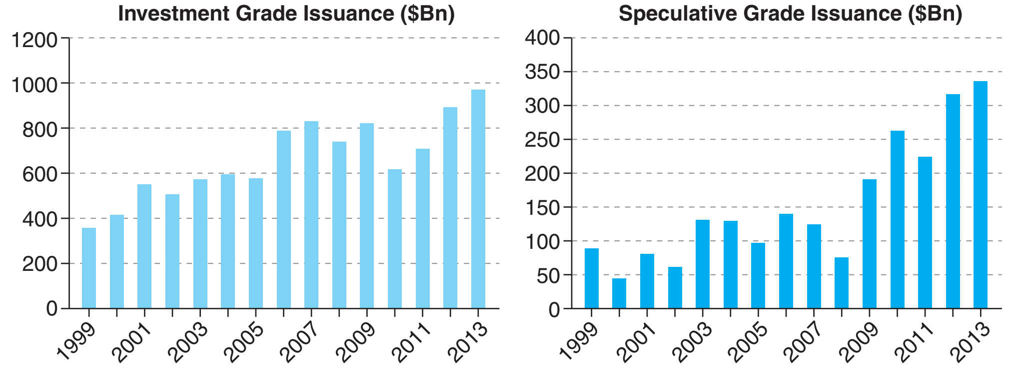
The cyclicality of a company's cash flows can also materially impact the choice of an optimal credit rating. Though credit rating agencies often take a "through the cycle" view of a company's capital structure, cash flows in some industries are highly cyclical. In such situations, particularly if a company is close to the speculative grade threshold, it may be desirable to target a rating that is higher than the theoretical optimum to build a sufficient cushion for the rating in the event of an economic downturn. Such downturns carry a disproportionately larger effect for companies with sensitive cash flows and weaker credit profiles. Speculative grade issuances exhibit significantly more volatility over the course of an economic cycle than the market for investment grade debt.[3] Stress-testing the capital structure under various economic scenarios is emerging as a tool to assess the appropriate rating buffer for companies that need to manage this cyclicality.

Credit ratings also play a prominent role in counterparty risk assessment as customers and suppliers are increasingly engaged in enterprise risk management. In a 2010 survey, about 70 percent of respondents said that they use credit ratings along with credit default swap spreads to assess counterparty risk.[4] In sectors such as financial institutions, payments, and processing, counterparty risk is an important consideration in seeking new business opportunities. Maintaining a low counterparty risk profile can also be an important capital structure consideration in sectors involving long-dated contracts and licensing agreements, such as in defense, health care, and information technology. Therefore, a strong credit rating can materially contribute to the firm's overall business competitiveness.

In addition to the choice of the optimal leverage ratio or credit rating, several other aspects of capital structure design warrant careful consideration.

Liquidity management: Liquidity management has become a central aspect of capital structure design in light of the recent financial crisis. Companies with high leverage ratios can mitigate financial risk

Figure 4 Greater fluctuation in issuance volume for speculative grade issuers



Source: Bloomberg.

by ensuring adequate access to external sources of liquidity to meet planned and unexpected needs for investment and capital structure refinancing. Maintaining sufficient cash holdings along with access to bank loan facilities is therefore important for all companies, and access to adequate liquidity has now become part of the credit rating evaluation process. For firms that have limited access to the bank market, synthetic solutions employing capital market alternatives have emerged as tools to enhance liquidity. Treasury and working capital management solutions are also gaining popularity as efficient methods to centralize cash management and free up operational liquidity needs that can be used to support overall corporate liquidity.

Funding base diversification: The global banking sector has seen significant changes in recent years as banks adapt to the new regulatory environment including Basel III capital standards, Dodd-Frank regulation, and the introduction of new liquidity requirements. These changes have forced banks to carefully evaluate the trade-off between balance sheet growth, underlying capital requirements, and return dynamics across the credit spectrum. Evaluating the use of bank credit and diversification of funding sources has thus become an increasingly important aspect of optimal capital structure design. The advantages of funding diversification are particularly important for speculative grade issuers in light of Basel III requirements that impose higher risk weightings on their offerings, resulting in reduced credit availability and higher pricing. Companies can also diversify their external funding base through the issuance of convertible and hybrid securities, which can bring a broader base of investors to support the capital structure beyond traditional fixed income investors.

Liability management: Optimizing the structure of liabilities is a critical element of capital structure. Short tenor debt is typically cheaper but entails greater refinancing risk. Companies requiring access to the commercial paper market typically need to target strong investment grade ratings. At the lower end of the credit spectrum, proactively addressing upcoming maturities and avoiding large maturity towers is essential to managing refinancing risk. Interest rate and exchange rate risks pose additional challenges. However, an appropriate mix of fixed and floating rate debt can optimize borrowing costs as well as manage risks associated with changes in interest rates and the term structure. Overseas denominated debt can similarly serve both as a hedge against exchange rate movements and as a platform for the issuer to establish a more globally diversified investor base.

Business and financial risk management: A comprehensive risk management program can be a vital component of capital structure design since corporate cash flows are exposed to a multitude of risks stemming from foreign exchange, commodity prices, and market risk factors. In some sectors such as consumer and natural resources, for example, commodity price volatility can have a substantial impact on cash flows, thereby affecting leverage ratios and potentially impairing credit ratings. The ability to hedge such risks can make cash flows more stable, mitigating some of the risks associated with a high leverage ratio. Therefore, the choice of a target leverage and credit rating should be considered in conjunction with the company's financial exposures arising from these operational considerations and its ability to manage these risks.

Managing contingent and off-balance sheet liabilities: Managing off-balance sheet exposures such as liabilities from defined benefit pension plans has become an increasingly important element of capital structure assessment for firms with legacy healthcare and retirement programs. Over the past decade, many firms sponsoring defined benefit pension plans have experienced significant levels of plan underfunding and rising contributions stemming from the low interest rate environment. As pension underfunding has increased, pension-adjusted debt ratios have risen, pressuring credit ratings and limiting financial flexibility. The size of pension liabilities has thus become an important consideration in designing the optimal capital structure. Risks to the capital structure stemming from pension plans can be managed in a variety of ways. These tools include liability-driven investment strategies, de-risking strategies, as well as risk transfer strategies such as pension buyouts, buy-ins, and longevity swaps.

Capital structure design should also consider the extent of contingent liabilities that arise in the context of potential litigation due to unforeseen legal risks, environmental exposures, and a changing regulatory environment. The often unpredictable nature of these risks can create exposures to financing and operating plans that can be partially mitigated through a robust capital structure and access to adequate liquidity.

Implications for capital allocation

Capital structure choices have important ramifications for capital allocation decisions. An appropriately designed capital structure can help lower financing costs and affect the hurdle rates used to evaluate various investment alternatives. Not surprisingly, appropriate capital allocation in conjunction with a well-designed capital structure directly influences firm value. Across most sectors, equity valuation multiples are closely linked to both the firm's cost of capital as well as the incremental return from investments over the cost of capital.[5] Hence, corporate executives should holistically evaluate capital structure decisions with an emphasis on allocating capital toward businesses that are likely to generate the highest risk-adjusted returns for the firm. Under this portfolio approach, in some cases it may even be rational to invest in businesses generating a low current return if these projects carry a valuable embedded growth option and/or complement other business units within the firm.

Along with new investments, distribution of capital in the form of dividends and share repurchases has become an integral part of the capital allocation process. While equity markets tend to prefer a stable or rising pattern of dividend payouts, share buybacks have also become a regular component of shareholder distributions for many firms. Since distribution preferences vary across investors, firms need to pay careful attention to their shareholder composition and appropriately balance the decision to reinvest capital in new growth projects versus returning capital in the form of dividends and share repurchases. A balance sheet that accommodates these funding considerations from shareholder distributions is another fundamental step in optimizing capital structure and maximizing shareholder value. Companies that successfully integrate investment and distribution decisions alongside the long-term strategic and financial objectives of the firm are best positioned to deliver value through capital structure management.

Notes

1 We thank Dan Pakenham for helpful feedback and discussions.

2 For a detailed discussion and analysis of transformative acquisitions, please see our Citi Financial Strategy and Solutions Group (FSG) report, *Time to Transform*, Ajay Khorana, Elinor Hoover, Anil Shivdasani, and Nikolina Kalkanova, 2014.

3 The annual change of aggregate speculative grade issuances is four times more volatile than investment grade issuances from 2000 to 2013.

4 For a detailed discussion of counterparty risk, please see our Citi FSG report, *2010 Corporate Finance Priorities*, Carsten Stendevad, Anil Shivdasani, Shams Butt, Ajay Khorana, Dan Pakenham, Gabriel Kimyagarov, and Michael Simonetti, 2010.

5 For a detailed discussion of corporate valuations and the cost of capital, please see our Citi FSG report, *Hedging Cost of Capital*, Elinor Hoover, Ajay Khorana, Anil Shivdasani, Jeffrey Colpitts, and Lorenzo Beacco, 2013.

20 How to win the say-on-pay vote

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For most companies, the say-on-pay vote is an annual rite of spring just like baseball's opening day. Like all competitors, company directors and executives are interested in one outcome—winning.

And, for the first three years of say-on-pay voting, companies have been doing so in overwhelming numbers as companies have done a good job of aligning pay and performance, differentiating pay based on actual results, eliminating poor pay practices, and communicating these efforts to shareholders. But each year, the playing field changes and the bar is raised, requiring companies to consider doing things differently (eg realizable pay, relative pay-performance analyses, proxy advisory firms' voting simulations, shareholder outreach) in order to continue their successes or overcome setbacks.

With the right planning and preparation, including practices, companies can maintain or improve their chances of winning their say-on-pay vote more than the participants in those other springtime contests.

What is say-on-pay?

Born out of Dodd-Frank and formally enacted in 2011, say-on-pay is a nonbinding vote by shareholders as to whether they support or do not support the pay program in place for the company's named executive officers (NEOs), as described in its proxy for the prior year (ie the vote in 2014 is in consideration of the pay reported for 2013). The board of directors is not bound to make any changes as a result of the vote. According to the Securities and Exchange Commission (SEC) rules, companies must conduct a say-on-pay vote once every three years and provide shareholders the opportunity to vote on the frequency of their company's say-on-pay vote once every six years. Most companies (81 percent) adopted annual say-on-pay voting frequency in 2011, with others conducting votes every three years (18 percent) or every two years (1 percent).

What is a winning vote?

What constitutes a say-on-pay "win" varies depending on one's perspective. Most companies' by-laws define a "win" as a simple majority. However, institutional investors typically expect more than a simple majority, though views vary. Finally, ISS and Glass Lewis have greater expectations:

1. ISS considers a vote with less than 70 percent support to be indicative of "significant opposition" to a company's executive compensation program. Interestingly, our research indicates this level of support corresponds to the historical level of support companies receive on average (65–70 percent) when they do NOT receive ISS's support.
2. Glass Lewis considers a vote with less than 75 percent support to be indicative of "a significant level of shareholder disapproval."

As one might expect, both ISS and Glass Lewis expect companies to respond to a perceived lack of support by addressing problems with their pay program and disclosing the details of how this was done in the following year's proxy. This expectation weighs heavily in ISS's and Glass Lewis's future voting recommendations and does not consider the level of shareholder support garnered or the nonbinding nature of the vote.

Directors also vary in their view of what constitutes support. The survey Pay Governance conducted with NYSE Governance Services and *Corporate Board Member* asked directors about these issues. We asked what level of say-on-pay support should require a strategic review of executive pay programs. Seventy-four percent of respondents suggest that support below 70 percent indicates a need for strategic review. Only 18 percent indicated 50 percent support to be the threshold for detailed review. We also asked what level of say-on-pay support should *mandate* changes to executive pay programs. Forty-two percent indicated 50 percent to be the threshold for pay changes, while 22 percent consider 70 percent to be the threshold. In our experience, directors also consider year-over-year changes in say-on-pay support. A vote that remains high (eg 90 percent) but down slightly from the prior year probably is no cause for concern. However, a vote that slips to 75 percent or 80 percent from over 90 percent may precipitate some discussions among directors about the program's practices, pay levels, linkages to performance, and shareholder expectations.

Since the initial say-on-pay votes in 2011, the average level of support for all companies is remarkably high and consistent year over year (Table 1).

Three years of vote results indicate shareholders overwhelmingly support the executive compensation models in place. Despite all of the media attention on

Table 1 Average level of support for say-on-pay vote

	2011	2012	2013	Total/Aggregate
Companies "Winning"	98.6%	97.5%	97.7%	97.9%
Companies "Losing"	1.4%	2.5%	2.3%	2.1%
No. of Companies "Losing"*	37	56	53	146
Average Level of Support for "All" Companies	91.6%	90.8%	91.3%	91.3%

* Includes nine companies that have failed twice and three companies that have failed all three years.

and, in some cases, outcry over executive compensation, shareholders believe the pay model works.

Why have companies won?

Pay Governance's research and analysis have proven executive pay and company performance are aligned over the long term. Pay Governance researched CEO pay opportunities from 2003 to 2012 for a constant sample of long-service CEOs at 45 Fortune 500 companies. This long-service, constant CEO sample was selected to prevent bias due to changes in incumbents, company mergers, or significant acquisitions.

For this group, we assessed pay and performance for the 10-year performance period ending in the first quarter of 2013. Performance was based on the company's total shareholders' return (TSR). Pay for the period equaled the CEO's realizable pay (actual salaries, cash incentives earned, vesting date value of stock awards earned for continued service or meeting performance goals, realized gains on exercised options, and the paper value of all unvested or outstanding equity awards at the end of the period). Realizable pay is quite different from the pay disclosed in the proxy's summary compensation table (SCT), which is actual salaries, cash incentives earned, and the grant date or accounting value of equity awards. The accounting value of equity awards can vary significantly from the realizable value, which takes into account changes in the number of shares earned and the stock price based on changes to a company's financial results. In our view, realizable pay is a better basis than SCT pay for evaluating the alignment between pay and performance.

Our research helps explain why shareholders have been overwhelmingly supportive in their say-on-pay votes:

1. Realizable pay has a much higher correlation with TSR performance than pay disclosed in the SCT of proxies (Table 2).
2. Companies with high performance have meaningfully higher realizable pay than low performers (Table 3).

Table 2 Correlation to TSR

Compensation Definition	5-Year	10-Year
SCT/Proxy-Reported Pay	3%	–6%
Realizable Pay	41%	38%

Table 3 10-Year Analysis

Segment	Median TSR	Total Realizable Pay as a % of Low-Performing Group Realizable Pay	
		Median	*Average*
High TSR Performers	640%	217%	209%
Medium TSR Performers	313%	128%	164%
Low TSR Performers	91%	100%	100%
S&P 500	85%		

In addition to strong pay and performance alignment, most companies have done a good job addressing executive pay practices that are typically viewed negatively, including: reducing or eliminating executive perquisites, eliminating tax gross-ups associated with perks and other benefits, reining in of lucrative retirement benefits, transitioning from individual employment contracts to executive severance polices, eliminating single trigger change-in-control (CIC) equity awards, as well as reducing CIC-related benefits.

Our experience suggests companies historically have won their say-on-pay vote by:

- having strong TSR results
- basing cash and stock incentives on performance metrics that generally appear to be highly correlated with their investors' returns
- setting goals for incentives that are appropriately demanding from both the perspectives of shareholders and executives
- aligning pay opportunities and resulting pay levels well versus those performance expectations
- avoiding "toxic" pay practices that could potentially offset any of the benefits from the above practices.

How can companies continue this success?

Now that we are in year four of say-on-pay, some might argue there is little more to be done to enhance the alignment of pay and performance and most companies have addressed poor pay practices. However, ISS and Glass Lewis continue to modify their voting guidelines and with volatile TSR and an unpredictable economy, companies are always at risk. Diligence will remain the watchword.

In order to continue the say-on-pay winning streak, companies should:

- eliminate any "problematic" pay practices that still exist that do not have a clear business rationale or support the company's strategic direction
- validate and communicate the business case for those practices that remain
- conduct realizable pay and performance analyses relative to peers to identify any potential issues between pay and performance alignment
  - Analyses could be based on TSR as well as other key financial metrics.
  - Analyses can also be done separately of annual cash compensation (salary plus actual bonus earned) to determine if issues reside with the company's annual or long-term incentive plans.
- assess annual and long-term incentive payout levels versus the company's historical financial results or past performance as well as relative to competitors or peers
- analyze the correlations between metrics used for annual and long-term incentives and stock price valuation, stock price growth, and TSR
- examine the degree of difficulty associated with incentive goals from multiple perspectives: company's historical results, peers' historical results, probability of achievement, cost of capital, analysts' estimates of the company, as well as peers and discounted cash flow modeling.

Furthermore, companies should examine and understand if ISS and Glass Lewis will support their say-on-pay proposal in advance. Say what you might about ISS, their quantitative pay-for-performance tests are fully disclosed and pretty well understood, making it relatively easy for companies to simulate them and understand any potential exposure. While less transparent than ISS, Glass Lewis's pay-for-performance tests can also be tested. Conducting these tests well in advance of a company's annual shareholders' meetings helps companies understand their implications, determine the need for additional actions, appropriately structure their Compensation Discussion and Analysis (CD&A) and conduct any necessary outreach to ISS or institutional investors.

If necessary, companies may need to go beyond the quantitative tests of ISS and Glass Lewis. While proxy advisory firms' quantitative analyses have become clearer, their qualitative assessments of companies' pay programs have become more subjective and murky at best. While it is well known that "HIGH" concerns from ISS regarding a company's quantitative pay-for-performance alignment will lead to a qualitative assessment of the company's pay practices, we have observed inconsistencies in how these qualitative assessments are applied. Numbers aside, it has normally been difficult for companies to understand what issues they should focus on to secure support.

Pay Governance researched how various qualitative factors affected ISS's voting recommendation in 2013 for those companies receiving a "HIGH" concern on the ISS's quantitative pay-for-performance tests. We focused on ISS as access to their reports is more readily available than those for Glass Lewis. This research led to a proprietary methodology ("Qualitative Factors Score") to understand how ISS's qualitative reviews are related to its vote recommendations. The core of this methodology is a database of 118 companies, including all S&P 1500 companies receiving "HIGH" levels of concern on their quantitative tests for 2013. These companies normally are subjected to ISS's qualitative review. We split the sample into companies receiving "FOR" and "AGAINST" vote recommendations from ISS and analyzed the influence of their Qualitative Factors Score on the ISS vote recommendation. We found:

1. The balance between ISS "praises" and "concerns" appears to have been influential in ISS's final 2013 vote recommendations. In other words, companies should have more pay practices that are viewed positively by ISS than those that may be viewed negatively by ISS.
2. ISS analyst subjectivity and unique company factors may play an important role in final vote recommendations.

However, failure to gain ISS or Glass Lewis support is not a death knell. Eighty-four percent of companies NOT receiving ISS's support still pass every year, though the average level of support (72 percent) is 23 percent lower than those receiving a "For" recommendation.

How do companies stay ahead?

Acknowledging the changing ISS and Glass Lewis tides, shareholder outreach is essential in this fluid say-on-pay environment. Companies need to understand constituents' perspectives. No politician goes into an election without understanding the issues near and dear to their voters' hearts; companies should do the same. Companies need to know their shareholder base, including the percent of the overall vote each investor controls, the role ISS and Glass Lewis play in determining their voting recommendations, and any internal voting policies those institutions may have.

Good communication of programs' pay and performance alignment is essential. Unfortunately, this is an area where most companies aren't as effective as they could be. CD&As are getting longer but not necessarily better. Considerable time is spent describing the pay program and the process but not enough is spent on how pay and performance are aligned. In our view, more companies need to focus on hard facts in the CD&A:

- Demonstrate the stretch in the performance goals, which could be done by comparing current year targets to prior year's targets and current year actual results to prior year's actual results.
- Discuss the (real or perceived) degree of difficulty associated with goals based on past results, those versus peers or probability of achievement.
- Illustrate current year's payout levels versus prior years' payout levels and

the related volatility in payout levels to communicate the truly "at-risk" nature of compensation.
- Include realizable pay analysis, which few companies disclose (even if they conduct the analysis) and may take companies more time getting comfortable with the results of such analyses. For example, high relative realizable pay for high relative TSR results is just as appropriate of an outcome as low (or median) realizable pay for low (median) relative TSR. Back-testing realizable pay analyses for pay-for-performance alignment may help in this regard.
- Communication can no longer be a one-way "CD&A Avenue." Companies need to actively engage with shareholders, even if preliminary results appear to be positive. Developing and cultivating relationships with investors will enable companies to gather context, potentially pay dividends in the future, and should become an integral part of the annual compensation process just like the say-on-pay vote, proxy and CD&A preparation, goal setting, and so forth.

In approaching shareholders, companies typically go beyond trying to influence or change the voting recommendations of ISS and Glass Lewis. Specifically, in conducting shareholder outreach companies should consider the following:

- *What influences institutional investors' voting:* The company's pay policies and analyses (including those analyzing pay and performance alignment), its proxy statement, and direct engagement with the investor group are viewed as more effective in influencing institutional investors than proxy advisor recommendations or third-party research.
- *What's the reason for engagement*: This could range from communicating the pay plan to improve understanding, seeking shareholder input about current practices, discussing potential program changes, or responding to low shareholder support, which is probably the most common reason.
- *What is the proxy solicitor's role*: Proxy solicitors may have some insights into portfolio managers that may be able to influence the vote, whether they are influenced by proxy advisory firms' recommendations or have their own guidelines about what are the most critical issues (inaccuracies in proxy advisory firms' reports, peers for benchmarking, incentive plan design, goal difficulty, CIC benefits, etc).
- *Who should represent the company*: Most investors do not want to hear from the CEO, as their pay could be at the heart of the issue. The Compensation Committee Chair is an obvious choice as they are responsible for administering and managing the company's pay program from the board's perspective. However, companies should consider the issues being discussed with investors and whether they warrant the chair's participation. Finally, whoever is involved from management should be close enough to the issues to have a meaningful conversation.
- *When to engage*: Waiting two days before the annual meeting will not cut it. Even trying to schedule something during the height of the proxy season (say, January to May) may be difficult. Our experience is that firms like ISS, Glass Lewis, and other institutional investors have ample time outside the proxy season crunch.
- *Who to engage*: While portfolio managers may not be doing the actual voting at investment firms, they may have some influence on the voting process, particularly at mid-size firms as opposed to small firms (which may rely more on ISS and Glass Lewis recommendations) or large ones (that have their own governance groups).
- *What to say:* Companies need to be careful here so as not to violate Regulation Fair Disclosure requirements. Investors want to understand how the pay program supports the company's goals of creating

value as well as the rationale behind the program's decisions. More important, shareholders (and advisors) want assurance that their views are being heard and the company will consider and/or commit to changes, as appropriate.

Obviously, each company's approach will vary depending on the facts and circumstances. However, an ongoing dialogue with shareholders can help build support for the company's pay program, provide insight into potential problems outside the areas of concern for proxy advisory firms, and may provide companies benefits when they are most needed—at a time when their programs are being challenged by shareholders.

What if you fail?

Nobody's perfect—what happens if you stumble and lose say-on-pay (or the support is a slim majority)? In 2012, 26 of the 37 companies that had failed say-on-pay the prior year gained majority support. We think say-on-pay winners and losers should examine the factors behind the tremendous turnaround in support from the 26 companies that lost their vote in 2011 but won it in 2012. In other words, these companies were first-time losers, second-time winners. The most common actions by these companies were:

- *Communication*—enhanced shareholder outreach, proxy advisor outreach, more transparent CD&As, enhanced disclosure of performance goals, and goal setting rigor.
- *Pay levels*—some companies reduced pay levels and disclosed that they were "sharing the pain" felt by shareholders.
- *Design*—two thirds of companies made changes to their long-term incentive programs, with almost all of them adding a performance-based program (eg performance-restricted stock, performance shares) going forward.
- *Stock ownership guidelines*—fifty percent implemented or enhanced executive ownership guidelines for their CEO and NEOs.

There's always next year—winners and losers both are looking ahead to next year's say-on-pay vote and wondering what changes may come to this game: legislation, voting policies, and sentiment may change. Companies need to bring their A Game, which requires continued thoughtful program design and continued testing and rationalization of that design and resulting pay levels, as well as savvy communication.

"To win. Nothing else matters,
and nothing else will do."

– Sandy Koufax.

21 Board of director compensation: evolution and aligning design with shareholders

Stephen J. Pakela, Managing Partner, and John R. Sinkular, Partner Pay Governance LLC

Over the past 15 years, the methods of compensating nonemployee directors have changed in tandem with the risk and workload of being a director. The catalyst for change over this time period includes a variety of regulatory changes, such as Sarbanes-Oxley and Dodd-Frank, revamped proxy disclosure rules, which have enhanced transparency, and an overall increase in shareholder activism. For example, audit committees meet more frequently and must have a qualified financial expert as one of their members; compensation committees have greater workloads as a result of a combination of the enhanced proxy disclosure rules and the impact of the say-on-pay shareholder advisory vote; and governance committees must now wrestle with governance practices and policies and shareholder rights issues.

In simple terms, today's corporate director needs to dedicate more time to the job, assume greater risk, and meet a higher qualification standard. Arguably, these issues and newer issues such as director tenure limits have reduced the pool of available individuals who are willing or qualify to serve as a director. As with all things impacted by supply and demand, the total compensation provided to directors has risen. Over the past decade, total director remuneration has increased annually by approximately five percent on average. Despite this level of increase surpassing the typical increase in employee pay, it lags behind the increase in CEO compensation over the same time frame.

The methods and design of director compensation programs have changed over time as well. The basic construct of director compensation arrangement continues to be a mix of cash compensation and an equity award. However, the means of delivering those two elements has changed rather dramatically over the past decade.

Design principles

In designing and administering director compensation packages, a common framework followed by companies includes the following:

1. *Pay philosophy*—Total pay is targeted to be competitive with the market median with an emphasis on equity compensation and an ongoing stock ownership or holding requirement.
2. *Peer group*—Comparisons are made to the company's pay peer group (companies used for CEO and senior executive pay benchmarking) and, as appropriate, a large data set of comparably-sized general industry companies.
3. *Pay benchmarking*—Companies conduct detailed pay benchmarking annually or, at least, every two years.
4. *Pay adjustment timing*—The bias is to not make changes every year (even though pay benchmarking may be conducted more frequently) and to consider increases following a "lead-lag" approach.

In the following sections, we review each element of compensation.

Cash compensation

The traditional directors' compensation program included both an annual retainer and a separate fee provided for attending board and committee meetings. The presence of a meeting fee encourages meeting attendance and automatically adjusts for workload as measured by the number of board and committee meetings. Some companies even provide a lower meeting fee for telephonic meeting participation. Meeting attendance is less of an issue today as companies disclose whether their directors attend at least 75 percent of meetings and proxy advisors scrutinize those directors who fail to meet the threshold. More recently, most large companies and more mid-size and small companies have simplified their approach to delivering cash compensation by eliminating the meeting fee element and instead providing a larger single cash retainer. The rationale for this change is to ease the administrative burden associated with paying a director a fee for each meeting attended and to communicate that meeting attendance is expected with less emphasis on actual time spent and more emphasis on the annual service provided to shareholders. We expect this shift to continue among smaller and mid-size companies where the elimination of meeting fees is not yet a majority practice.

Growth in the value of director cash compensation has varied and is best analyzed before, during, and after the Great Recession (2008–2009). Prior to the Great Recession, fees were increasing at a high single-digit percentage rate as boards transitioned to the new regulatory requirements that demanded a greater workload and increased the level of risk and responsibility for directors. During the Great Recession, board fees and retainers were largely frozen or in some cases reduced to align with the generally modest reductions in executive salaries at some companies. More recently, director cash compensation has generally increased at a rate of three percent to five percent as a more normal economic climate has settled in.

Equity and cash compensation mix

Over time, as director compensation has increased, the trend has been to provide greater focus on equity compensation, which provides direct economic alignment to the shareholders whom directors represent. Currently, it is common to have equity represent a slight majority of regular annual compensation—such as a pay mix of equity compensation 55 percent and cash compensation 45 percent. In analyzing broad market practices, we typically find directors' total compensation allocated 40 percent to 50 percent to cash compensation and 50 percent to 60 percent to equity compensation. The emphasis on equity compensation is also directionally consistent with the typical pay mix for senior executives.

Equity grant design

In the early 2000s, stock options delivered most or all of director equity compensation, similar to the approach for compensating executives. The strong trend since then has been to use full-value shares to deliver all (or at least most) of equity compensation. This shift in approach was driven by the change in accounting standards, negative views of stock options as a compensation vehicle for directors (and executives), and other factors. During this time the perception of using stock options for directors changed dramatically, particularly from high-profile scandals in the first half of the 2000s (Enron and WorldCom, among others) and the reassessment of the alignment of the incentive characteristics of stock options relative to directors' duties and fiduciary responsibilities. As a result, today, the most common market practice is to deliver equity compensation solely through full-value shares; a minority of companies (typically 25 percent or less, depending on the set of companies analyzed) continue to grant stock options.

Companies vary in the delivery of the full-value shares with the most common approaches including:

1. restricted shares (restricted stock or restricted stock units), which have a restriction period that may range from six months to three years (with one year generally the most common)
2. deferred stock units, in which actual shares are not delivered or sold until departing the board
3. outright grants, which are immediately vested at grant.

The use of performance-based awards for directors is nearly nonexistent due to the desire to avoid any misperceptions between compensation and their duties and fiduciary responsibilities (which include setting performance goals, then assessing and certifying performance results for executive incentive compensation plans). Those companies that desire to give some level of performance-based compensation typically do so through a modest grant of stock options in combination with a grant of full-value shares.

Board leadership compensation

Following the scandals mentioned above, the debate over board leadership intensified with many outside governance experts calling for a separation in the board chairman and the CEO roles. While this debate is ongoing, a governance model has emerged where independent directors are either led by a non-executive chairman (at companies that have separated the leadership role) or a lead director (for companies that maintain a combined chairman and CEO role or an executive chairman). At companies that have separated the board chairman and CEO roles, an independent non-executive chairman is appointed to lead the independent directors. The responsibilities of this position vary by company as does the compensation of the position. Typically the non-executive chairman receives an additional chairman's retainer delivered in cash, equity, or a combination thereof that is in addition to the typical director compensation. At the low end of the spectrum, the non-executive chairman's extra retainer is typically positioned modestly above the extra retainer provided to the audit committee chairman (or the lead director, as discussed below), or at the high end of the spectrum, the additional retainer can be significantly higher, such as an additional $200,000 or more.

At a minority of companies, the executive chairman is typically a founder or outgoing CEO. This position is typically limited in duration, ranging from three months to two years, and generally receives the executive's previous salary and bonus opportunity with no or a modest equity award. Executive chairmen typically assist the transition of the new CEO and continuation of an ongoing corporate strategy.

For those companies that have decided to continue with a single combined role, an independent director serving in the role of lead director (or presiding director) has emerged as a best practice to lead an executive session of the independent directors. When this role emerged in the years between 2000 and 2005, the lead director often received no additional compensation and frequently rotated among independent committee chairmen or was represented by the governance committee chairman.

More recently, for companies to maintain the combined role of chairman and CEO, lead directors have become more prominent and are now typically appointed by the independent directors and are compensated with an additional retainer, which in many cases is above that provided to the audit committee chairman.

Board committee chairmen are typically provided an extra retainer to compensate for the additional work with management and outside advisors in preparing to lead committee meetings. Following the introduction of Sarbanes-Oxley, the extra retainer provided to the chairman of the audit committee increased at a higher rate than other committee chairs in recognition of the additional workload in terms of number of meetings and required preparation, heightened risk, and the financial expertise required of the position. Following the introduction of the enhanced proxy disclosure rules in 2006 and the say-on-pay advisory vote in 2010, extra retainers provided to the chairman of the compensation committee were increased to be positioned closer to (or just below) that of the audit committee chairman.

Benefits and perquisites

Few companies provide retirement benefits and perquisites to directors, which results in "total compensation" typically equaling the sum of cash meeting fees and retainers, and annual equity grants. Those companies that previously had director retirement plans transitioned away from such programs, due to the increased focus on equity compensation, the broader trend to close defined benefit plans for employees, and other factors. Some companies continue to provide directors (and executives) with a matching charitable gift contribution to the charity of the director's choice.

Stock ownership guidelines and requirements

There is near universal use of stock ownership guidelines or holding requirements for directors, which is consistent with the prevalence of requirements for senior executives. In order to align directors' economic interests with the shareholders they represent, companies typically provide full-value equity awards and require minimum stock ownership specified as a multiple of the annual retainer or equity award value. At larger companies, the minimum stock ownership guideline is typically three to five times the annual retainer or equity award value, with the expectation that this will be achieved within five years of joining the board.

Some companies also have stock holding requirements, which may be used in addition to stock ownership guidelines. For example, companies may require directors to retain net (after tax) shares upon lapse of restrictions until the minimum stock ownership guideline is achieved. Other companies may solely use stock holding requirements (such as grant equity compensation as deferred stock units) to ensure directors accumulate and retain meaningful levels of stock ownership through their tenure as a director.

Due to their duties and fiduciary responsibilities, shareholder optics, and other factors, many directors decide to retain all of the equity compensation provided during their board service. In addition, some directors may decide to make outright stock purchases to accelerate their accumulation of company stock.

Contemporary best practices

Over time, director compensation levels and program design have evolved to address the changing regulatory environment and changing role of the typical director, as described above. Director compensation arrangements have settled to a general design adopted by most companies:

- annual cash retainer representing approximately 40 percent to 45 percent of the total program value
  - some continued use of meeting fees (with smaller annual retainer), particularly at smaller to mid-size companies

- annual equity award most often delivered through full-value shares that vest after a specified time and representing approximately 55 percent to 60 percent of the total program value
  - some continued use of stock options in combination with full-value shares
- extra retainers for leadership positions (ie non-executive chairman, lead directors, and committee chairmen) and in some instances members of committees who are impacted by significantly different workloads (ie audit committee members) when compared to other committees
- stock ownership guidelines representing three to five times the annual retainer.

Going forward, a number of issues could potentially impact the level of compensation provided to directors both positively and negatively. Issues that could limit the supply of available directors and potentially drive pay higher include director term limits and limitations on how many boards a director can serve. However, future shareholder proposals regarding "director say-on-pay" and similar examples of shareholder activism or proxy advisor policy regarding director compensation could serve to limit future increases in director pay levels. With these issues in mind, we anticipate that pay levels will increase nominally (generally three percent to five percent per year) and that program designs will generally be stable (with some companies continuing the trend of eliminating per-meeting fees in favor of higher annual cash retainers). In reviewing market practices, we note that there are some variances by industry and company size and that each company should consider its objectives and other circumstances in reviewing its directors' pay and determining whether any changes should be made going forward.

22 Principles for effective enterprise risk management

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The operating environment at many companies today is in a state of constant flux as a result of new regulations and increased regulatory scrutiny as well as disruptive business models and a myriad of emerging risks. These conditions have placed enterprise risk management (ERM) at the forefront of company initiatives to anticipate and manage volatility and continuing economic uncertainty. We find organizations either establishing ERM programs or enhancing the maturity of their existing programs to manage the dynamic landscape, understand their most critical risks, make well-informed decisions, and respond with increased confidence to heightened financial scrutiny and the related expectations of their boards of directors, shareholders, and regulatory and rating agencies.

ERM is an organization-wide means of identifying, assessing, communicating, and managing risk. Using a systematic approach, ERM aims to:

- strengthen risk management capabilities as an integrated part of strategic and business planning
- foster a culture for communicating and sharing information to support robust decision-making throughout an organization
- provide an expanded understanding of risks and their interrelationships to help drive performance and value.

As organizations re-engineer their processes or adapt newer operating models to address their evolving risks and challenges over time, they need to adjust their ERM practices in alignment with these changes. This chapter elucidates four time-tested, foundational principles for effective enterprise risk management: (1) executive sponsorship and risk culture; (2) effective governance and infrastructure; (3) risk management enablers and accelerators; and (4) effective communication and change management. These principles serve as the backbone for an effective ERM program throughout an organization and at all maturity levels, from implementation to advanced programs.

Principle 1: executive sponsorship and risk culture

A sustainable and effective enterprise risk management program begins with and requires strong executive sponsorship and an organization-wide respect for risk. Commitment to ERM requires dedication and a willingness to get involved; leadership's commitment, in turn, denotes its stand for effective risk management and a strong risk culture. This commitment is reflected through three core activities:

1. *Lead by example*: An organization can affect behaviors by demonstrating a strong risk culture with integrity and commitment by all leaders. By walking the talk, executive leadership naturally sets an example for the rest of the organization to follow.
2. *Encourage good behaviors*: Organizations can effectively promote a positive risk culture by directly and explicating rewarding people for culturally congruent behaviors and sanctioning them for non-compliant behaviors. Such actions send a clear signal about what executive leaders truly value.
3. *Champion risk culture*: "Tone at the top" is unequivocally the most important driver of organizational risk management culture. While the phrase may be overused, there is simple truth in the idea that when leadership sets the example, others will follow.

Risk culture

Risk culture determines how an organization identifies, understands, and acts on the risks it faces. Culture can significantly affect an organization's ability to make strategic risk decisions and deliver business performance. It can be extraordinarily fragile without executive leadership's endorsement and commitment.

Risk culture cannot be influenced by the risk management function alone; it is driven by a combination of the "C-level's" commitment to risk management and the tone at the bottom. While executive leaders are able to authorize resources, empower people, and reward achievements, an effective risk culture requires commitment of all levels of the organization. In a strong risk culture, all members of the workforce understand that managing risk is part of their daily responsibilities.

In addition, transforming risk culture requires effective communication—including regular, consistent messaging to employees—to help ensure that everyone across the organizations understands his or her daily responsibilities for managing risk. Leaders must send a strong message that they use ERM as a strategic tool to manage the business, and, therefore, risk management is valued and critical to organizational success and survival. Structured communication and ongoing training can demonstrate unambiguously that risk culture is on the leadership agenda. These efforts can also cultivate an organization-wide understanding for risk management protocols and the roles and responsibilities for helping drive risk management decisions.

ERM fosters collaboration and integration; it involves everyone working together and making a concerted effort to manage risks in a cohesive and cost-effective manner. Each "line" plays a vital role in the organization's risk management. As primary stakeholders, executive leadership is best positioned to truly transform a traditional risk management function into an integrated one that provides enterprise-wide capability to drive performance and value.

Principle 2: effective governance and infrastructure

Effective governance and a supportive risk infrastructure are critical to the success of ERM. The governance framework should establish clear accountability and rigorous, yet practical oversight for risk management throughout the organization. The "three lines of defense" risk management model illustrates the distinct roles organization-wide and manifests that everyone plays a role in its execution. (See Figure 1.) The *first line* (business unit) involves those employees whose everyday responsibility is to help identify and manage risks. The *second line* (management oversight) includes management personnel in business, risk, compliance, and other oversight functions who establish risk management policies, set standards for managing risks, and enforce and monitor specific risk and controls. The *third line* (independent assurance) includes internal audit, which provides assurance over business activities.

Within these three lines of defense, certain fundamental governance components are required for an effective and efficient program: clear accountability, a common ERM framework and methodology, data definition and governance, and technology.

Clear accountability and rigorous oversight

A governance structure supports oversight of risk management policies and processes, rationalizes and systematizes risk assessment and governance reporting, and provides assurance that processes are adequate and appropriate. Within this structure are defined roles and responsibilities for the board, executive management, and the three lines of defense—business unit, management, and independent assurance functions.

Boards should validate that strategy and risk are aligned—by setting risk appetite, evaluating strategic risks, and providing a check and balance on management decisions. The full board is accountable for both risk content and risk process and defining effective risk oversight objectives, while multiple board committees may be established to provide oversight on specific risk areas, depending on their expertise. The management team is responsible for embedding risk management into the operations of the business, overseeing control design and implementation, and reporting risk information to the board. First-line (business unit) personnel are responsible for identifying risk, implementing and operating controls, and risk reporting.

Management is responsible for communicating risk information to the board. In many companies, establishing a management risk committee or council can help:

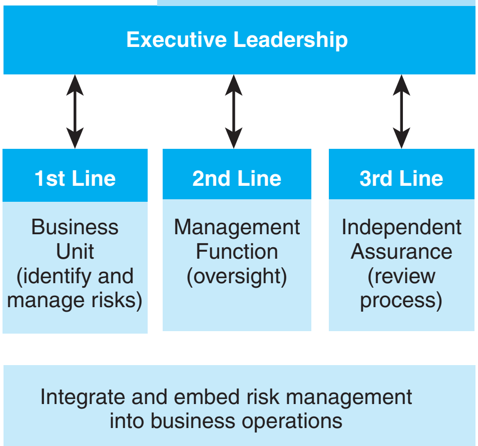
- facilitate oversight and encourage discussion of risks across the organization
- create buy-in, as well as a shared vision of the desired target state and the understanding that achieving it is an evolutionary process
- drive follow-up activities on mitigation plans to close gaps.

Typically, organizations develop standard tools for board risk reporting, such as ERM program dashboards and templates. In general, reports should enumerate and prioritize risk exposures, indicating category, description, risk mitigation assessment, and audit review findings, as well as corrective action plans and current status. Such reporting provides high-level visibility into both risk exposures and business opportunities and fulfills heightened expectations that corporate leaders will be actively engaged in the risk management process.

Common ERM framework and methodology

An ERM framework promotes a common view and understanding of risk across an organization and is essential for effective program implementation and execution.

Figure 1 Three lines of defense risk management model



For organizations with developmental programs, a framework outlines the program's necessary, primary elements; companies with mature ERM programs consistently leverage a common framework and methodology throughout the organization. Use of a common framework facilitates a repeatable process that allows companies to identify both current and emerging risks, as well as assess and improve the adequacy of the risk management process. Such a process involves reviewing risks that have seriously affected the company in the past, both to understand their causes and consequences and to evaluate the effectiveness of corrective actions. Looking forward, the framework establishes a means for timely identification of emerging trends and processes for developing response strategies, gaining consensus, and implementing action plans.

Utilizing a common risk language and tools throughout the risk management program—from risk assessment to risk reporting—will help drive standardization in both process and output. The framework and supporting methodology should include standard risk taxonomies, risk rating scales, and risk assessment templates. Once the framework is developed, users should be trained on its requirements to facilitate consistent application.

Operating models vary by organization; thus, developing and implementing an ERM program framework within an organization also involves an analysis of how its risk management practices align with other management activities and strategic objectives. Risk management enablers that are extremely important to this alignment include clearly articulating a company's risk appetite, risk tolerance metrics, and risk thresholds for decision-making, along with delegation of authority and associated limits. Additional discussion of select risk management enablers is provided in Principle 3: introduce risk management enablers and accelerators.

Data definition and governance

While adopting common risk taxonomy is critical to the success of an integrated ERM program, equally important is providing the ability and flexibility to make changes to the data definitions and structure to continue to meet the evolving needs of the organization. However, this change must be subject to appropriate management and oversight to help provide business users with high-quality risk data that is easily accessible in a consistent manner. Risk data governance calls for specifying an authority and accountability framework to encourage desirable behavior in the creation, storage, use, archival, and deletion of risk-related data and information. It involves consultation with key stakeholders regarding potential changes to established risk taxonomies and data definitions. Formal approval should be granted before any changes are made that will impact the organization's shared risk language. A key principle of effective ERM is to maintain agreed-upon data definitions and formats, identify data quality issues, and ensure that business users adhere to specified standards.

Technology and organizational infrastructure

Convergence of risk management through enabling technology provides the means for organizations to develop a shared repository for risk data that supports a common view of risk and sharing of compliance information across the enterprise. Similarly, transparent risk reporting ensures the appropriate connections and linkages are made. A centralized risk management platform may also be used to achieve a consistent set of information on key risks, issues, and mitigating actions that allows for organizational impact to be analyzed and reported in a timely and consistent manner. This platform is very useful for establishing a baseline communication and reporting mechanisms among management and the board. Many risk management technologies are available, including some that support enhanced risk monitoring and analysis and automated work flows for reporting, assessments, and remediation management.

Principle 3: introduce risk management enablers and accelerators

A successful ERM program requires that multiple business units and functional areas of different sizes and uneven levels of maturity collaborate on risk management. Often, the result is a large gap between inception, adoption, and implementation of program activities.

Consequently, most organizations seek to introduce specific enablers and accelerators to drive their ERM programs and reduce these gaps. Foundational elements such as common risk taxonomy and risk policy, an integrated technology solution, risk strategy and appetite, and change management (people) practices as well as increased use of insights and analytics are among leading practice enablers that position ERM to promote value throughout the organization. Below, we focus on two enablers—the risk appetite statement and data and analytics—that are rapidly gaining importance as organizations ascend the risk management maturity continuum.

Risk appetite statement

Regulatory and industry practices strongly suggest that companies develop a risk appetite program to guide risk governance. Such a program includes *a risk appetite statement that identifies major risks and defines acceptable levels for major areas of risk*.

An effective risk appetite statement should be easy to communicate and encourage early adoption from all stakeholders. In addition, it should include the following "best in class" attributes.

While both the risk appetite statement and the strategic plan share a common objective of promoting sustainable and controlled business growth, often the combined message can be contradictory and result in unapproved or stalled business activities. Many factors contribute to striking a good balance:

- First, organizations should *acknowledge the commonalities and potential overlaps* in the risk appetite statement and strategic plan and ensure cross-functional collaboration when developing the two documents.
- Next, the organization should *establish boundaries* or protocols by which each document is expected to pursue common objectives.
- Finally, firms should establish a formal mechanism by which to *resolve conflicts and harmonize* the risk appetite statement and the strategic plan.

Data and analytics

The benefits of embedding data and analytics in ERM are immense. For instance, a data-driven organization will have at its disposal numerous scenarios and hypotheses that can help the organization effectively respond to unanticipated macroeconomic shifts or sudden operational challenges and leverage those insights to identify potential business opportunities (the upside of risk) in a more uncertain and competitive environment.

Perhaps there has been no greater impact of advanced data and analytics techniques than on enabling the prolific use of unstructured data for risk management. Traditionally, internal auditors and ERM practitioners have used limited-functionality tools to manage large volumes of structured or numerical data for risk management purposes. However, the latest technology solutions can also process and analyze non-numerical, unstructured data—including e-mails, social media chats, or proprietary customer relationship management (CRM) and point of sale (POS) data—to provide a wealth of insights that supplement empirical information. The key difference is that these tools supply real-time data that provide a view into the thoughts and actions ("sentiments") of a variety of external stakeholders and other influencers, including customers and consumers. Mature ERM programs are taking these qualitative inputs and supplementing their quantitative risk assessments to effectively identify risks—particularly those related to corporate conduct, reputation, or fraud—and even identify unexploited opportunities.

Principle 4: effective communication and change management

Similar to the premise that ERM is everyone's responsibility, these foundational principles for effective ERM complement each other and are more valuable when practiced in concert than by themselves. The executive sponsorship and cultivation of risk culture discussed in Principle 1 encourage active involvement of all members of the workforce, thereby building the trusted relationships necessary to share information and ideas that shape results and improve decision-making by collectively aligning with strategies and objectives. This risk-informed and aware culture is supported by a target-operating model that provides governance mechanisms and processes highlighted in Principle 2. The structure furnishes the necessary support and establishes consistent practices, standards, and behaviors that solidify a strong, repeatable program and lead to a risk culture that exemplifies effective communication and consistent messaging (albeit at different levels of granularity, as necessary) throughout the three lines of defense.

Program sustainability, consistent communication, and consultative approach

Effective communication means continual improvement in how the risk function and the business lines work together to consistently share risk information across the business. From the onset, employees need to understand stakeholder expectations, the potential impact and importance of the ERM program, and how it ties to strategy and goals.

An effective risk management model needs to consider the unique challenges and circumstances that present to the different levels of risk management—executive, assurance, management, and operational (business units). Adopting a consultative approach to communication helps create the openness required to encourage brainstorming and supports the parties in challenging each other and considering different perspectives when making decisions. For example, when a risk like disruptive technologies impacts various areas within a business, it will require collaborations to truly appreciate the impact and implications of such a risk event.

As risk is discussed in different forums there should be a mechanism to share information, ideas, and decisions across the lines of defense. In addition to fostering a well-informed risk culture, the ongoing communication will promote consistency in risk management and change management practices.

Change management

Just as creating an ERM program with a clear and practical vision is critical, pragmatic change management is essential for sustainability. Proper change management through the right communication, management buy-in, and stakeholder involvement solidifies the risk culture established at the onset and ensures that the ERM program remains viable.

To remain efficient and functional, change management needs to be woven into the ERM program infrastructure at all levels. This is the process by which new risks and opportunities are realized, challenges are noted, and processes and practices are enhanced and updated before they become ineffective or obsolete. ERM is a constantly evolving science; mechanisms must be built in to allow the program to change in tandem with emerging risks, business challenges, and new opportunities that shape the organizational landscape.

23 Audit committee priorities

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The challenges faced by companies have never been greater, from the rapid pace of change in technology to the impact of globalization and geopolitical disruption, to an exponential increase in the level of regulation and enforcement. Companies must be prepared to navigate through these challenges in a manner that not only mitigates the risks but enables the company to seize opportunities in the short term and build sustainable growth in the long term. If this weren't complex enough, this must be managed in a climate that demands an unprecedented level of transparency and accountability.

As business has become more complex, the role of the audit committee has also evolved. Importantly, high-performing audit committees no longer simply sit back and listen passively to management presentations. They are actively engaged—setting the proper tone to ensure that the organization creates and maintains a culture of honesty and high ethical standards, providing strong oversight in the area of legal compliance as well as with respect to other risk areas within its purview, taking control by defining the information they want to see and seeking out diverse and unfiltered perspectives.

The breadth of the audit committee's responsibility has evolved also, and it varies by company—in some companies the committee's mandate is identical to the requirements placed upon it by law, regulation, and New York Stock Exchange (NYSE) listing standards, while in other companies the audit committee may have a purview that is so broad it can encompass any and all potential regulatory, operational, or strategic risks. Whatever the committee's scope, a top-performing audit committee will need to *prioritize* in order to successfully guide its company through the challenges. This chapter is not intended to be a comprehensive survey of the laws and regulations impacting the audit committee. Rather, it is intended to offer a guide to help focus audit committee time and attention on what matters most.

Scope of the audit committee's responsibilities

The role and responsibilities of the audit committee should be clearly laid out in its charter. This includes those responsibilities that are specified by law and NYSE listing standards. Broadly stated, the audit committee is required to provide oversight of the company's financial reporting and internal control over financial reporting; oversee the internal audit function and the external auditors; discuss policies with respect to risk assessment and risk management; establish procedures with respect to whistle-blower complaints; and engage in self-assessment of its performance.

In addition to the responsibilities that are required, many boards assign to the audit committee broader responsibilities in areas relating to the full array of risk. KPMG's Audit Committee Institute conducted a global survey that included approximately 500 audit committee members of US companies. The responses below indicate the percentage of US-based respondents who indicated that the referenced category of risk resides with their audit committee.

- Financial risks (cash flow, access to capital, compliance with debt covenants, etc.): 58 percent
- Anti-bribery and corruption: 45 percent
- IT/cybersecurity risk: 45 percent
- Legal/regulatory compliance: 42 percent
- Risk management process: 34 percent
- Operational/supply chain risks: 12 percent

A small number of audit committee members even indicated that their committee has primary responsibility for risks relating to business model disruption and/or strategy.

As these responses suggest, there is no "one size fits all" when it comes to the scope of the audit committee's responsibilities. On the one hand, it is important to ensure that the audit committee is not overburdened and has the time to carry out the responsibilities that are required by law. On the other hand, particularly for large, mature companies, regulators, investors, and the public at large expect the company's management of risk to be broad and robust, including strong oversight at the board level. Depending on the overall board-level workload and the expertise of the directors assigned to the various committees, this oversight can take place in various places: the full board, the audit committee, a separate risk committee, or a different committee. As a best practice, many companies map their major strategic, operational, and compliance risks to ensure that each and every one has been allocated an appropriate amount of time on the agenda of the board or one of its committees. In doing so, care should be taken to prioritize responsibilities and balance the overall workload among the board and its committees.

Committee composition

In light of the critical role of the audit committee, it is imperative that committee members have the knowledge, time, and level of commitment needed to provide strong oversight and insightful counsel. The NYSE listing standards require that an audit committee include a minimum of three directors. Given the range in the scope of audit committee responsibilities and the specific needs and challenges of different companies, not surprisingly there is some variation in the size of audit committees and the skill sets of the committee members.

Audit committees of NYSE-listed companies typically contain three to five members. First and foremost, all directors who serve on the audit committee must be "financially literate" and "independent." In addition, the NYSE requires that at least one member of the committee have accounting or related financial management expertise, and the Securities and Exchange Commission (SEC) rules require a company to disclose whether any member of its audit committee qualifies as an "audit committee financial expert." Beyond these requirements, it is helpful if the audit committee collectively has the knowledge to identify the unspoken issues and concerns, challenge the assumptions, ask the hard questions, and assess the quality of the responses. Therefore, consider whether the audit committee should include members who have direct experience in the company's industry as well as general experience in key areas, such as emerging markets, supply chain, information technology (IT), and so forth, as relevant and appropriate. Companies that need a key expertise that is not available among the members of the committee sometimes retain outside experts, for example in the area of IT risk, such as cybersecurity.

Oversight of financial reporting and internal control over financial reporting

Before the company's annual and quarterly financial statements are filed or distributed, and before the company communicates its annual and quarterly results through press releases and analyst calls, the audit committee discusses these materials with the chief financial officer (CFO), the internal auditor, and the external auditor. Given the importance of this oversight responsibility, sufficient time must be allocated on the agenda. The committee members can, and should, ask probing questions and continue to ask questions and request information until they are satisfied that the communications and disclosures are appropriate. For example, the committee members should be informed about how the company applied accounting policies and judgments, including any changes in application of policies, assumptions in critical areas that could impact estimates such as reserves or valuations, any changes or adjustments since the prior disclosure of a matter, any issues with respect to which there was a disagreement or even a significant discussion between management and the auditors, any unusual transactions, and any other information or issue that significantly impacts the financial statements.

Separately from the substance of the financial statements, and equally important, the audit committee also monitors the company's internal control over financial reporting (commonly abbreviated as ICOFR). As part of the annual audit, the external auditors will audit ICOFR and advise the committee if they have identified any significant deficiencies or material weaknesses in ICOFR.

Relationship with the company's external auditors

Pure and simple, the company's external auditors work for the audit committee. Section 301(2) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) requires audit committees of listed companies to appoint, compensate, retain, and oversee the external auditor, including resolution of disagreements with management on financial reporting matters. When engaging a new audit firm, management will typically participate in vetting firms and making recommendations, but the final decision must be up to the audit committee. The audit committee reviews the external audit plan annually, and as matters arise, to ensure that the audit plan appropriately takes into account new concerns, emerging risks, or changes to the company's business operations. Under Sarbanes-Oxley, the audit committee has the responsibility and authority to compensate the external auditor and so must ensure that any negotiated fee will provide for an appropriate audit while making efficient use of the company's resources. Also, any nonaudit services to be provided to the company by the external audit firm must be approved by the committee in advance, since with certain *de minimis* exceptions the external auditor will not continue to be considered independent if it performs nonaudit services for the company without such prior approval. Finally, the audit committee evaluates the performance of the external auditors.

Relationship with the company's internal audit group

According to the Institute of Internal Auditors, the value proposition provided by the internal audit function is "assurance," "insight," and "objectivity." (Source: https://na.theiia.org/about-us/about-ia/

Pages/Value-Proposition.aspx.) The audit committee should leverage internal audit as a barometer, helping the committee understand the critical risks to the business and plans in place to address those risks—including key operational and technology risks and related controls, as well as risks in the critical areas of compliance and financial reporting. Leading practices with respect to audit committee oversight of internal audit include review of the department's structure and succession plans; approval of the annual internal audit plan—including confirmation that internal audit has been granted resources and access to people and information as needed to appropriately implement the audit plan; review of the selection, retention, performance, and compensation of the head of the internal audit function (chief audit executive, or CAE); and open lines of communication among the CAE, the external auditors, and the audit committee chair.

Oversight of ethics and compliance—related matters

In accordance with Section 301 of Sarbanes-Oxley, audit committees are required to establish procedures for the receipt, retention, and treatment of complaints received by a company regarding accounting, internal controls or auditing matters, and confidential, anonymous submission by company employees of concerns about questionable accounting or auditing matters. Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) and its implementing regulations provide for financial rewards to individuals who provide information to the SEC with respect to securities violations and protect them against retaliation. While there is no specific procedure mandated for a company's handling of complaints, it is in a company's interest to encourage employees to raise issues or questions early and ensure that they feel comfortable and protected in doing so, to elevate issues and concerns to the appropriate level within the organization, and to address them quickly and appropriately. Strong audit committee oversight of the process and the resolution of complaints can help instill the right level of attention.

Audit committees can also provide an important safeguard by actively modeling integrity and closely monitoring the tone in the organization, at the C-suite level and below. The committee may also have responsibility for overseeing the code of ethical business conduct and the company's programs and controls designed to prevent, deter, and detect fraud, corruption, and other illegal conduct.

Taking control of the committee meeting agendas

Given the broad responsibilities and heavy workload of the audit committee, it can be challenging to find the time to get it all done in a quality manner. Some of the practices used by leading companies are:

- Develop a rolling agenda that calendars all of the committee's responsibilities for the year. This way the committee can look at its overall workload and rebalance agenda items as needed.
- Craft individual meeting agendas so that the important issues are addressed first, and allow flexibility in the time allotted to each item, to ensure there is sufficient time for robust discussion.
- Be selective in the quality and quantity of information provided to the committee. Audit committee members should insist on receiving the information that they find most helpful as they perform their roles, and on receiving it sufficiently in advance of the meeting. The amount of information should be appropriate—one of the unfortunate side effects of the move by many companies from printed materials to electronic board portals is that there is no longer a natural temper, such as binder size or postage cost, on the volume. Care should be taken to ensure that the materials provided to the committee are high in quality and manageable in quantity.

- Use the meeting time for discussion and questions. Materials should be provided to committee members at least a few days before the meeting, and they should read and think about them in advance, so that the meeting can be geared more toward focused discussion than on listening to management read PowerPoint slides.
- Make the most of the executive sessions. Audit committees of NYSE-listed companies are required to meet separately with the external and internal auditors. These sessions can be used to gain valuable insight into the company's financial reporting and internal controls as well as the culture and tone of the organization.

Evaluating committee performance

Annual evaluation of the committee's performance is required for NYSE-listed companies. The listing standard does not specify any particular process, and the process may vary from company to company. In determining what is right for any particular company, consider the following variables:

Should the evaluation be performed solely by the committee members or with the help of a third party? Particularly if there are issues, a third party may hear about and be able to communicate concerns that would otherwise remain unspoken.

Who should provide input? At minimum, each committee member should be heard. In addition, input from the chair/lead director and the board members who do not sit on the committee can be a good way to calibrate the helpfulness of the committee's work to the board at large. Some companies engage in 360-degree assessments, including input from management and the external auditors. The number of participants involved in this type of assessment varies by company, and companies that engage in a 360-degree assessment typically do not do so every year.

On what should the evaluation focus? In addition to confirming that the committee has satisfied the requirements of its charter, evaluations should include questions such as whether the committee is devoting sufficient time to the most important issues, whether it requests and receives the right type and depth of information, whether the committee members are prepared, engaged, and add value to the discussions, whether they exhibit the right level of independence from and healthy skepticism of management, and whether the chair provides effective leadership. To truly add value, the committee evaluation should be more than just a "check-the-box" exercise and should serve instead as the touchstone for a robust discussion that enables continuous improvement. Given the ever-present potential for litigation, the company's legal counsel should be consulted before any documents, including notes, are created.

Conclusion

Clearly, the audit committee plays a critical role in protecting the long-term interests of the company and its investors. To do so effectively, the committee must use its time wisely and focus on the right priorities. A company that has a top-tier audit committee will be able to answer "yes" to all of the following questions: (1) Is the committee operating in accordance with all applicable requirements (law, regulation, listing standards, committee charter)? (2) Does the scope of the committee's work strike the right balance between its required responsibilities and broader risk issues in light of the critical need to provide strong oversight of matters bearing on financial reporting, the totality of other issues and challenges facing the company, the workload of the full board and its other committees, investor and regulatory expectations regarding the level of oversight, and the company's maturity cycle? (3) Does the committee collectively have the appropriate set of skills, experience, and judgment to identify risks, challenge assumptions, and provide valuable perspective with respect to the matters on its agenda? (4) Are new members effectively "onboarded"? (5) Are the committee members actively engaged, asking probing questions, contributing valuable insight, and devoting sufficient time inside and outside the boardroom to truly understand the "rhythm" of the organization? (6) Are the agendas constructed to ensure that there is sufficient time for meaningful discussion of important issues? (7) Does the committee set and enforce clear expectations with respect to integrity, transparency, and open dialogue? (8) Does the committee hold itself, management, and the external auditor to high standards and insist on continuous improvement?

24 Best practices in code of conduct development

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A company Code of Conduct is often the foundation of upon which an effective compliance program is built.

***Resource Guide to the U.S. Foreign Corrupt Practices Guide*, Chapter 5**

An effective ethics and compliance program must establish standards of ethical conduct, as well as procedures to prevent and detect criminal conduct. Those standards should be clearly drafted and appropriate both for the size of the organization and the industry in which the organization operates.

Indeed, a properly assembled and distributed code of conduct is the single most effective and impactful part of any compliance and ethics program. Such a code is a written record of not only an organization's expectations but also its ethical culture. This fulfills the first hallmark set forth by the Federal Sentencing Guidelines (FSG), which recommends "the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law [through the establishment of] standards and procedures to prevent and detect criminal conduct."

A code of conduct is called the cornerstone of an effective compliance program because it "knowledge-sets" the "floor" across the organization. The document's goal is to provide the tools to allow every employee, regardless of job description, to spot the key red flags for the company's most important risk areas. It is *not* intended to include all of the information they may need to understand each substantive risk area in full, as much of that information only applies to those whose job responsibilities require them to act in that area. However, the code addresses the key topics and makes clear the behavioral expectations and company values—with the best codes focusing on affirmative conduct rather than prohibitions. The more detailed information is delivered through policies, which should be cross-referenced in the applicable section of the code.

However, organizations often view the code of conduct as a necessary evil, mandated by various regulatory and governmental agencies, rather than an opportunity to educate employees about the behavioral expectation to which they are held.[1] Codes that focus on rules rather than values tend to be overly formal and difficult to read, having clearly been written by a team of lawyers. Organizations that take this approach miss a prime opportunity to pronounce their values, standards, and expectations to both internal and external constituents. Studies show that companies exhibiting a pronounced emphasis on ethics and trust have higher employee retention rates and attract more prospective employees. Therefore, taking time to relate your company's values, reputation, and success with compliance in a meaningful way not only helps your organization fulfill the FSG, but is also a shrewd business decision.

The code serves as the primary means for your organization to communicate its commitment to ethical and legal conduct to both internal and external stakeholders. While a single document cannot anticipate every possible situation that an employee might face, your code should provide proper and effective guideposts for behavior. To achieve this, tie the code's guidelines to your company's values and ethical commitments. Do so in a manner that facilitates employees' grasp of the critical nature of compliance and ethical decision-making, consistent with the code. In addition, the code should enable employees to quickly recognize when to seek guidance, encourage them to report concerns, and provide various avenues through which they can do both.

When revising or creating the code, consider the audience to which the code is directed. Ensure that the language is at such a level that your largest employee base will fully comprehend the content. Take into account the locations where your employees conduct business and ensure that all code content is applicable to all of the audiences receiving it. Scrub this content to ensure that it will resonate with employees in foreign jurisdictions, and be sure to provide translated versions of the code in these locations, as appropriate. Furthermore, in order to reach your employees in an effective and engaging manner, allocate proper resources to layout and graphic design.

When engaging in the code-creation or code-revision process, be sure to account for the many ways in which the code will be used. For example, factors such as proliferation, certification, and training should all be considered. Properly distributing the code, tracking its acknowledgment, and conducting training on its subject matter sends strong signals to regulatory and legal entities that your organization is making a good faith effort to implement an effective compliance program.

The code-creation or code-revision process is a daunting task and can quickly become overwhelming without proper planning and knowledge of the issues at hand. NYSE Governance Services, with its team of attorneys, analysts, subject matter experts, writers, and editors, has provided this article as a useful reference guide for those embarking on or considering the code of conduct revision or development process.

Developing the code

Once the team responsible for code revision or creation has completed the planning process and established a basic time line, there is one more step to complete before drafting may commence: the collection and synthesis of pertinent supporting and related materials. Supporting materials include the employee handbook, internal policies or processes, and to a lesser extent the corporate responsibility report or philanthropy report. Related materials are more general and tend to come in the form of marketing materials, sections of the company website that cover company history or values and generally speak to the internal culture at the organization. It is also important to look to samples of internal communication coming from the C-suite or the management level. These documents are crucial in helping to ensure a consistent voice not only in the code itself but also as compared to other materials produced by the organization. More on how to utilize these materials effectively is covered in the "Risk topic coverage" section later in this chapter.

Once these materials have been gathered and factored into the overall organization (or outline) of the code document, the team is ready to start drafting. Following, you will find points of consideration when drafting your code of conduct.

Tone from the top

One of the most effective tools a company can utilize to communicate confidence in a code, and the ethics and compliance program as a whole, is a clear and pronounced endorsement of the document by the executive leadership team. A common format for demonstrating a convincing tone from the top is an introductory message from a member of this team. This most commonly takes the form of an introductory letter from the company's CEO, president, and/or chairperson, though it could also come from the chief compliance officer or could even be signed by the entire executive team. It is critical that this letter employ a tone and vocabulary that employees will recognize as coming from the executive author to whom the letter is attributed.

Since the code is often one of the first documents new hires read when they join a company, this introduction by a high-level executive should also serve as a welcoming smile and handshake. We encourage including a photograph and signature of the executive(s) in question to provide a visual connection between the executive team and the code.

Readability and tone

As with any professional document, codes must strike the right balance between detail and brevity. Codes that are too brief often do not adequately cover the necessary risk areas, prompting many questions and providing too few answers. Conversely, verbose codes run the risk of losing readers' interest and may begin to resemble a policy manual or employee handbook. As a rule of thumb, effective codes fall somewhere between 8,000 and 10,000 words in length. However, companies with complex international operations, a bevy of unrelated business units, operations in highly regulated fields or high-risk geographic locations, or US government contracts may need to maintain slightly longer codes. However, creative use of space on the page, effective bullet points, and call-out boxes can keep information concise, yet thorough, meaning that even longer or more detailed codes can be quite readable.

While organizations are becoming increasingly adept at crafting effective executive introductions, far fewer are able to maintain a consistently warm tone beyond the preamble. Too often, the remainder of the code is handed off to internal counsel for drafting, leaving this majority of the document a legalistic, incomprehensible encyclopedia of "thou shalt not" rhetoric. Simply put, a code's success is defined by its ability to energize employees and motivate them to ethical behavior—in order to achieve such success, the language and tone used must be well received by the employee base.

To achieve an engaging and inviting tone, it is important that you pay ample attention to voice during the drafting phase. Generally speaking, avoid the third person (eg "All employees must"), as this can create a tone that appears condescending at worst, or distant and impersonal at best. Instead, use a warm, first-person voice (we, us). An inclusive voice allows employees to feel a sense of ownership of the code and implicitly reminds readers that the code applies to everyone at the organization.

Focus on expected behaviors rather than prohibitions. To avoid alienating employees with what sounds like a list of state lottery rules, begin each risk area with a positive explanation of the guidelines they must follow rather than a list of prohibitions. If the topic in question is based on clear, right-versus-wrong reasoning, focus your efforts on explaining the preferred behaviors rather than those that are forbidden. For example, when discussing guidelines for giving and receiving gifts, set forth the criteria that a gift must meet in order to comply with company policy. For those risk topics that require a degree of interpretation, provide examples of positive or recommended behavior along with the internal or external resources available for seeking guidance.

Tailor the complexity of the material to your target audience. While codes are frequently written by lawyers, they do not have to sound as though they were. Remember, the purpose of a code is to present behavioral guidelines and explain ethical decision-making to your average employee, not necessarily to the most educated individual in your organization. When drafting your code, target the level of complexity to your broadest employee base. Modern word-processing software contains the necessary tools to determine the approximate grade level of the document as you draft it. Be sure to employ the services of a professional editor to vet the complexity of your code's language.

Nonretaliation and reporting

Clearly communicate resources for asking questions or making reports. It is pivotal that whatever resources your company provides to employees to ask questions or report misconduct are clear and outlined within the code. Commonly, code documents will include a dedicated reporting section that sets forth the avenues by which employees should seek guidance and report ethical or legal misconduct. Such a section should be placed near the beginning of the code to educate employees about the necessity of reporting known or suspected misconduct, as well as the process by which they are expected to do so. This section does not necessarily need to be an exhaustive list of reporting channels and contact information but should include the most important contacts and state where a comprehensive list is available.

Make a firm statement of the nonretaliation policy. It is important that a code not only shows employees how to report misconduct but also takes steps to ensure that they fully understand and act in accordance with the clearly stated culture of nonretaliation within the organization. More and more, best practices codes are explaining the various ways retaliation can occur, so that employees are clear about what behavior is unacceptable. Retaliation, including what it looks like and how employees react to it, is a complex and serious issue, and fear of retaliation is a leading cause of employees failing to report misconduct. All employees are expected to abide by and endorse a firm culture of nonretaliation. Managers have the additional responsibility to encourage their direct reports to communicate unethical conduct and ensure that any "good faith" report is not met with acts of retaliation.

Emphasize that by reporting concerns, employees are doing the right thing and helping the company halt and/or prevent misconduct. It is important to create a link between ethical conduct and reporting, rather than to simply emphasize that reporting violations is expected or that failing to do so violates company policy. While the latter can have its intended effect, emphasizing the importance of speaking up to the organization's culture is more likely to inspire employees to overall ethical behavior and is therefore more effective. Elucidate the ways in which reporting concerns allows your company to halt or prevent misconduct and thus contributes to the ethical culture at your company.

Given the whistle-blower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 USC § 5301 [2010]) that provide lucrative incentives for those who report wrongdoing to the government in furtherance of its investigations, it is more important than ever to encourage employees to report internally rather than report to a government agency first—or worse, not speak up at all.

Ensure compliance with international reporting laws. While US law allows companies to mandate that employees report ethics and legal violations, this is not true in all countries. Many nations permit language indicating that employees "should" report, but failure to report is not necessarily considered sufficiently egregious to justify termination, depending on the seriousness of the unreported incident. In certain jurisdictions, such as France, you may only go so far as to encourage employees to report. The French Data Protection Authority's (CNIL) 2005 guidelines state that "reporting should always be discretionary and by no means mandatory." (Source: "Anonymous Reporting Procedures and Codes of Ethical Conduct in the European Union," at http://www.gibsondunn.com/Publications/Pages/AnonymousReportingProceduresandCodesofEthicalConductintheEuropeanUnion.aspx.) Thus, it is important to ensure that global code language is consistent with such guidelines; you should also stress face-to-face interaction.

It is also important to note that some jurisdictions require not only that the company protect "good faith" reports, but also that it expressly inform employees that making reports not in good faith is a behavior that is not protected from retaliation and will result in disciplinary action.

Finally, if you have European Union subsidiaries, it is generally recommended that you check for possible conflicts with local labor legislation. For example, in Germany if the subsidiary has established a works council, you need to obtain prior approval from this body before adopting the code. In France, you will likely need to request the nonbinding opinion of the works council before proliferating any reporting requirements to local employees by means of the code or other document. While challenging, satisfying the requirements of these and other laws is feasible without necessitating country-specific codes of conduct.

Risk topic coverage

Give thought to risk topics in accordance with your organization's size, structure, and industry. While regulatory mandates require organizations to implement a code of conduct, very little guidance is provided regarding what that code should contain. Instead, SOX, the FSG, and various stock market regulations focus on what should be the intended purpose of the code—generally, to deter wrongdoing and promote honest, ethical conduct and compliance with laws.

Determining the substance of the code is the most important step in the code development process. Consider the risks your organization faces, looking to those risks that are both systemic to your organization and unique to your industry. Benchmarking against your peers and leveraging recently completed internal audits and/or compliance risk-assessment results will provide focus as to which topic areas to cover. Culture and knowledge surveys are also excellent ways to gauge the temperature of compliance and general understanding of compliance across the organization. If no such risk assessment, audit information, or survey process or tools exist, give serious consideration to the deployment of resources to further identify, prioritize, and mitigate your company's ethics and compliance risks. Referencing the codes of peer companies will provide additional insight into applicable risk areas.

Reference corresponding company policies. Faced with the difficulty of communicating a wide range of topics to a broad audience, operationally diverse and globally-reaching organizations often struggle to maintain codes of reasonable depth. Failing to appropriately limit guidance can result in a lengthy document, posing legitimate readability concerns. To provide employees adequate detail on topics while maintaining reasonable document length, codes should aim to illustrate expected behaviors for important risk areas rather than to duplicate the company's collection of stand-alone policies. Providing the name and/or location of the corresponding policy (or policies) provides quick access for those who require additional information.

Learning aids

Supplement the code content with learning aids. Keep in mind that, while codes aim to break down policy material into a more digestible and direct format, some readers are less comfortable than others with the written word. While the code's text should explain difficult-to-understand concepts and terms, you can further ensure comprehension of these by including learning aids, which supplement the main code text by bringing abstract concepts into the realm of practical advice. Learning aids can take many forms, including question-and-answer segments and real-life scenarios and vignettes that demonstrate the implications for certain courses of action.

Ensure that the learning aids are relevant. It is important that you ensure that the learning aids depict realistic scenarios for your organization and the business you conduct. This requires that you utilize relevant job titles, geographic locations, work environments, and scenarios. The best scenarios tend to be drawn from actual situations that have occurred in the past, common questions and complaints, and hotline reports. If the learning aids are written in the form of vignettes, be sure to use names that represent all geographic locations in which you operate.

Presentation, style, and organization

Ensure the code is visually appealing and consistent with design cues found in other company documents. While we are taught not to judge a book by its cover, the converse is often true when it comes to codes of conduct. When a code looks like just another policy, it will likely be disregarded as such. Oftentimes, organizations choose to enlist their marketing and communications teams to create a look and feel for the code of conduct. Having a colorful and vibrant code can vastly increase the likelihood that the code will be read from cover to cover.

When designing the look and feel of your organization's code, adopt a visual style that fits with existing internal and external company communications. For example, employ the same design resources responsible for your company's annual report. Keeping a design aesthetic consistent with existing company branding will convey that this code is unique to your organization. A code that is branded in this manner can serve not only as an internal marketing tool for ethics and compliance but also as an external marketing tool.

While lavish page layouts are certainly engaging to readers, keep in mind that they are not necessarily imperative. It is quite possible to create a relatively low-tech document that will engage your reader, so long as your design team pays proper attention to format and use of white space.

Communicating the code

Translations

According to section 8B2.1 of the FSG, companies must show they have made a good faith effort to educate their employees on the standards and laws to which they will be held. Therefore, companies with a global reach will often provide publicly available copies of their code in various local languages. Generally, if your company maintains more than 50 employees in a given jurisdiction, you will want to translate the code into the local language of that jurisdiction. This remains true even when you are fairly certain your employees speak English as a second language, as their reading comprehension is likely to be higher in their first language. Additionally, if you are operating in a high-risk area from a compliance perspective (such as doing business with the government in the People's Republic of China), you should consider translating the material regardless of the number employees you maintain in this location. When determining such high-risk areas, utilize the results of your most recent compliance risk-assessment or external tools such as Transparency International's Corruption Perception Index (source: Transparency International's 2013 Corruption Perception Index, http://www.transparency.org/cpi2013/), which ranks the risk of corruption by country.

Maintaining the code

Update the code on a regular basis

Remember, your organization will need to re-examine and revise the code to keep it fresh as a teaching document. In the event of significant corporate compositional changes (such as mergers, acquisitions, or overseas expansion) or regulatory changes affecting your operations, you will most likely need to update the guidelines set forth in the code at the time these changes occur. Otherwise, consider updating the content of the code every two years. Keep in mind that a regular schedule of review and revision of the code is consistent with the FSG, which require organizations to evaluate periodically the effectiveness of their programs.

Refreshing the code does not necessarily require changing the precepts of the code and can be as simple as updating the presentation to ensure that readers remain engaged. Better yet, add new examples, comprehension aids, and other attention-getters, or add interactive elements. A static code will quickly lead to perfunctory review on the part of employees, and such review undercuts the purposes of the code and the annual certification process.

Notes

1 A few key laws and regulations that highlight the need for a Code, include: Federal Sentencing Guidelines, Chapter 8 - PART B - REMEDYING HARM FROM CRIMINAL CONDUCT, AND EFFECTIVE COMPLIANCE AND ETHICS PROGRAM, §8B2.1. Effective Compliance and Ethics Program; Sarbanes-Oxley Act of 2002, Section 406, 15 USC Section 7264, Code of ethics for senior financial officers; Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 922; Federal Acquisition Regulation (FAR), Section 52.203-13, Contractor Code of Business Ethics and Conduct; UK Bribery Act 2010, Section 7, Failure of Commercial Organisations to Prevent Bribery; Brazil's "Clean Company Law," Law n.12.846/2013; Securities and Exchange Commission; 17 CFR 229.406, PART 229_STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975_REGULATION S-K, Sec. 229.406 (Item 406) Code of ethics; New York Stock Exchange, Listed Company Manual Section 303A.10, 303A.00 Corporate Governance Standards, 303A.10 Code of Business Conduct and Ethics; NASDAQ Market Rule 4350(n) Code of Conduct.

25 How to survive and thrive in a crisis

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On April 24, 2013, Rana Plaza, an eight-story garment factory in Dhaka, Bangladesh, collapsed. Thousands were killed or injured. By any definition, it was a tragedy of the highest order. Less than 24 hours after the collapse, fashion giant Benetton—headquartered 4,500 miles away in Treviso, Italy—denied that any of its clothes were supplied by Rana Plaza. But, as the incident and Benetton's ties to the factory were investigated, it quickly and publicly became clear that Benetton had been supplied by Rana Plaza. Benetton had to retract its earlier statement and admit to manufacturing clothes at the factory. At this point, the Rana Plaza tragedy became a crisis for Benetton. The reputation and trademark that Benetton had so carefully nurtured were placed in jeopardy.

The Rana Plaza incident and the trap that Benetton fell into are not unique—they are the "new normal." We live in a world that is flattening and shrinking. Companies have become interconnected in complex ways that they may not be able to fully understand. When disaster strikes, these complex connections become transparent to all as information travels around the globe with blinding speed. The Internet, 24-hour news cycle, and social media give instant exposure before there is time to consider a matter and respond.

Many companies have exploited these new market conditions and, as a result, have been richly rewarded. But, at the same time, they must prepare for the inevitable volatility that also comes from this flat, complex, interconnected, and transparent world.

This "new normal" precipitates a crisis where, in the past, Benetton's connection to this tragedy might have passed without note. Twenty years ago, Benetton's operations would have been simpler, and it would have better understood its own supply chain. Benetton's connection to Rana Plaza would probably not have been discovered. If discovered, Benetton would have had days to prepare its response. Instead, it felt compelled to make a statement less than 24 hours after the incident that proved to be false. There was no deceit here, the company simply did not know the truth. The new normal cannot be controlled. Companies can only control how to respond to crises. To quote Andrew Zolli: "if we cannot control the volatile tides of change, we can learn to build better boats." Indeed, companies need sophisticated crisis management plans to weather the type of storm that hit Benetton.

What is a crisis?

A crisis is *an event that has the potential to result in a catastrophic financial and/or reputational loss that requires a sophisticated, multidisciplinary response within a collapsed time frame*. Let's unpack that statement.

- An event that has the potential to result in a catastrophic financial or reputational loss

Not every disaster is a crisis. A crisis is typically unpredictable and extraordinary and can occur to the best-managed companies in the world. A true crisis jeopardizes the future of a company. These crisis events are often rare occurrences that are hard, if not impossible, to predict. They are not usually found on the list of major incidents, for which most companies have defined emergency response plans. They are unexpected "Black Swan" events such as the *Exxon Valdez* oil spill or the racist remarks of a National Basketball Association team owner. While the spill or remark may cause a crisis, and a preplanned response may begin to limit a company's exposure; in a crisis, liability management is needed to stem the tide of cascading events triggered by it.

- Requires a sophisticated, multidisciplinary response

During a crisis, the rules of the game can change. Things behave differently. To give an example: Before the *Deepwater Horizon* oil spill in the Gulf of Mexico, the US had almost never prosecuted a nonoperating investor in an oil well under the Clean Water Act. (The US had only prosecuted one nonoperator before and under very different circumstances.) Faced with the largest oil spill in US history, the government made the extraordinary decision to do just that. What had been a crisis for all parties involved became much more serious for nonoperators who had not anticipated such exposure. Such an unexpected consequence requires improvisation, not strict implementation of a set plan. The nonoperators needed professionals who could recognize that the rules could change. In a crisis, companies also need assistance from crisis management professionals who can understand how the rules can and will change in the circumstances that are unique to their industry. A company needs to be ready for a sophisticated response commensurate with the uncertainty, magnitude, and complexity of a crisis. Many law firms advertise "crisis management," but they are simply repackaging their traditional major litigation practice. Do not be fooled, effective crisis management requires a multidisciplinary team that includes but is not dominated by litigators. You do not want to win your litigation and lose your company. The team that supports you should include lobbyists who are familiar with both the legislative and executive branches of government. It should also include lawyer and nonlawyer subject matter specialists. Furthermore, the person coordinating the response needs to understand what can and cannot be done effectively by outside crisis communicators. All of these elements must be carefully orchestrated and protected to the greatest extent possible within the attorney-client and work product privileges.

- Within a collapsed time frame

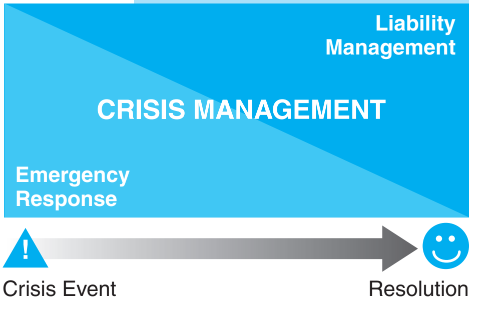
A crisis demands immediate action. However, *trajectory is more important than velocity*. In other words, the direction you are heading is more important than your speed. In a crisis it is easy to find yourself moving rapidly in the wrong direction because the actions taken at the outset of a crisis can have a disproportionate effect on the ultimate outcome. Fact gathering and analysis are critical to setting your company's trajectory out of a crisis. Then, once your trajectory is set, *concerted effort over time will produce* *extraordinary results*. But all this requires that the facts are gathered and analyzed by competent experts and then internalized into corporate goals that are achievable. This takes time, and unless you are working with experts who are familiar with crisis management, that time is often wasted by distractions caused by mistakes made early in a response.

There are two main components to crisis management: (1) emergency response and (2) liability management. Emergency response typically involves operational personnel who implement a company's incident response plan in the field. At the outset of a major incident, this is the most important task. But as first responders get an emergency under control—for example, containment of an oil spill—a separate group of liability managers needs to focus on liability management. Liability management is less formalistic and is implemented at the senior executive level. It involves the fact gathering and analysis, strategic planning, goal setting, narrative framing, and communication that, if properly executed, will significantly reduce a company's total exposure (Figure 1).

The crisis hypothesis

In our experience, most crises follow recognizable patterns. While it is almost impossible to predict most crises, best practices can be identified that will help management prepare, organize, and lead during a crisis.

Figure 1 The crisis management progression



Emergency response best practices

In the immediate aftermath of a crisis, certain predictable response issues will arise that a company should be prepared to manage.

- *Evidence preservation.* Rule number one, two, and three: Never destroy evidence. Ever. A company's document retention policy should be clearly and verifiably communicated to all employees as a matter of routine training and reiterated in the early stages of an emergency. A legal hold memorandum for record retention should be circulated at the earliest possible time, and procedures for collecting physical evidence should be in place, as well as procedures for gathering electronic data and securing critical hard-copy documents.
- *Interaction with investigating agencies.* Should a government agency with investigatory powers respond to the incident, a company must take great care in how it communicates with the agency and how it assists with the investigation. Control and access to the incident site will be a critical issue. Throughout the investigation, a company should exercise firm but reasonable controls. It should not be afraid to say "no" to investigators, but it should do so for good reason and it must recognize the potential consequences. Consent to an agency's demands—or lack thereof—should be memorialized. If an agency requests a site preservation agreement, it should exclude unrelated property. Also, it should be clear that the agreement does not represent consent to an agency's jurisdiction.
- *Document collection and preservation.* A company should anticipate document requests from an investigating agency, as well as discovery in subsequent litigation. Here are a few ground rules:
  - All document requests should be clear and in writing.
  - The company should be aware of its rights to object to certain document requests and withhold certain types of information.

   - Clear internal procedures for document collection, review, and production should be developed.
- *Employee interviews.* Before an employee is interviewed by an investigating agency, the employee should be informed of his or her rights during the interview (eg to take notes, to have someone else present), and the employer's expectation that the employee tell the truth and not guess or speculate. *It is imperative that no one intimidate employees or improperly influence their testimony*. The company should also be sure employees know the company's counsel does not represent them individually.

Liability management best practices

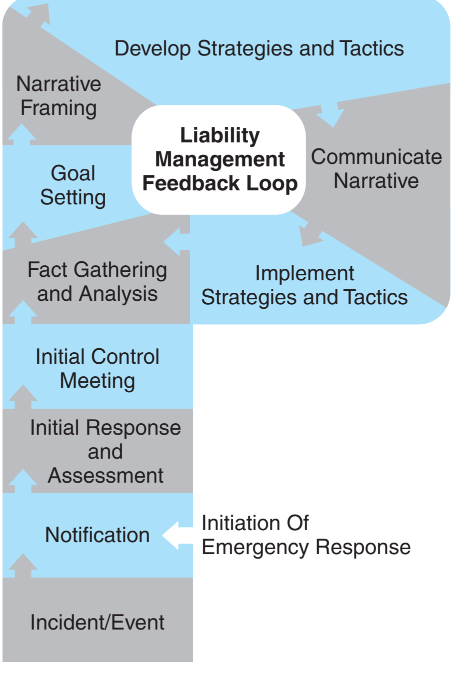
While you may not be able to plan for "Black Swan" events, you can implement systems and procedures for dealing with them when they arise. Through years of managing our clients' crisis liabilities, we have created the following template for how to intake, process, and act on rapidly evolving, difficult circumstances. We refer to it as the Pillsbury Crisis Management Process, as shown in Figure 2.

Once a company is notified of the crisis, emergency response is initiated and the company's incident response plan is implemented. At the same time, management must prepare for an initial response and assess the situation. An important initial step is to prepare a holding statement. This is also the first misstep that many companies make. To avoid errant or unworkable statements, the holding statement must not speculate or make assertions of fact that could be untrue. Nor should it admit liability. But it should express an appropriate level of empathy for those injured. Here is an example:

> Our thoughts and prayers go out to those affected by this tragic accident. As the cause is under investigation, drawing any conclusions at this stage would be premature. We are fully cooperating with governmental authorities and will provide updates on the investigation as soon as possible.

While the statement is being framed, the company should assemble the full crisis management team it will need to manage its exposure. There should be a core team consisting of senior management, the general counsel, in-house communications, and an internal and/or external crisis manager. This group should be small and take full advantage of the attorney-client and work product privileges. As areas of expertise are identified, a second, multidisciplinary team should be created and expanded. This could include, for example, an external crisis communications firm, insurance coverage experts, litigators, and lobbyists. Members of the teams will need to work together, seamlessly. Trust is key. Build trust relationships by conducting training drills with members of the teams *before a crisis*. These drills should be more about building trust and learning the strengths and

Figure 2 The Pillsbury crisis management process



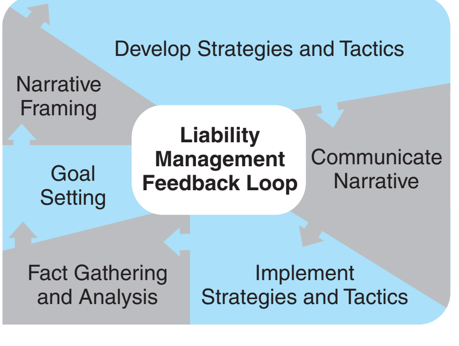
weaknesses of a team, rather than the proper response to a particular set of facts.

Once the team members are identified, there should be an initial control meeting at which the scope, structure, and terms of an internal investigation are authorized. This is the beginning of the "race to the truth." Legal counsel should direct the investigation so it is privileged and confidential. It is imperative to establish and reinforce controls during an investigation. There should be guidelines for document preparation and retention. There should also be limitations on collecting documents outside the formal investigation process.

Regardless of the protections and privileges that are felt to be in place, the investigation team should act as if everything that is written is discoverable. Remember, in a crisis the rules can change. Traditional barriers can break down and the opposition could bring resources to bear that result in unprecedented discovery. Also, at some point, documents or communications could be inadvertently disclosed or a company could waive privilege.

Fact gathering and analysis is time intensive and may require significant manpower. In the race to stay ahead of government agencies, media, or other outside parties, implementing a 24-hour work loop can allow critical tasks to get done faster. We have had success with the systematic utilization of team members in other time zones to pass projects back and forth in order to work around the clock. Not only can this keep the company a step ahead but it will allow the teams to rest, and rested people make better and quicker decisions.

Figure 3 The liability management feedback loop



Fact gathering begins what we call the Liability Management Feedback Loop. Figure 3 illustrates the iterative process that we have developed to manage this crisis.

Once the facts are known, the company must engage in the critical task of goal setting. As a result of a crisis, a company is inevitably changed. It is critical to determine what the new company will look like and set ambitious but achievable master goals. Again, trajectory is more important than velocity. The goals should be "big picture" and long-term, yet specific enough to guide decisions. Such goals might be to preserve brand integrity or to resume operations as quickly as possible. The absence of long-term planning will result in being trapped in the "thick of thin things."

Once the company's master goals are set, they should be communicated to the entire team in most cases. This will allow the team to weigh its decisions against achievement of the master goals. In some instances, however, certain goals, strategies, and tactics must be withheld.

With clear master goals, the company must distill the facts it has gathered and develop pointed messages to various stakeholders that complement and further its goals. This is called narrative framing. It starts with the development of a master narrative that addresses all of the facts on hand. From the master narrative, subnarratives are developed for the various stakeholders. This is an important exercise as not every stakeholder needs or wants to hear the same thing. The subnarratives should be carefully tailored to each audience, but must be dynamic. The master narrative and subnarratives should be reframed and rewritten as new facts emerge or circumstances change. But, to the extent possible, key messages should remain consistent and the narrative should always further the master goals.

Once the company has identified its narrative, it can develop a strategic and tactical plan to communicate the narrative and achieve its goals. The company could, for example, identify governmental actors it may want to contact. It could also develop a communications strategy that identifies media outlets with whom the company can work to convey key public messages. However, before external communications are made, it is important that all potential spokespersons receive media training or refreshment training.

Communication of the narrative should closely follow the strategies and tactics the company develops. It should reach stakeholders quickly and efficiently in a way that allows the company to convey its message and, in turn, to manage public perception. Key groups include the media, industry, and the public. The company should not forget to communicate the narrative to employees and customers, too. In the face of a crisis, morale may be low and customer loyalty could be questioned. If the company is to maintain its core business, these critical relationships must be preserved.

As the narrative is communicated and the company implements its strategies and tactics, the cycle of gathering facts, setting goals, and narrative framing should continue. Circumstances are sure to change, and the company's management of the circumstances must change too.

The role of the general counsel

The general counsel should be at the center of your crisis management effort. It is critical that the attorney-client and work product privileges are preserved, to the extent possible. Constant, disciplined involvement by counsel is needed to achieve this goal.

With these privileges intact, the company can have candid internal discussions and will at least have some control over the timing of its disclosures. Control of information is critical and the involvement of counsel can make the difference. Also, as liability management displaces emergency response concerns, strategic legal issues will become more important. Specific demands and requirements, such as victims' assistance and insurance reports, will all need to be closely coordinated with the company's legal strategy. This, again, puts the general counsel at the center of the company's crisis management efforts. It is most effective when this role is written into a company's response plan, which helps eliminate confusion when a crisis arises.

A note for publicly-traded companies

Directors and officers of a company should always be as accurate as possible in any filings with the Securities and Exchange Commission (SEC) and in communicating with investors and the public. This is critically important and especially difficult in the immediate aftermath of a crisis incident, when the facts and the causes of an incident are unclear. False statements or omission of material facts can create additional exposure. The company should not say too much or the wrong thing at the risk of misstating the facts. But, at the same time, it cannot say too little and run the risk of omitting critical facts. The company must carefully evaluate its disclosures, especially disclosures to the SEC and public statements by upper management.

As a result of the "new normal" of greater interconnectivity, complexity, and transparency, companies will face volatility and crises on a more frequent basis. For that reason, companies have to be prepared to implement a sophisticated crisis management plan that will not only protect their core business but will allow them to change for the good in the aftermath of a crisis. If employed proactively, the strategies and tactics described above will help companies survive and even thrive when facing a crisis.

26 Crisis communications in the age of permanent engagement

Richard S. Levick, Chairman and CEO LEVICK

The diverse crises that continue to confront just about every industry sector of the global economy did not begin with the economic meltdown of 2008. Nor will they end with legislative and enforcement solutions even if we were tempted to believe that such solutions are obtainable in the practical world.

On the financial and investment side, the challenges are especially formidable. In this sector, crisis is by definition an intrinsic part of business under both ordinary and extraordinary circumstances, in a way that is not absolutely the case elsewhere. Who knows, new technologies might, for example, someday minimize the threat of data security breaches.

But contention, accusation, and imperilment are inevitable wherever and whenever money changes hands.

Crisis is permanent and ubiquitous

The elephant is in every room. In M&A, there are those who think too much is being paid and others who think they're being shortchanged. During public offerings, reputation must be guarded and promoted against any number of present or foreseeable contingencies. Executive compensation remains a festering issue that can roil shareholder relations. Good governance is a persistently elusive goal as earnings statements are held to withering scrutiny and directors struggle to define and meet their increasingly burdensome obligations.

The overarching impact of the financial crisis was to exacerbate the situation to a historic extent. Thanks to the meltdown, and the endless inquiries and punitive actions that resulted, public distrust has become pandemic. The focus is no longer limited to specific targets, an Enron or a WorldCom, but extends instead to practically every financial institution and public company. In response to that distrust, regulatory activity has accelerated to a feverish pace and won't likely abate in the near future irrespective of who holds political power.

In this chapter, we're going to talk about best practices for businesses trying to survive and grow in this culture of permanent crisis, in terms of both strategy and tactics. Significantly, many governance experts and market analysts resolutely advocate a one-size-fits-all strategy with their every breath—a simple enough yet compelling strategy predicated on transparency and accountability. Tactically, the agendas are naturally variegated as different problems call for different solutions—especially in a digital marketplace where exigent communications proliferate in the blogosphere and the social media, in ways that often seem beyond the control of affected parties.

It is our intent that this discussion will prove broadly relevant to public companies facing any type of crisis. That said, we have chosen to focus on one specific area—the challenge brought by activist investors—for three reasons.

First, it is the most convenient spectrum through which to view all the issues that spell crisis in the financial sector. An activist uprising may involve governance as well as performance; say-on-pay challenges to executive comp no less than loud opposition to planned mergers and acquisitions. And, the best practices appropriate during such shareholder crises apply equally when any challenges beset management, whether activists are in the picture or not.

Second, the activist phenomenon usefully broadens the discussion inasmuch as it potentially affects all public companies—from PepsiCo to Sotheby's—and not just the financial institutions whose practices and decisions have been the particular target of public disapprobation since the meltdown.

Third, the activist challenge particularly underscores the need to respond to changing circumstances. If crisis communication is all about the management of risk and perception, those risks and perceptions are subject to historic trends and remain in constant flux. Management must be nimble, be quick to respond, and modify their approach as the attitudes of one decade are transformed *in toto* in a matter of just a few years.

Crisis strategy: the old narrative doesn't work

While such megachange is generally relevant to any crisis situation, it is transparently relevant here. As SEC chairman Mary Jo White told the Commission's 10th Annual Transatlantic Corporate Governance Dialogue in December 2013, "It was not so long ago that the 'activist' moniker had a distinctly negative connotation. It was a term equated with the generally frowned upon practice of taking an ownership position to influence a company for short-term gain. But that view of shareholder activists, which has its roots in the raiders of the 1980s takeover battles, is not necessarily the current view and it is certainly not the only view."

What is the message here for management? In any crisis situation, an entity under attack must have a narrative, a controlling story to tell that will provide a persuasive context in which the confidence and loyalty of key stakeholders can be reaffirmed. Traditionally, that narrative has involved good guys and bad guys: for example, "management is under siege because XYZ seeks a short-term gain that is clearly not in the interest of long-term investors. You shareholders are the prospective victims and, as officers and directors, we are the vindicators who will fend off this pre-emptive attack, stay the course, and recommit to providing long-term value."

It is a long-patented narrative but, significantly, observers as different as Charles Elson and Nell Minow are not surprised by White's implicit challenge to it. "The dominant view in the current environment is that activism has its benefits," says Elson, Professor of Finance at the University of Delaware and Director of the John L. Weinberg Center for Corporate Governance. "Activism has many friends."

"The SEC is traditionally a captive of managers, so I guess it's a good sign that [White] would make such a statement," says Minow, a founder of GMI Ratings, who as early as 2003 was dubbed "the queen of good corporate governance" by BusinessWeek Online. In any event, the potentially salutary impact of activism is now widely recognized—which means that if management wants to successfully confront the activist challenge, it will need a new narrative, a new strategy.

This need for a new strategy goes beyond the simple question of who wears the white hat and who wears the black. Events ongoing in 2014 confirm that it's no longer enough to simply persuade stakeholders that the company is performing well and producing value, or that its governance practices are sound.

Among recent cases in point, activist Nelson Peltz, having forced the spin-off of Kraft's North American business to form Mondelez, then pressured PepsiCo to buy Mondelez and split into two companies, beverages and snacks. The split "would create two leaner and more entrepreneurial companies," according to Peltz.

It's significant that, during this fracas, third parties characterized PepsiCo (among other activist targets) as a corporate governance gold standard and one of the world's best-managed enterprises. That perspective seems to return us to the old crisis narrative: that is, an opportunistic attempt to plunder a great company for short-term purposes.

To its credit, PepsiCo did not fall back on this storyline to counter Peltz. It chose a different kind of strategy altogether, as PepsiCo apparently understood that its corporate performance and governance *didn't matter*—not when Peltz was essentially claiming that however well PepsiCo was doing, *he could do better*.

The high road

Shrewdly, PepsiCo's message, effectively delivered by chief executive Indra Nooyi, was all about the positive. Just the facts, ma'am: PepsiCo has enjoyed six consecutive quarters of organic revenue growth as core earnings per share grew 17 percent and gross margins expanded. The company's snacks, beverages, and healthy foods portfolio has high co-purchase and co-consumption levels, generating $1 billion per year. Cash flow from traditional beverages supports investments and emerging markets growth. Stock was up 25 percent over the preceding two years, 14 percent better than Coca-Cola.

Peltz balked at what he called PepsiCo's "dismissive tone" in rejecting the split-up bid, and his Trian Fund Management LP continued to meet with major investors, marshalling purported evidence of bloated revenue and volume share loss suffered on Nooyi's watch. But "that's the beauty of the free market system," says Minow. "Like any investor, Peltz thinks he knows something that no one else knows. It's up to both sides to make their case to the shareholders."

From management's standpoint, it's a glass-half-empty or glass-half-full scenario.

The half-empty perspective: "We've done everything right. Now we have to defend a proven record against someone else's unproven proposition." According to Minow, "the burden of proof is always on management because it's management that goes to market every day."

The half-full perspective: Management is in the catbird's seat because the challenger is the one who must prove that he or she has a better approach than the present course of action, which is yielding substantial benefits to stakeholders. "Absent performance and governance issues, it is much tougher to make that case," says Elson. "The implicit response is, who are you to dictate policy changes to a high-performer like us?"

Understood in the narrower context of crisis communications, the same best practice—what we refer to above as the "one-size-fits-all strategy"—drives the approach in either case: namely, complete candor and transparency. And, what works in the context of an activist insurrection is likewise imperative during any sort of crisis, especially when metrics and performance indices cannot be jiggered or suppressed. "No word games or sophistries," advises Elson, whether the crisis at hand is a shareholder revolt, an SEC inquiry, or an earnings restatement.

Implicit in this fundamental strategy is a willingness to sit down and negotiate in good faith with a Carl Icahn no less than the Department of Justice. Attacks and denigration are self-defeating. Never make it personal. Being dismissive of the other guy's position as "noise" was a dubious strategy in 1985; in 2014 it is not a strategy at all.

Always be willing to bargain; it is never a sign of weakness, no more than a settlement agreement with a regulator necessarily constitutes an admission of enterprise-wide culpability. Do not fall back on the self-deceiving position that the other side is negotiating in bad faith. "Who are you to say whether they're negotiating in good faith or not?" warns Minow.

A commitment to bargain also serves the entity's self-interest if only because corporate spokespersons must apprehend and co-opt the other side's message. They'll likely hear that message at the negotiating table and, as a result, gain a road map as to what their own countermessages will be.

Who speaks for management?

The essence of crisis management is communications and, in any communications campaign, specific actions—the choice of who is to speak, how the message is worded, and where it is to be delivered—can be as decisive as what the entity says.

To be sure, language and style matter. When Peltz uses a word like "dismissive" to characterize PepsiCo's response to his split-up proposal, he was sending shareholders a message, or trying to, that the company was unwilling to entertain new ideas; that it was uninterested in the kind of dialogue and negotiation that counselors like Elson and Minow quite appropriately deem essential.

Even more pointedly, when activist Daniel Loeb campaigned to seize a board position at Sotheby's, he called the auction house "an old master painting in desperate need of renovation." Executives, he averred, devour "organic delicacies" and rare wines while shareholders foot the bill. No less than in a court of law, language can engender major rule change as, in this case, Loeb also targeted a two-tier shareholder system that limits activists' holdings to 10 percent compared to 20 percent for passive shareholders.

Like aggressive plaintiffs' lawyers, such activists have a freer range in their choice of language and are typically more apt to shoot from the hip. In all crisis engagement, the best institutional practice is usually to not take the bait, to stay on the high road, and to continue to refrain from personalizing the response.

But the question also arises, who speaks for management?

It's all about timing. In a crisis situation of any sort, credibility depends on the appearance of disinterestedness. In responding to activists, it may therefore be too late for management to spearhead the crisis communications campaign once the challengers reveal their presence.

"The very appearance of the activist confirms that management has messed up the communications. If he's after you, you've already failed," says Minow. "The advisable course is to openly acknowledge that you've messed up, and to pick a credible third party to represent the company's position. That third party is inevitably the outside directors. That's their job."

The board may only be theoretically disinterested, but it's the officers, not the directors, who are now under direct fire. "The directors need to go on a protracted listening tour, equaling or surpassing the dialogue that the activists are certainly having with major shareholders. In fact, I wouldn't even call the board a third party at that point. It is now the company's own voice," adds Minow.

Nor should outside directors wait until there's a crisis (any kind of crisis) to act in lieu of management. "Make friends before you need them," advises Minow. "Keep the directors out there; make sure they meet with major investors at least a couple of times a year. Find out what those investors are looking for."

It's a particularly pointed lesson for companies that, like PepsiCo, have no visible wounds or conspicuous vulnerabilities. No matter who you are, effective crisis communications always begin before there's a crisis.

Crisis tactics: all media are "social"

Anecdotal evidence, and the observations of sundry consultants, suggests that more outside directors are now committed to just the kind of intensified activity that Minow advocates. "Boards are preempting what activists could do by taking the same action themselves," according to Leigh Ann Schultz, managing director of Riveron Consulting.

Among those actions, boards and the companies they serve are no longer content with "protracted listening tours." Some (but certainly not all) have realized that, whatever the crisis, a more robust engagement is necessary before crises, during crises, and—in order to regroup, resolve lingering issues, and rebuild the brand—post-crises. The inevitable place for such engagement is, of course, the social media.

Most corporate adversaries, from plaintiffs' lawyers to nongovernmental organizations, got to those media first. It was in 2007 that activist shareholders really saw proof of what was possible in the digital age. Shareholder Eric Jackson posted videos on YouTube and created what became a high-authority blog to air grievances about Yahoo's business performance. Small investors, representing around 2.6 million shares, responded warmly. Six days after a contentious board meeting, chief executive Terry Semel stepped down. The online initiative clearly played a role in the shake-up.

Since Yahoo, shrewd activist use of the social media has grown apace, especially as the Goliaths have taken their cues from the Davids. In late 2013, for example, Carl Icahn used Twitter to announce his stake in Talisman Energy. By Christmas he'd won two board seats without a proxy fight. Icahn continues to use his own Web platform, Shareholders' Square Table, to "discuss what can be done to change our current, dysfunctional system of corporate governance."

A powerful name like Icahn leveraged by viral communications spells constant crisis for management. But activists have gone even further to instantly roil markets. They created online forums like us.proxyexchange.org (USPX) to build voting blocs, allowing users to transfer their proxy-voting rights to other like-minded investors.

Such grassroots coalition-building via the social media catalyzes multiple communications initiatives. For instance, USPX has disseminated guidelines for say-on-pay voting decisions, reminding investors that "if we mindlessly vote in favor of executive pay packages we will be . . . providing 'insulation' for compensation committees and CEOs."

There are numerous examples of companies that have, in response, effectively engaged social media for other purposes than promoting goods and services. eBay tweeted updates on earnings calls and analyst meetings. By 2009, Amgen was using the Web to survey shareholders about executive pay. A year later Intel set up interactive online Q&As and allowed shareholders to vote online during its annual meeting. Alcoa's Facebook page drew many thousands of followers; its Twitter account linked to the earnings release, earnings call webcast, and the investor presentation.

Such companies are at least sending a message that they're as much a part of the twenty-first century as their adversaries.

Many other companies have more recently joined the fray, yet here too the adversaries have an advantage. We noted above that corporations must be more restrained in their language than activists, plaintiffs' lawyers, and the like. Similarly, corporations face risks in their online practices that shareholder activists don't. Corporate missteps are brand-damaging if not actionable. Every Tweet can have global impact.

The solution involves a delicate balancing act, as scrupulously orchestrated as it is aggressively implemented. As entities match the adversary tweet for tweet—with again, unstinted transparency—specific best practices for most digital crisis communications include:

- Engage in a way that keeps opinions open. The goal isn't to pre-empt discussion; it's to respectfully lead it.
- Act quickly. Companies can't hope to "own" the conversation by responding to two-day-old criticisms or questions.

- Respond to adversaries on the same channels they're using—tweets for tweets, Like for Like. The implicit message to shareholders: "We're listening."
- Enlist a social media team. Someone needs to monitor what's happening online. Someone needs to set and maintain the tone with which management responds. Someone needs to ensure that the company has an online personality that matches its brand and that the company actually takes action by day's end.

The worst thing a company can do as it ponders the social media landscape is to simply say, "This is all too risky. We won't do it." Risk management as a component of crisis management is not about avoiding risk; it is about identifying the benefits that may or may not justify running the anticipated risk. It is also about identifying the risks that *must* be run.

The digital challenge is one salient example of how the crisis communications burden falls heavily on directors who are now obliged to confirm the crisis readiness of the companies they serve, including their levels of social media engagement. It is all the more reason to start planning ahead of need, not just by communicating regularly with major investors but by fostering open dialogue internally as well, to assure a united front once war is declared.

27 The importance of effective board oversight

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During the last two decades, the role that directors play with respect to oversight of an organization's ethics and compliance program has expanded due to the enactment of the US Federal Sentencing Guidelines for Organizations (the Organizational Guidelines), guidance from the Department of Justice (DOJ) for prosecuting organizations, several key court decisions, and the growing expectations of employees, partners, shareholders, and the public. All of these changes mean that directors must now exercise greater oversight and control of compliance.

Despite these fundamental changes, organizations often fail to adequately support directors with the vital resources and expertise they need to exercise effective oversight of an ethics and compliance program. Failure to educate directors about the content of the program and support their oversight of the program will render the program "ineffective" in the eyes of regulators. This chapter examines the history of events leading to board oversight of ethics and compliance programs and examines those actions that constitute appropriate oversight in light thereof.

Background

The development of director responsibility for organizational ethics and compliance has been a steady progression of key events, including court decisions, federal sentencing policy, and guidance from the DOJ.

The responsible corporate officer doctrine

The "responsible corporate officer doctrine" first arose out of two US Supreme Court case decisions rendered more than 30 years apart. In essence, the doctrine established that corporate officers and directors could be held criminally liable for corporate legal violations when they are in a position of responsibility and authority, have the power to prevent the violation, and fail to do so. This liability can attach even in situations where the officer or director did not specifically participate in or authorize the act in question, as happened in the two cases described in this chapter.

Over time, federal and state prosecutors have successfully applied this doctrine to executives and directors for violations arising in cases as varied as antitrust, environmental controls, and fraud. The Department of Justice has been very clear that it will continue to hold directors and officers responsible for corporate wrongdoing. The decision to pursue a particular director may hinge upon factors such as the committee upon which the director served, his or her meeting attendance, or the director's role in the organization in general. As a result of these tightening standards and regulator expectations, serving as a director has become a more dangerous proposition requiring the exercise of greater care.

Delaware corporate law

It is worthwhile to consider the tightening standards that have evolved in Delaware, always at the forefront of corporate law due to its central role as the most-used incorporation jurisdiction. Delaware law for some time has allowed the imposition of criminal liability upon directors in combination with potential civil liability for violating a director's duty of loyalty.

In 1996, Delaware's Court of Chancery made waves in the compliance and corporate law communities with its opinion in *In re Caremark* by defining a strict role for careful director oversight of organizational compliance.

Several federal and state agency investigations resulted in federal indictments of Caremark and two of its officers based on allegations of unlawful kickbacks. The company pled guilty to a single felony count of mail fraud and agreed to pay approximately $250 million in civil fines and criminal reimbursements. This led to several shareholder derivative suits that alleged Caremark's board of directors breached their fiduciary duty of care by failing adequately to "supervise the conduct of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability." The court determined that, as part of their duty of good faith, directors have an obligation to ensure that a corporate information and reporting system exists and is adequate. The following standard for assessing liability in situations where directors are unaware of employee misconduct that results in corporate liability was announced by the Court:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.

This standard created a keener awareness of the importance of board oversight of a company's ethics and compliance program and had a substantial impact on related best practices.

Ten years after the *Caremark* decision, the Delaware Supreme Court clarified the *Caremark* language in the case of *Stone v. Ritter*, a derivative action brought by shareholders on behalf of AmSouth Bancorporation against 15 present and former directors. The plaintiffs alleged that the bank's directors had failed to ensure the existence of a reasonable compliance and reporting system that resulted in violations of the law and eventual fines and penalties of $50 million.

The *Stone* court reiterated much of what the Chancery Court had said in *Caremark*, and stated again that directors have a duty of good faith separate from their duties of loyalty and care. The *Stone* court explained that the duty of good faith at issue in *Caremark* and *Stone*—the alleged failure to establish or oversee compliance systems—is a subset of the duty of loyalty. This is particularly important because, unlike situations where directors have violated their duty of care, corporations cannot limit or eliminate directors' liability for violating their duty of loyalty. The court stated that directors may be held liable if they completely fail to implement a reporting or information system or controls, or having implemented such a system, consciously fail to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention.

The *Stone* decision has had a significant impact on the field of ethics and compliance. It builds upon the standard announced in *Caremark* regarding potential liability of directors, by determining that directors are liable for the damages resulting from legal violations committed by employees of a corporation when the directors do not exercise due care. Under this holding, if directors fail to implement a reporting or information system or controls, or fail to monitor such systems, they may be liable. Furthermore, the *Stone* case looked to factors similar to those found in the US Sentencing Commission's Organizational Guidelines (discussed below) in determining whether board oversight of a company's ethics and compliance program is adequate. The court focused primarily on the structure of oversight of the compliance systems at the bank—for example, the position of compliance officer and the role of the oversight committee of the board—and also discussed the staff designated to implement the program, including training, policies, and monitoring systems.

The Organizational Guidelines

When Congress passed the Sentencing Reform Act in 1984, it created an entirely new system of sentencing for federal crimes based around binding sentencing guidelines and created an independent expert body, the US Sentencing Commission, to produce the guidelines. The first sentencing guidelines for individuals were introduced in 1987. The Commission tabled consideration of guidelines for organizations at that time, but continued to study the topic by compiling a comprehensive database of organizational cases. When the Commission finally settled on a hybrid sentencing scheme for organizations where the "culpability" of an organization was calculated to determine fine range, adjusted by aggravating and mitigating factors, these guidelines included probationary terms for organizations so that effective compliance programs could be developed while they were under supervision. When the Commission promulgated the first sentencing guidelines for organizations in 1991, the preamble stated in part that "steps taken by the organization prior to the offense to prevent and detect criminal conduct, the level and extent of involvement in or tolerance of the offense by certain personnel, and the organization's actions after an offense has been committed" would be the standards that determined the organization's penalty. Additionally, the Commission noted, "probation is an appropriate sentence for an organizational defendant when needed to ensure that another sanction will be fully implemented, or to ensure that steps will be taken within the organization to reduce the likelihood of future criminal conduct."

Additionally, the first version of the Organizational Guidelines clearly stated that companies that had directors who "participated in, condoned, or [were] willfully ignorant of the offense," or did not train all employees with regard to the compliance program, could face enhanced penalties. However, beyond the broad mandates for all employees, including directors, to be aware of the organization's program and avoid direct involvement in misconduct, the original Organizational Guidelines offered no specific guidance as to the unique responsibilities of directors with regard to the oversight of organizational compliance.

That all changed in 2004. As part of the Sarbanes-Oxley Act of 2002 (SOX), the Commission received a Congressional directive to ensure that the Organizational Guidelines and their associated Commentary were sufficient to "deter and punish organizational criminal misconduct." A broad range of experts were drafted onto an Advisory Group and spent 18 months examining the effectiveness of the compliance criteria of the Organizational Guidelines. When the Group concluded their efforts, they recommended that the Commission promulgate a stand-alone guideline to address effective ethics and compliance program hallmarks. One of the primary recommendations that the Advisory Group made to the Commission was to "specify the responsibilities of an organization's governing authority . . . for compliance."

An effective ethics and compliance program is defined in the Organizational Guidelines as one through which an organization exercises "due diligence to prevent and detect criminal conduct" and otherwise promotes "an organizational culture that encourages ethical conduct and a commitment to compliance with the law." As previously noted, one of the factors accounted for in an effective program is whether the "governing authority" is knowledgeable about the content and operation of the ethics and compliance program and exercises reasonable oversight of that program. This requirement caused considerable concern, given the multiple responsibilities many directors already have. As a result of public comment, the Commission's 2004 amendments allow the board to delegate oversight responsibility to a subcommittee, such as the audit committee, as appropriate. If the board does delegate oversight, however, it must ensure that it is still receiving sufficient information to fulfill its oversight obligations.

While the 2004 amended Organizational Guidelines did not provide great detail on how board oversight must be exercised, board training was clearly addressed. The amended Organizational Guidelines' training requirement applies to directors and high-level personnel, in addition to all other employees. Regardless, some companies still fail to train their board members on their codes of conduct, high-level risk areas, or other ethics and compliance program components.

Additionally, to have an effective ethics and compliance program under the Organizational Guidelines, a compliance officer should report to the board or its designated subcommittee no less than annually about the implementation and effectiveness of the program. Although such limited reporting now falls short of what are considered best practices, the 2004 amendments to the Organizational Guidelines certainly caused organizations to pause when evaluating the board oversight aspect of their program.

In 2010, the most recent amendments to the Organizational Guidelines further clarified the role the board should have with the compliance officer. Under the Organizational Guidelines, an organization is deemed to have an effective ethics and compliance program, even if high-level personnel are involved in a criminal offense, so long as the individual with operational responsibility for the program has "direct reporting obligations" to the board of directors or its designated committee.

This change reflects the increased importance of providing timely information to the board regarding misconduct, potential misconduct, and the operation of the organization's program in general. While the Commission did not designate that organizations must change existing reporting relationships between the board and the executive level of the organization, the new amendment suggests that the organization should have a formalized procedure for the individual with day-to-day operational responsibility for the program to communicate with the board. In practice, organizations should consider whether they are receiving regular reporting on the operation of the ethics and compliance program from operational staff and whether those individuals have the "expressed authority" to communicate with the board should they need to.

Department of Justice guidance

Board oversight of ethics and compliance programs is further detailed in the DOJ's McNulty Memorandum, which gives guidance to prosecutors on the factors they should consider in determining whether to indict a corporation. These factors were permanently memorialized in the DOJ's *U.S. Attorneys' Manual* in 2008. The DOJ considers, among other factors, the existence and adequacy of a corporation's ethics and compliance program when determining whether to charge a corporation. The DOJ also takes into account whether directors exercise independent review over proposed corporate actions and whether they received information sufficient to do so. In addition, the DOJ considers whether directors have made efforts to ensure the organization has established an information and reporting system reasonably designed to provide management and the board of directors with timely and accurate information regarding the corporation's compliance with the law. When the DOJ is determining how to dispose of a case, the role of the organization's board in implementing and overseeing the ethics and compliance program is heavily scrutinized.

Lessons learned

What constitutes appropriate board oversight?

Since the implementation of SOX, most corporations have kept their audit committees apprised when the corporation receives allegations of suspected misconduct and of the company's responses to those allegations. A majority of companies are also requiring board approval of the company's code of conduct and any related major policies. Communication of this type of information continues to be very important, but falls far short of the information required for the board to exercise appropriate oversight. In order to exercise oversight, boards should receive expanded information regarding a company's ethics and compliance activities in order to adhere to the requirements of the Organizational Guidelines, DOJ guidance, and applicable law.

For example, beyond acquiring basic information such as misconduct reports and approving major written standards, boards should also periodically receive information about:

1. the structure and resourcing of the ethics and compliance program, and whether the compliance officer has sufficient authority to implement the program
2. the structure of the company's reporting system and the company's policies regarding responding to suspected misconduct
3. the types of compliance training that employees and others, particularly managers, are required to complete, and any modifications to those training requirements
4. the company's risk-assessment process and results, and the methods developed by the company to prioritize and address the risks identified therein
5. the way in which the company audits for implementation of the ethics and compliance program and for substantive violations, especially in high-risk areas
6. the perception of employees regarding the culture of ethics and compliance at the corporation, including fear of retaliation for reporting suspected misconduct, and whether employees believe that management is committed to compliance.

This information, at a minimum, should be provided to the board on a regular, periodic, and timely basis. Best practices suggest that reports to the board (or appropriate subgroup) regarding the program—including the direction in which the program is heading and other high-level information—should be made quarterly. The minimum standard for reporting under the Organizational Guidelines is annually.

Active oversight also requires training for the board of directors. Directors may feel that they receive overlapping training by virtue of sitting on more than one organization's board; however, mandatory training on each organization's code of conduct, as well as on industry-specific risk topics of particular significance, is critical for directors to complete. It allows directors to be sufficiently familiar with said policies, procedures, and training initiatives to exercise reasonable oversight of those programs. Not only does such training protect the organization in the event of corporate malfeasance, it also protects the individual directors from civil and/or criminal liability. It is very difficult for a director to ensure the "consistent" application and enforcement of the organization's ethics and compliance program that the Organizational Guidelines require without periodic, applicable training on risk topics, the code of conduct, and a director's role in oversight.

Conclusion

Corporate governance and compliance practices have undergone enormous change in a relatively short period of time and best practices are continually developing. The level of scrutiny of a board's monitoring—or failure to monitor—a corporation's ethics and compliance activities has increased dramatically. The challenge for boards, executive officers, and ethics and compliance officers is to view the increased scrutiny and enhanced standards not merely as a host of new legal requirements but as an opportunity to review and enhance their corporate governance and ethics and compliance practices and set a true "tone from the top."

28 FCPA and compliance: a board and senior management perspective

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In today's post–financial crisis enforcement environment, companies devote greater effort and resources than in the past to overseeing the implementation and operation of an effective compliance program. Regulation has become more extensive and complex; the US government has grown more aggressive and demanding in its compliance expectations and enforcement efforts; and foreign governments have similarly increased their enforcement activities. The price of compliance has gone up, as has the cost of non-compliance.

This chapter addresses the oversight roles played by the board and senior managers of a US-listed public company with regard to compliance with the Foreign Corrupt Practices Act (FCPA). This area of compliance is critically important to listed companies with multinational operations. More generally, this discussion of compliance in the context of the FCPA illustrates issues that cut across different areas of compliance, including the appropriate roles of senior management and the board and key elements of an effective compliance program.

The legal obligations of boards and senior managers in regard to compliance

The Delaware Supreme Court's 1963 decision in *Graham v. Allis-Chalmers Mfg. Co.*[1] illustrates that, just as the board is not responsible for managing the day-to-day business affairs of a company, so too, it is not responsible for day-to-day compliance. The directors in that case were sued on the theory that they should have known that company employees engaged in behavior leading to corporate antitrust liability and that they should have brought the company into compliance, thereby preventing the loss. The Delaware Supreme Court stated in emphatic terms that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[2]

Chancellor Allen's decision in *In re Caremark International Inc. Derivative Litigation*[3] interpreted Allis-Chalmers for the modern era. Consistent with the board's oversight responsibilities generally, *Caremark* recognized a limited role for boards to help assure that senior managers adopt and implement an effective compliance program. As recognized by the Delaware Supreme Court in *Stone v. Ritter,* liability under *Caremark* may arise from "a sustained or systematic failure of the board to exercise oversight," which might be found if "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[4]

Caremark liability requires a showing of bad faith and has been called "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[5] However, the bad faith requirement also means that violations of *Caremark* duties are generally not subject to exculpation or indemnification.[6] While the standard for finding *Caremark* liability is high, the boards of companies that announce compliance problems nonetheless have been subject to such claims almost reflexively. Numerous,[7] but not all,[8] cases have been dismissed. The lesson from multiple perspectives—prevention, good governance, and defending a potential *Caremark* claim—is that the board should assure itself through its oversight that an adequate compliance program (inclusive of adequate information systems and controls) has been implemented and is continuing to function effectively. The board's oversight role should be precisely that: to receive periodic reports, and otherwise when circumstances require, to see that management is focused on these issues and has taken what appear to be proper and timely steps to identify and address compliance risks in its business. Exercising that oversight sends the message that the board itself regards compliance as important and that management should thus do so too.

While senior management should enact an effective compliance program, distinctions should be made between managers with different functions at different levels of the corporate enterprise. Senior management of large multinational companies with geographically diverse operations may not know of the day-to-day activities of employees or agents in remote locations. Senior management should thus enact systems providing for monitoring, internal reporting, and periodic reviews, and then should be able to rely on such systems, lower levels of management, and "control" functions until an issue comes to their attention requiring senior-level involvement.

When such an issue does come to senior management's attention, however, it is important to respond in a timely manner to gather facts and to implement remedial steps as needed and appropriate. This does not mean that a full-blown independent internal investigation is always required. Rather, the nature as well as the scope of the inquiry should be appropriately tailored to the circumstances. There are many circumstances where a focused effort by in-house counsel and others within the company to gather the necessary facts will suffice and be most expeditious and efficient.

Regardless of the nature of the fact-gathering process, in certain circumstances evidence of problems in the past may signal a risk of future misconduct. Senior managers who were not aware of questionable conduct in the past when it occurred, and thus may not be criticized on that basis, may be criticized for letting new violations happen "on their watch." To protect the company and all concerned, prompt consideration should be given where necessary to taking preventive measures on an interim basis pending further inquiry or other remedial steps that may be appropriate.

Summary of the FCPA

The FCPA was enacted in 1977 in the wake of revelations of widespread bribery of foreign governmental officials by American companies seeking to do business overseas. The FCPA, as amended, consists of anti-bribery provisions and also so-called accounting provisions (which in fact impose broad record-keeping and internal control requirements on issuers).[9]

The anti-bribery provisions apply to: (1) "issuers," ie, companies with US registered securities or that are otherwise required to file periodic reports with the SEC, including foreign issuers with ADRs trading on a US exchange;[10] (2) "domestic concerns," which include US individuals (ie citizens, nationals, and residents) and US corporations, partnerships, and certain other US entities;[11] (3) foreign nationals or entities that act to further a corrupt payment while in the US;[12] and (4) officers, directors, employees, agents, and stockholders of issuers or domestic concerns.[13]

The anti-bribery provisions generally prohibit covered persons and entities from corruptly making, authorizing, promising, or offering payments ("anything of value") to foreign officials (any officer, employee, or representative of a foreign government, agency, department, or instrumentality thereof, such as a state-owned enterprise), foreign political parties or their representatives, candidates for foreign political office, and employees or representatives of a public international organization (eg International Monetary Fund [IMF], World Trade Organization [WTO], World Bank) with the purpose of assisting in "obtaining or retaining business."[14] That so-called "business purpose test" does not require that the bribe's purpose specifically be to facilitate obtaining or keeping a government contract. US enforcement authorities interpret the business purpose test broadly, treating bribes for the purpose of obtaining a business advantage as meeting this statutory requirement.[15]

The FCPA requires that the payment be made or offered "corruptly," essentially with an intent to wrongfully influence the recipient to misuse his official position. Thus, while the FCPA does not specify a minimum value of what is offered or paid, a gift of company promotional items of nominal value normally would not reflect corrupt intent.

Given the prevalence of state-owned or controlled entities engaged in commercial activities, for example in China, it should be highlighted that foreign officials may include officers or employees of such "agenc[ies]" or "instrumentalit[ies]" of a foreign government.[16]

The FCPA by its terms applies to the activities of agents or intermediaries who would pay a bribe, and the issuers or others who would employ them to do so. The FCPA specifically prohibits payments or offers to a third party (such as an agent) while "knowing" that all or a portion of such payment to the third party will be passed on or offered to a foreign official.[17] It is not necessary that the identity of the foreign official be known. The FCPA contains a definition of "knowing" that relaxes the traditional meaning of that word in certain respects—for example, it presumes the "knowing" condition to be satisfied where the allegedly knowing party is aware of a high probability of the existence of the relevant circumstance.[18]

The FCPA applies to other "indirect" benefits as well. For example, the FCPA may be implicated in certain circumstances by making charitable donations or underwriting sponsorships at the behest of a foreign official or to organizations associated with a foreign official.[19] Similarly, hiring or otherwise benefiting members of the family of a foreign official may present FCPA issues. The government remains focused on these and other alleged means of "evading" the FCPA.

There are two affirmative defenses to the anti-bribery prohibitions of the FCPA for which a defendant would bear the burden of proof. One affirmative defense is for expenses directly related to the bona fide "promotion, demonstration, or explanation" of a company's products or performance of a contract, but not a trip for personal entertainment.[20] The other affirmative defense is for payments that are lawful under the written local law of the foreign country; however, absence of law prohibiting a payment or conduct, or the fact that corrupt payments may not be prosecuted or are otherwise part of the generally accepted custom and practice in a foreign jurisdiction, do not fall within this defense.[21] There is also an exception for payments to facilitate or expedite "routine government action" involving "nondiscretionary acts," although US enforcement authorities have taken a narrow view of this exception."[22]

The accounting provisions of the FCPA require issuers to make and keep books and records that, in reasonable detail, accurately and fairly reflect an issuer's transactions and dispositions of an issuer's assets, and further require issuers to devise and maintain a system of internal accounting controls sufficient to assure management's control, authority, and responsibility over the firm's assets.[23] The FCPA's accounting provisions are not limited to the subject matter of foreign bribery. Individuals and businesses may not knowingly falsify the company's books and records, or circumvent or fail to implement a system of controls.

The US Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) share responsibility to enforce the FCPA. The DOJ has sole authority to bring criminal cases, including for violations of the accounting provisions.[24] For an individual defendant to be criminally prosecuted, he or she must have acted "wilfully," which requires that the defendant acted voluntarily, purposefully, and with "knowledge that [the defendant] was doing a 'bad' act under the general rules of law," without, according to the US government and certain cases, requiring that the defendant "have known of the specific terms of the [FCPA] or even the existence of the statute."[25]

Regardless of such legal standards, most cases, including criminal cases, against corporations settle. They often involve (in the case of an anti-bribery violation) a guilty plea, criminal and/or civil fines, disgorgement of profits from the wrongful conduct, and ancillary "remedies" such as the imposition of a compliance monitor. There can be collateral consequences from an announced FCPA violation as well, including possible debarment from government contracting, civil litigation, management distraction, and stock drops. While the DOJ and SEC have consistently stated that they will reward cooperation, including self-reporting ("if we [the government] find the violations on our own, the consequences will surely be worse than if you had self-reported the conduct"[26]), a "pass" may not be available,[27] and there continue to be substantial costs in any event. This includes the cost of the company's internal investigation itself. Without compromising the integrity of the investigation, it must be carefully managed to ensure efficiency and proportionality. The DOJ and SEC have also signaled their intent to pursue FCPA charges against individuals more aggressively.

An effective FCPA compliance program

The following discussion is intended to highlight certain important elements of an effective FCPA compliance program. Familiarity with these elements, and more generally with the issues raised by corporate compliance programs, should enable nonexperts to ask better questions and to improve compliance efforts.

Tone at the top and at ground level—An effective compliance program requires that management set the correct "tone at the top"—that is, that compliance with applicable laws and regulations, including the FCPA, is "the" priority, that management expects employees to make compliance part of the day-to-day business culture of the company and that non-compliance should not be "balanced" against business or other considerations, however compelling. Thus, the message should be conveyed specifically that it is not a justification for "looking the other way" that it is impossible to do business in a jurisdiction without paying a bribe. That tone at the top can be set by management actions (eg rewarding good compliance and punishing bad) and words (eg sending periodic reminders emphasizing the importance of compliance such as after another firm has been charged with an FCPA violation or announced an investigation).

Equally important, managers at the local, operational, or "ground" level doing business overseas should reinforce the message that compliance with the FCPA is an important part of doing day-to-day business. An effective compliance program will focus on both levels: providing for standard-setting and overall monitoring at the top, implementation and controls at ground level, and effective communication up and down the organization.

Tailored procedures that enforce policies—An effective compliance program requires, in addition to strong written FCPA policies, procedures—that is, corporate controls and processes—designed to ensure that the company's FCPA policies are being followed as business is conducted. For example, companies retaining third-party agents in foreign jurisdictions should implement specific procedures to vet, document, train, and monitor the agents' activities on their behalf. Another example is that companies that do business with foreign governmental counterparties should implement specific procedures to approve and monitor promotional and other activities involving transfers of value, such as travel and entertainment, gift giving, and charitable and political donations, to ensure that they not mask improper payments.

It is almost always possible for the government, in retrospect, to criticize a company for not having a procedure that would have helped prevent the particular problem that occurred. Nonetheless, it is important that a company design a "reasonable" (or in the parlance of the UK Bribery Act, "proportionate"[28]) set of procedures tailored to the particular risks inherent in its business activities. Industry "best practices" may be considered along with other factors in determining what procedures will pass muster as "reasonable."

A prerequisite to developing an appropriate set of "reasonable" FCPA procedures is that management perform an assessment of, and thereby attempt to understand, the particular risks inherent in its business. Different industries have different kinds and levels of risk, as do different companies operating within those industries and different business practices. The different countries in which a company may operate also will present greatly varying levels of risk. Improving visibility into local practices in foreign countries is an important element in shaping an effective compliance program.

In-house and, in certain cases, outside counsel can play a critical role in identifying FCPA risks so that a set of procedures can be tailored accordingly. Identifying such risks requires an assessment of government-related "touch points" in the particular business, both "direct" ones (such as doing business with a governmental department/agency or state-owned enterprise as counterparty) and "indirect" ones (such as governmental licenses/permits/approvals, tax, labor/employment or environmental rulings, audits and inspections, and import/export duties). Being able to gather information on a privileged basis can be essential in certain circumstances to improving compliance prospectively while avoiding pitfalls. An FCPA risk assessment also requires an understanding of where "value" may be created in the business from which an improper payment may be made (eg unusual discounts, rebates, or margin in sales or distribution transactions). Finally, it is also important that companies reassess these touch points and risks inherent in their business periodically and when entering new businesses or new foreign markets (or implementing new business approaches) to ensure that FCPA risks are identified and addressed proactively.

Training—An effective compliance program must operate at "ground" level, and this includes training. While Internet-based training is typically an efficient way of conducting basic training for large groups of employees, tailored training of employees who perform critical roles overseas on the front lines of FCPA compliance may improve the tone on the ground and the overall effectiveness of the program. Thus, for example, training of country managers and local/regional controllers and similar personnel may be best conducted at group meetings for other management purposes, where senior management can convey the importance of compliance and performance expectations. The law may be complex, but the best training is often simple—that is, geared to what will educate and persuade particular audiences to spot as early as possible the issues that arise in their business so that they may, where necessary, bring the matter to the attention of others who are best positioned to deal with the complexity and to safeguard corporate interests beyond local business needs.

Detection—An effective compliance program should also include adequate systems to detect possible instances of wrongdoing. Line managers are often in the best position to detect possible wrongdoing, and there are a variety of techniques designed to ensure that line managers are looking for, and timely reporting, issues. For example, bottom-up certifications may serve to detect questionable conduct in addition to supplying a basis on which the company and its senior management may rely. Ground-level finance, compliance, and other "control" personnel also may play a key role in preventing and detecting possible wrongdoing. On a centralized level, periodic internal audits focused on anti-corruption issues may detect risks and potentially wrongful activities. And in-house counsel, alone or operating with the assistance of outside counsel, may conduct inquiries to evaluate specific issues (including possible instances of wrongdoing) on a privileged basis. The availability of internal whistle-blower systems, and the ease of use of such systems, is also important to detection.

Mergers & acquisitions—Companies that devote considerable effort to their own FCPA compliance may nonetheless "inherit" the FCPA risk of the companies they combine with or acquire. FCPA due diligence should be tailored to the risk profile of the target, including the direct and indirect governmental touch points discussed above. Due diligence should specifically focus on assessing the adequacy of the target's existing compliance program, and identifying past or ongoing FCPA issues. Representations and warranties and other deal terms may be used to allocate or otherwise manage FCPA risk in the transaction. In any event, FCPA compliance at the newly acquired company should be integrated in a timely manner in coordination with other integration efforts.

Agents—It is important that a company assess its dealings with "agents" or other third parties whose actions on behalf of the company could create FCPA liability. This has historically been a major problem area for companies, as a very high percentage of FCPA enforcement actions involve misconduct by agents or other third-party intermediaries.[29] There are a variety of different compliance measures that address this risk, including performing due diligence concerning the agent, carefully documenting the agent's retention, training the agent, obtaining representations and warranties, monitoring the agent's activities, and promptly responding to "red flags."

Conclusion

It is important that directors and senior managers fulfill their respective roles with respect to compliance with the FCPA, as well as other laws and regulations generally. While questions exist as to whether the government adequately "rewards" effective compliance when problems do arise, an effective compliance program is critically important to giving the company the chance to: (1) prevent wrongful conduct before it occurs; (2) detect potential wrongful conduct earlier; (3) remediate wrongful conduct in a more timely and effective manner; (4) achieve a "better" outcome in the event of an enforcement investigation; and (5) best protect the company, and its board, senior management, and other constituents, from potential civil liability and other collateral consequences.

Notes

1 188 A.2d 125 (Del. 1963).

2 188 A.2d at 130.

3 698 A.2d 959 (Del. Ch. 1996).

4 911 A.2d 362, 369-70 (Del. 2006).

5 *In re Caremark*, 698 A.2d at 967.

6 *See* DEL. CODE ANN. tit. 8, §§102(b)(7), 145(a) (West 2011).

7 *Wood v. Baum*, 953 A.2d 136 (Del. 2008); *In re Intel Corp. Deriv. Litig.*, 621 F. Supp. 2d 165 (D. Del. 2009); *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007).

8 *American International Group v. Greenberg, et al.*, 965 A.2d 763 (Del. Ch. 2009); *In re Countrywide Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044 (C.D. Cal. 2008).

9 Other jurisdictions have their own anti-bribery laws, eg, the UK Bribery Act. An effective anti-corruption compliance program would take into account all potentially applicable foreign and local laws.

10 15 U.S.C. § 78dd-1 *et seq*.

11 *Id*. § 78dd-2.

12 *Id*. § 78dd-3.

13 *Id*. §§ 78dd-1(a); 78dd-2(a).

14 *Id*. §§ 78dd-1(a)(1)(B)-(a)(2)(B); 78dd-2(a)(1)(B)-(a)(2)(B); 78dd-3(a)(1)(B)-(a)(2)(B).

15 *See,* eg, *United States v. Kay*, 359 F.3d 738, 755 (5th Cir. 2004) ("Congress intended for the FCPA to apply broadly to payments intended to assist the payor, either directly or indirectly, in obtaining or retaining business for some person, and that bribes paid to foreign tax officials to secure illegally reduced customs and tax liability constitute a type of payment that can fall within this broad coverage."). *See* US Department of Justice, Criminal Division & Securities and Exchange Commission, Enforcement Division, *A Resource Guide to the US Foreign Corrupt Practices Act* (Nov. 2012) at 12-13. ("FCPA Resource Guide").

16 15 U.S.C. §§ 78dd-1(f)(1)(A); 78dd-2(h)(2)(A); 78dd-3(f)(2)(A).

17 *Id*. §§ 78dd-1(a)(3); 78dd-2(a)(3); 78dd-3(a)(3).

18 *Id*. §§ 78dd-1(f)(2)(A)(i)-(ii); 78dd-2(h)(3)(A)(i)-(ii); 78dd-3(f)(3)(A)(i)-(ii).

19 *SEC v. Schering-Plough Corp.,* No. 04-cv-945 (D.D.C. June 9, 2004) (Compliant) and *In re Schering-Pough Corp.*, Exchange Act Release No. (June 9, 2004).

20 *Id*. §§ 78dd-1(c)(2)(A); 78dd-2(c)(2)(A); 78dd-3(c)(2)(A). FCPA Resource Guide at 24.

21 *Id*. §§ 78dd-1(c)(1); 78dd-2(c)(1); 78dd-3(c)(1). *See,* eg, *United States v. Kozeny*, 582 F. Supp. 2d 535 (S.D.N.Y. 2008) (rejecting local law defense where written Azeri law did not legalize the improper payment at issue; local law relief from criminal liability for bribe payer who made voluntary disclosure to local authorities was insufficient).

22 *Id*. §§ 78dd-1(b); 78dd-2(b); 78dd-3(b). FCPA Resource Guide at 25. It should also be noted that the UK Bribery Act does not contain an exception for facilitation payments and so care must be exercised to ensure applicability of the exception to a company's activities.

23 *Id*. § 78m(2)(A)-(B).

24 FCPA Resource Guide at 4.

25 Eg, *United States v. Kay*, 513 F.3d 432, 447-48 (5th Cir. 2007).

26 Andrew Ceresney, Keynote Address at the International Conference on the Foreign Corrupt Practices Act (Nov. 19, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540392284.

27 *Compare* eg, Press Release, SEC, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct (Apr. 22, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514780 *with* Press Release, DOJ, Former Morgan Stanley Managing Director Pleads Guilty for Role in Evading Internal Controls Required by FCPA (Apr. 25, 2012), *available at* http://www.justice.gov/opa/pr/2012/April/12-crm-534.html. *See also* DOJ, "A Resource Guide to the U.S. Foreign Corrupt Practices Act," at 21-23 (discussing bribes paid by foreign agents).

28 *See* Ministry of Justice, *The Bribery Act 2010: Guidance*, at 21, *available at* http://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf ("Adequate bribery prevention procedures ought to be proportionate to the risks that the organisation faces.").

29 *See,* eg, Press Release, DOJ, Marubeni Corporation Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay a $54.6 Million Criminal Penalty (Jan. 17, 2012), *available at* http://www.justice.gov/opa/pr/2012/January/12-crm-060.html; Press Release, DOJ, Oil Services Companies and a Freight Forwarding Company Agree to Resolve Foreign Bribery Investigations and to Pay More than $156 Million in Criminal Penalties (Nov. 4, 2010), *available at* http://www.justice.gov/opa/pr/2010/November/10-crm-1251.html.

29 Handling regulatory inquiries, investigations, and settlements

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We live in an era of heightened regulatory scrutiny of public companies. As Mary Jo White, the chair of the US Securities and Exchange Commission (SEC), promised at her confirmation hearing, the SEC is pursuing an enforcement strategy that is "bold and unrelenting." In today's regulatory climate, companies increasingly are being judged by the way they respond to investigations, and any perceived failure to respond appropriately can have severe consequences. As a result, companies must react swiftly and effectively when confronted with an inquiry. This chapter summarizes key practical considerations in responding to an investigation.

Who are the regulators and what do they investigate?

The SEC is the primary regulator of public companies and is a law enforcement agency. SEC investigations are conducted by the staff of the Division of Enforcement (Staff). These investigations involve the full range of issues under the federal securities laws, including improper financial reporting, misleading disclosures, incorrect accounting, false filings and offerings, inadequate internal controls, inaccurate books and records, insider trading, stock manipulation, misappropriation of assets, and anticorruption violations. Each year, the SEC brings hundreds of civil and administrative enforcement actions.

While this chapter focuses on SEC investigations, many of the practical considerations also apply to inquiries conducted by other law enforcers, including the US Department of Justice (DOJ), state securities departments and attorneys general, and regulators such as the Commodity Futures Trading Commission, Financial Industry Regulatory Authority, and Public Company Accounting Oversight Board. High-profile investigations often can lead to a media blitz, shareholder litigation, delisting, and reputational harm, as well as capture the attention of Congress.

The commencement of an investigation

SEC investigations, like most others, can begin in a variety of ways—from the informal (such as a call from an investigator or a voluntary letter request) to the formal (such as a subpoena for documents or testimony). The Staff is authorized to conduct informal inquiries, called Matters Under Inquiry (MUIs), or formal investigations upon the issuance of a Formal Order of Investigation (Formal Order). Formal Orders designate members of the Staff to act as officers of the SEC for purposes of conducting the investigation, including issuing subpoenas to compel the production of documents and testimony.

Practice Pointer

Any person who is compelled or requested to furnish documents or testimony has the right to request and be shown the Formal Order. To receive and retain a copy, however, such persons must follow certain procedures in sending a written request, and approval of the request is at the discretion of the Staff (although such requests typically are granted). See Rule 7(a) of the SEC's Rules Relating to Investigations, 17 C.F.R. § 203.7(a); see also SEC Enforcement Manual, Section 2.3.4.2. While Formal Orders are generic in nature, they do provide some information with respect to the potential violations being investigated.

Regardless of how investigations start, companies should take them seriously and avoid compounding problems by failing to stop ongoing violations, destroying or failing to preserve documents, making inaccurate or false statements, or doing anything else that results in losing credibility. Throughout the course of an investigation, companies should remember that credibility and cooperation are key. The SEC and DOJ, among others, have issued frameworks for obtaining cooperation credit during an investigation. See, for example, SEC Enforcement Manual, Section 6; United States Attorneys' Manual, Title 9-28.

Disclosing the investigation

There is no line-item requirement under the federal securities laws requiring that public companies disclose investigations. Instead, companies must determine whether the facts and circumstances require line-item disclosure (for example, under Item 103 of Regulation S-K) or if disclosure is required because the investigation is quantitatively or qualitatively material. In doing so, companies should assess the probability and magnitude of the outcome of the investigation, including whether any potential losses are probable and reasonably estimable. In addition, issues or events that arise during or as a result of the investigation may themselves require disclosure (for example, if significant errors in previously issued financial statements are uncovered).

If required, disclosure should be prompt and complete. If not required, companies should consider whether to make a voluntary disclosure, including assessing factors such as the ability to place the issues in context and the likelihood of the investigation becoming known without disclosure. The timing of disclosure is critical. It can be premature if the details and depth of the potential problems are unknown and end up understated, or too late if it is perceived that a company did not react in a timely fashion. Company securities counsel should be consulted on all disclosure issues.

Practice Pointer

Companies should consider implementing crisis communications plans to deal with the marketplace, as well as employees, customers, vendors, and the like. These plans can be developed generally in advance of any problem and tailored to specific situations as they arise, and they can be helpful at all stages of an investigation (from initial disclosure through resolution). In developing communications plans, companies should assess whether a public relations firm should be engaged. If feasible, the engagement should be made through counsel to preserve the attorney-client privilege and to protect work product.

Preserving relevant evidence

Upon receiving notice of an investigation, companies should take immediate action to preserve potentially relevant documents, including considering the following steps:

1. Identify a list of individuals who might have information and documents relevant to the investigation and, if necessary, expand the list as more information is learned.
2. Send written notices to these individuals instructing them to preserve hard-copy and electronic documents. Provide examples of the types of documents to be preserved (including documents that might not be readily apparent, such as instant and text messages and voicemails), as well as the potential locations of such documents. Instruct personnel to err on the side of being overinclusive in their preservation efforts and to preserve all originals, drafts, and duplicates. If practical, obtain representations or certifications from personnel stating that they are complying with the preservation memoranda.

Practice Pointer

For certain personnel, the circumstances also might warrant taking control of hard-copy documents, hard drives, laptops, and personal devices. In this regard, companies should not rely on certain individuals to preserve documents, particularly if it is possible they were involved in potential wrongdoing. Companies should take immediate control of all files of suspected wrongdoers.

3. Work with company technology personnel to preserve electronic documents, and consider using an outside document vendor retained through counsel. Ensure that all relevant documents are preserved even if they are scheduled for routine disposal as part of a pre-existing policy. If electronic documents are not automatically archived, consider retaining relevant backup tapes and ceasing recycling of such tapes. Take a "snapshot" of the email system and other servers and databases as appropriate.
4. If the authority conducting the investigation issues a preservation notice, the specific terms must be followed—clarification or modification can be sought as necessary.

Collecting, reviewing, and producing documents

There are different options for collecting documents, ranging from self-collection by asking individuals to provide documents for review and production, to guided collection by interviewing individuals to identify responsive documents, to more centralized collection by imaging individuals' hard drives and conducting "office sweeps." Companies also should collect noncustodial responsive documents, such as centrally stored hard-copy or electronic documents, and use a system to track the source of documents and compliance with collection requests. Failure to collect and produce all responsive documents and properly comply with a subpoena can create negative inferences and even lead to self-standing proceedings to enforce the subpoena—something the SEC has trumpeted in recent pronouncements and acted on by marching into federal court.

Practice Pointer

Companies should determine if responsive documents from former employees have been maintained. Similarly, companies should consider collecting from individuals who depart the company during the investigation (for example, retaining their hard drives).

Much of the early part of the investigation will be spent reviewing and producing documents. In doing so, companies should consider the following steps:

1. Use a database provided by a qualified vendor to store, review, and produce collected documents.
2. For larger requests, consider using search terms to identify potentially responsive documents.

Practice Pointer

Discussing search terms and related issues with the authority conducting the investigation can help ensure that the company is responding appropriately. Depending on the circumstances, agreements to narrow certain aspects of a request or subpoena can be reached.

3. Review and code all documents for responsiveness and privilege. This process also can be used to identify key documents that will be useful as the investigation proceeds.

Practice Pointer

The review process will depend on the nature of the documents. In addition to a privilege review, companies should consider whether documents might contain information that is personal, proprietary, or covered by statutory privileges or protections. If documents reside outside of the US, companies should be cognizant that foreign jurisdictions often have data-protection laws and other legal restrictions.

4. Comply with the instructions in the request or subpoena when determining the mechanics and format of productions and be transparent about production protocols (for example, identifying the reasons for redactions).
5. Where permissible, request confidential treatment of the documents, including notification of requests made by third parties to access the documents.

Practice Pointer

Whether confidential treatment can be requested will depend on the authority conducting the investigation. For example, the SEC has specific requirements for making confidential treatment requests under the Freedom of Information Act (FOIA). See, for example, 17 C.F.R. § 200.83. Conversely, certain other regulators do not permit requests for confidential treatment.

Inquiring into the facts

Companies should begin inquiring into the facts as soon as possible. In certain instances, this might warrant an independent internal investigation—but, in others, it might involve a less formal review. In either case, the ultimate goal is to uncover and assess all of the facts (the good, bad, and ugly).

Practice Pointer

Factors to consider when deciding whether to conduct an internal investigation include the egregiousness of the potential problem, the likelihood that financial statements or disclosures will be affected, whether the problem is systemic in nature, and how many individuals are involved and their seniority levels. Related questions include who should oversee the investigation (for example, management, the board, the audit committee, or a special board committee) and who should conduct it (for example, internal audit, in-house counsel, outside defense counsel, or independent outside counsel with no prior relationship with the company). To answer these questions, companies also should consider (1) the credibility of the investigation with the regulators, (2) efficiencies from using investigators familiar with the company, and (3) conducting the review under the attorney-client privilege.

Identifying key documents and conducting interviews are important parts of the fact-gathering process (whether or not a formal internal investigation is undertaken). As for interviews, companies should consider the following steps:

1. Generate a list of interviewees. Be aware that multiple interviews of the same individual may be necessary as further information is uncovered.
2. Determine whether cooperation of personnel can be required (through board resolution or otherwise) and what actions can be taken if an individual refuses to submit to an interview.

Practice Pointer

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, there are antiretaliation provisions prohibiting employers from taking adverse employment actions against whistle-blowers. Companies should consider these provisions (along with other relevant restrictions under employment law or otherwise) before requiring employees to submit to interviews under threat of termination for noncooperation.

3. Determine the subject areas of inquiry. In addition to substantive issues, cover the interviewees' document collection efforts and the identity of other individuals who might have relevant information.
4. Have two interviewers present at each interview to assure proper documentation of what was said and to avoid misunderstandings.
5. Provide Upjohn warnings at the outset, notifying interviewees that (1) counsel represents the company and not the interviewees, (2) the interview is being conducted to gather facts in order to provide legal advice to the company, (3) the discussion during the interview is privileged, but the privilege belongs solely to the company, not the interviewees, (4) the company can elect to waive the privilege and disclose the discussion to third parties, including regulators, without obtaining the interviewees' consent, and (5) the interviewees must keep the discussion in confidence and may not discuss the substance of the interview with anyone but counsel.

Practice Pointer

Interview notes or memoranda should reflect the fact that Upjohn warnings were provided, and companies should consider whether written acknowledgments should be obtained from interviewees.

6. Determine how to document interviews. Keep in mind that this documentation, including notes or formal interview memoranda, could be susceptible to production to the regulators (and possibly in civil litigation). Avoid verbatim recitations and use appropriate legends that identify the documentation as being covered by the attorney-client privilege and attorney work product doctrine.

Preparing for and defending testimony

If testimony is required, companies should determine whether and to what extent witnesses should be represented by separate counsel. (In some instances, individual representation already may have been secured—for example, in advance of internal interviews.) Depending on the circumstances, company counsel might represent certain individuals, or individual counsel might represent multiple witnesses, but potential conflicts of interest need to be considered. Company counsel also should assess the feasibility and advisability of entering into oral or written joint defense or common interest agreements with counsel for others. In addition, companies should determine whether it is mandatory or permissive to provide advancement of legal expenses (and, ultimately, indemnification) to individual directors, officers, or other employees, as well as the prerequisites for doing so—for example, undertakings to repay advanced funds.

Practice Pointer

SEC rules provide for witness sequestration and prohibit witnesses or their counsel from being present during the testimony of other witnesses (unless permitted in the discretion of the officer conducting the investigation). See Rule 7(b) of the SEC's Rules Relating to Investigations, 17 C.F.R. § 203.7(b). Counsel, however, is permitted to represent and defend the testimony of more than one witness. See SEC Enforcement Manual, Sections 3.3.5.2.2 and 4.1.1.1. During testimony, the Staff will typically ask counsel to confirm that they represent the witness. Accordingly, if company counsel intends to appear at testimony and is not already representing the witness, they should consider discussing this in advance with the Staff or entering into a limited representation for the purpose of defending the witness at testimony.

Preparation is crucial for any testimony, and sufficient time should be reserved to cover all potential areas of inquiry. Company counsel should already have an extensive understanding of the facts and issues, and the goal of preparation should be to help ensure that truthful, complete, and credible testimony is provided. Witnesses who do not recall much of anything, particularly if the facts at issue are recent or of a memorable nature, are not received well—and they can be perceived as noncooperative or even obstructionistic.

SEC and other regulatory testimony is not governed by evidentiary or civil procedure rules, but counsel should avoid the appearance of impeding the inquiry or coaching the witness during testimony. Counsel, however, can ask for clarification, as well as ask the witness substantive questions. This needs to be done effectively and for the purpose of creating a clear record.

Practice Pointer

Experienced securities enforcement practitioners typically do not "object" during SEC testimony. This notwithstanding, counsel should interject appropriately if an examiner goes out of bounds in terms of questions that call for privileged information, irrelevant questions, inaccurate statements of fact, poor treatment of the witness, or the like.

At the end of SEC testimony, counsel should request confidential treatment of the testimony under FOIA and follow up with a written request. Counsel may also request a copy of the testimony transcript, but sometimes it is advisable not to do so—for example, if there is ongoing civil litigation, counsel may decide not to request a transcript (but, even then, it could be subject to discovery).

Taking appropriate proactive steps

Based on an assessment of the facts, companies should consider taking appropriate proactive steps, including deciding whether to self-report improper conduct in advance of a regulatory investigation (taking into account a range of pros and cons) or to impose remedial measures. Companies can use remedial measures both as a sword (by gaining cooperation credit) and a shield (by making recurrence of the underlying misconduct less likely).

Remedial measures to consider include (1) developing new or enhanced policies, procedures, and controls, (2) providing training, (3) restructuring lines of reporting and hiring consultants or additional personnel, (4) reassigning, suspending, or terminating employees, (5) implementing heightened supervision, (6) withholding bonus payments and making additional revisions to equity-based or other compensation, and (7) providing restitution (if possible and appropriate).

Responding to a preliminary charging determination

At the end of SEC investigations, if the Staff makes a preliminary determination to recommend an enforcement action, they typically will issue a "Wells notice." These notices communicate the Staff's preliminary determination, identify the potential securities law violations, and advise of the opportunity to make a "Wells submission" responding to the charges. The Staff may also provide counsel with an oral briefing of their concerns.

The primary purpose of making a Wells submission is to dissuade the Staff initially, or the SEC Commissioners ultimately, from proceeding with an action or, if this is unsuccessful, to mitigate the charges. These submissions provide an opportunity to lay out the facts in the best light (including correcting any misconceptions on the part of the Staff), show why an action is unwarranted and would be unsuccessful if brought, and identify policy and other considerations militating against an action. When drafting a submission, counsel should be cognizant that the audience is the Staff (including senior enforcement officials, as well as the trial attorneys who would litigate the case) and the Commissioners (who will consider the submission if the Staff decides to proceed with a recommendation).

Practice Pointer

Wells submissions are not mandatory and, in certain circumstances, are not advisable. For example, if discussions have made it clear that the Staff will not change their mind and there is no possibility of an acceptable settlement, a company may decide to forego a submission. Doing so will avoid revealing the company's positions in advance of contested litigation and protect against potential admissions. In this regard, the Staff takes the position that Wells submissions are admissible as evidence. Significantly, false statements in a Wells submission could be charged as a separate criminal offense.

The conclusion of the investigation, including settlement and other considerations

Regulatory investigations can conclude in a number of different ways, ranging from no charges to the filing of a contested action. As for SEC investigations, if a decision is made not to pursue charges, Staff policy provides that a closing letter should be issued (although this has not always happened consistently). Other potential outcomes include a (1) deferred prosecution or nonprosecution agreement (see SEC Enforcement Manual, Sections 6.2.3 and 6.2.4), (2) settlement with an agreed-upon action, or (3) contested action filed by the SEC.

If an SEC settlement is contemplated, companies should consider a number of issues, including:

1. Can the company accept the charges being sought by the Staff? Is the Staff willing to reduce harsher charges (for example, scienter-based violations of the antifraud provisions) to lesser charges (for example, process-oriented violations such as nonscienter antifraud, books and records, or internal control violations)?
2. Is the Staff willing to proceed in a forum acceptable to the company, whether as an administrative cease-and-desist proceeding (which includes findings of fact, but generally is considered less severe, has relatively fewer collateral consequences, and does not require court approval) or a civil injunctive action in federal court (which includes only allegations rather than factual findings)?
3. Are the proposed monetary and nonmonetary sanctions acceptable? (The potential sanctions in an SEC action are discussed below.)
4. Will the Staff permit the company to settle without admitting or denying the violations, or will admissions be required? (The Staff recently has started to require admissions in certain cases involving egregious conduct.)
5. Can the company accept the collateral consequences of the action, such as reputational harm, potential consequences

in civil litigation, or disqualifications from certain issuer exemptions under the federal securities regulations (assuming the Staff does not agree to waive such provisions)?

Practice Pointer

Companies operating in particular industries also might face further consequences. For example, aspects of a settlement might trigger debarment provisions relevant to government contractors.

The SEC can impose a wide range of sanctions in connection with a settled or contested action. The nature of the sanctions will depend on the underlying conduct, as well as the company's response to such conduct (including self-reporting, cooperation, and remediation). Potential sanctions include (1) an injunction or cease-and-desist order, (2) disgorgement of "ill-gotten gains" and related prejudgment interest, (3) penalties ranging up to millions of dollars per incident, (4) barring individuals from serving as officers or directors of public companies, (5) barring accountants or attorneys from appearing or practicing before the SEC, and (6) requiring companies to agree to undertakings (such as the appointment of an independent consultant or monitor).

Practice Pointer

The SEC requires settling parties to agree not to seek or accept any indemnification or reimbursement (including from insurers) and not to claim, assert, or apply for any tax deduction with respect to penalties paid as part of the settlement. These restrictions typically apply only to penalties, and not to disgorgement or prejudgment interest.

Companies should assess the foregoing factors when deciding whether to resolve an investigation by settlement or to move to litigation. Decisions made during the course of the investigation can position the company and help determine the outcome, including whether the inquiry will conclude without any action being taken, an acceptable settlement will be possible, or litigation will be the only option.

30 Sarbanes-Oxley/internal control

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The Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act, or SOX) was enacted as a response to the crisis of confidence in the financial integrity of public companies. While SOX is composed of 11 titles, ranging from corporate tax return approvals to securities analyst independence, three titles (III, IV, and IX) specifically cover corporate governance and internal controls applicable to public companies.

Though all public companies must comply with applicable SOX requirements, pre-initial public offering (IPO) and newly public companies will face the greatest challenges in designing and implementing a robust system of internal controls to meet the requirements outlined in titles III, IV, and IX. Specifically, SOX Section 404(a), which requires management to assess the effectiveness of internal controls over financial reporting (ICOFR) annually, and Section 404(b), which requires the independent auditor to provide an independent assessment, can involve significant effort. Certain phase-in exemptions, however, are afforded newly public companies to allow time for implementation of these ICOFR requirements. With a well-planned and well-executed ICOFR implementation strategy that takes advantage of applicable exemptions, private companies can smoothly transition to public entities in full compliance with SOX. Management's assessment under Section 404(a) must be based on a suitable control framework. Though not required, most US registrants utilize Committee of Sponsoring Organizations of the Treadway Commission (COSO), discussed further below, as their internal control framework.

COSO internal control—integrated framework

In 1992, the COSO published the *Internal Control–Integrated Framework* (the original framework), an integrated framework establishing a common definition of internal control:

> *Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.*

In 2013, COSO released an update to the framework. The changes made to update the 1992 framework are evolutionary, not revolutionary. The 2013 framework takes into account changes in the business environment and operations over the last 20 years. The 2013 framework retains the definition of internal control and the COSO cube, illustrating the five components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring activities.

The principles-based COSO framework defines the elements of internal control that are expected to be present and functioning in an integrated manner, including ICOFR. Ultimately, ICOFR should provide reasonable assurance regarding the reliability of an entity's financial reporting and the preparation of financial statements.

SOX Sections 302 and 906

SOX imposes greater accountability on senior management for the company's financial reporting results. Section 302, in particular, requires the principal executive and financial officers to certify they have read the financial statements and, to the best of their knowledge, the financial and nonfinancial information is accurate, complete, and fairly presented. Additionally, they must certify that the following items, if applicable, have been appropriately disclosed: any material changes to the company's internal controls, any significant deficiencies or material weaknesses in the design or operation of the company's internal controls, and any evidence of fraud involving management or employees having a significant role in ICOFR.

SOX Section 906 holds the chief executive and financial officers legally liable for verifying that the report fairly presents, in all material respects, the financial condition and results of operations of the issuer. Under Section 906, upper management who knowingly certify misleading or fraudulent financial statements are subject to criminal penalties including fines of up to $5 million and up to 20 years in prison. This includes compliance with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 covering management's reporting of ICOFR. Such stringent penalties are designed to serve as a deterrent to executives who would otherwise be inclined to mislead the public or falsify financials for personal gain.

The Sections 302 and 906 certifications are required with a public company's first periodic Securities and Exchange Commission (SEC) filing (eg 10-Q, 10-K, 20-F) and all such filings thereafter. As a result, newly public companies will generally be required to certify under Sections 302 and 906 prior to having fully implemented an ICOFR assessment program under Section 404. Due to this difference in timing of implementation, certifying officers will need to ensure they have a sufficient basis on which to provide their required 302 and 906 certifications. Fortunately, one transitional period modification to the certification language is allowed for newly public companies, who may omit the paragraph on the 302 certification related to effectiveness of ICOFR, including responsibility for designing, establishing, and maintaining ICOFR, until their second annual filing (eg 10-K, 20-F).

Disclosure controls and procedures

To assist management in fulfilling their responsibilities under SOX Sections 302 and 906, companies will need to establish disclosure controls and procedures. Effective disclosure controls and procedures (DCP) include thorough financial statement review and mid-level management ownership of controls to provide comfort to the chief executive officer (CEO) and chief financial officer (CFO) that disclosures are complete and accurate. Some common elements of DCP can include the following:

- Disclosure policy—articulates the corporate disclosure objectives, and specifies the following: who is authorized to speak on behalf of the company, responsibility for disclosure processes throughout the organization, policies for maintaining disclosure records, and procedures for managing all disclosure channels such as electronic communications, corporate websites, and corporate and public presentations to parties other than the investment community.

- Disclosure committee—assists senior officers in implementing proper DCPs and overseeing the accuracy and timeliness of disclosures (eg review of periodic financial statements prior to public disclosure and filing with the SEC).
- Subcertification process—promotes and expands accountability of financial disclosure by requiring key company personnel to certify similar assertions as those included on the 302 and 906 certifications. Note: Ultimate responsibility under Sections 302 and 906 rests with the chief executive and financial officers and cannot be delegated through a subcertification process.
- Control owner certification process—requires control/information technology (IT) application owners to periodically certify to the adequacy and operating effectiveness of internal controls. Control owner certifications may include notification to management of any material changes in controls.

Section 404: assessment of internal control

Implementing an effective system of ICOFR, as required by SOX Section 404, involves significant cost and planning and coordination of multiple stakeholders including management, employees, and the company's independent auditor. The ongoing maintenance of the ICOFR program, however, is less burdensome as the focus shifts from identifying and adequately addressing (ie documenting and testing) all financial reporting risks and controls to only those items that have changed.

SOX 404 implementation phases

ICOFR implementations generally consist of the following components (see Figure 1):

- Scope evaluation/risk assessment—The implementation process begins with an evaluation of the company's locations, segments, and processes. Per both SEC and Public Company Accounting Oversight Board (PCAOB) guidance, companies are recommended to utilize a top-down, risk-based evaluation of financial reporting risks and related controls by performing both a quantitative analysis of account balances and a qualitative analysis of a variety of risk factors (eg susceptibility to errors, volume of activity, degree of judgment or estimate). Upon evaluating the qualitative and quantitative factors, management finalizes the locations and processes to include in its SOX 404 scope. Next, material financial statement line items are mapped to the in-scope processes. Finally, process-level risks are identified for relevant financial statement assertions.
- Document controls—Once the risk assessment is completed, key controls should be identified and documented, including those addressing assertions related to all significant accounts and disclosures. Major categories of controls include the following:
  - Entity-level controls (ELCs)—centralized monitoring controls that may reduce the reliance on lower-level process/transactional controls. ELCs can be further classified as direct or indirect based on whether or not they address a relevant financial statement assertion.
  - General information technology controls (GITCs)—controls governing the environment, effective operation of, access to, and program development and program changes related to the in-scope IT applications.
  - Process-level controls—controls, both manual and automated, within the in-scope processes that mitigate the identified risks to the relevant financial statement assertions to an appropriate level.

Documentation such as process flowcharts, narratives, and risk and controls matrices can facilitate management in understanding of the flow of financial reporting–related transactions and identifying the related risks and control points.

- Test controls—Upon identifying and documenting controls over financial reporting, management performs testing of controls to help ensure they are adequately designed—providing reasonable assurance regarding the reliability of financial reporting—and operating effectively. Testing strategies should be determined based on the nature of the account or disclosure (eg accounts with an inherently higher level of risk), and the volume, complexity, and homogeneity of individual transactions. Changes from a prior period are also considered when planning and executing tests of controls.
- Correct deficiencies—Identified control deficiencies related to design or operating effectiveness are documented and assessed individually and in aggregate to determine severity related to the potential magnitude and likelihood of misstatement in the financials. For purposes of SEC reporting, ratings of "deficiency," "significant deficiency," and "material weakness" are assigned. Per the SEC, significant deficiency and material weakness are defined as follows:
  - Significant deficiency—a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting.
  - Material weakness—a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal controls.
- Report on controls—The results of controls testing are formally documented by management in a report on the design and effectiveness of internal controls. The independent auditor reviews management's report and test work, as well as the results of their own testing, and issues an internal controls opinion as part of its overall audit report. If a material weakness exists, management cannot conclude they have maintained effective ICOFR. Significant deficiencies and material weaknesses must be reported to the company's audit committee of the board of directors. For material weaknesses, management must state in its annual report filed with the SEC that its internal controls are ineffective.

Figure 1 ICOFR implementation phases

Scope Evaluation	Document Controls	Test Controls	Correct Deficiencies	Report on Controls
• Determine significant controls and business units.	• Document design of controls over relevant assertions related to all significant accounts and disclosures.	• Test control design and operating effectiveness. • Document results.	• Identify and correct control deficiencies.	• Prepare written assertion of the effectiveness of ICOFR.

Additionally, the SEC recommends companies consider disclosing additional details regarding material weakness, including the nature, impact, and planned/executed remediation activities.

Management considerations

While there are several required components of a SOX program (eg testing of controls), management can exercise judgment over various aspects related to the program design and execution. Such items include, but are not limited to, the following:

- Alignment between management's and the external auditor's evaluation approaches—Management and the external auditor must individually express an opinion on the effectiveness of ICOFR. Provided certain criteria are met (eg competence and objectivity of management resources executing the SOX program, minimum control testing sample sizes), guidance allows the auditor to utilize the work of other parties as part of their assessment. In other words, the external audit may place reliance on a portion of the procedures performed by management as part of management's assessment. However, this will generally require the evaluation approach utilized by management to be aligned with the external audit evaluation approach, which may not be the most effective or cost beneficial for management purposes. Thus, the potential cost and benefits of maximizing auditor reliance should be evaluated early in the process to help ensure the desired level of reliance is achieved.
- Documentation format—There is no required format of control design documentation. Companies may elect to utilize flowcharts, narratives, policy and procedure manuals, risk and control matrices, or a combination to document their design of ICOFR. However, there has been recent emphasis from the PCAOB on auditors of public companies to clearly identify the flow of transactions utilizing a flowchart format. This is shifting the focus of many companies to create new or place more reliance on existing process flowcharts. Consideration of this should be given by companies anticipating an IPO, as well as newly public companies, as they evaluate and determine the format for their control documentation.
- Degree of centralization—For companies with decentralized operations and control environments or multiple locations/business units, consideration should be given as to whether a consistent, global set of controls will be established for the entire organization or if each location is granted a degree of autonomy in the identification of controls. There are advantages and disadvantages to either approach (eg uniformity versus flexibility; corporate versus entrepreneurial); consequently, management should evaluate its unique circumstances to determine the most effective approach.
- Multi-use documentation—Management may choose to leverage its SOX control documentation for purposes beyond satisfying its Section 404 ICOFR requirements. Examples include adding additional process steps, risks, and controls related to regulatory or operational aspects.

Obstacles to implementation

SOX compliance takes considerable planning and coordination across all levels of management to implement and maintain. Pre-IPO companies should evaluate obstacles prior to beginning SOX implementation. Potential obstacles may include limited resources with the appropriate business knowledge, competing priorities on management's time, and complex IT systems that must be aligned to SOX controls. Companies also face continual changes within business processes and ongoing costs of compliance efforts.

Considerable effort is required to identify and remediate control design deficiencies, instances where controls are either missing or inappropriately designed to achieve their specified objective. Even for well-controlled companies, challenges remain related to producing sufficient evidence supporting effective operation of controls. In many instances this includes education and cultural changes for areas outside of accounting and finance that may not be as accustomed to formalized documentation retention requirements (eg IT, operations), understanding the importance of documenting, and formalizing their controls.

Section 404 transitional timing for newly public companies and other exemptions

Due to the extensive burden placed on companies in implementing effective ICOFR, the SEC provided phased-in timing of compliance for newly public companies. In addition to the previously discussed Section 404 certification and auditor attestation exemptions, reliefs are afforded by some recent legislation.

Under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), nonaccelerated filers (companies having less than $75 million in market capitalization) receive permanent exemption from the auditor attestation requirements under Section 404(b).

The Jumpstart Our Business Startups Act (JOBS Act), ratified on April 5, 2012, created, among other things, a new category of public equity issuers called emerging growth companies (EGCs) that can elect to be exempt from some SEC reporting requirements for up to five years, including the auditor attestation requirement under Section 404(b). An EGC can elect exemption from the 404(b) requirement for the shorter of the period it continues to qualify as an EGC or five years. This election does not impact the Section 404(a) management assessment requirement.

Additional SOX requirements

In addition to SOX Sections 302, 906, and 404, several other sections relate to internal controls and corporate governance.

Section 406: code of conduct and ethics

Section 406(c) requires all US-listed companies to maintain a code of conduct applicable to all directors, executives, and employees with the definition of "code of ethics" as stated in this section. The NYSE Corporate Governance Rules (Provision 10) also require a company to adopt and disclose its Corporate Governance Guidelines and Code of Business Conduct and Ethics. The code of conduct must be publicly available and must define conflicts of interest, illegal and improper payments, anti-competitive guidelines, and Foreign Corrupt Practices Act (FCPA) compliance, as well as acceptable dealings with employees, suppliers, customers, investors, creditors, insurers, competitors, auditors, and so forth.

Section 303 and SEC Rule 10A-3(b)(3): anti-fraud

In addition to the legal liability that executive management has for the fairness of the financial statement presentation, SOX Section 303 forbids any officer or director from taking action to fraudulently influence, coerce, manipulate, or mislead independent public or certified accountants engaged in auditing the financial statements with the intention of rendering the financial statements materially misleading. However, unlike Section 906, Section 303 does not outline specific penalties for those found guilty of fraud.

Audit committees must also establish whistle-blower procedures and an ethics "hotline" for receiving, retaining, and processing complaints regarding accounting, internal control, or auditing matters (SEC Rule 10A-3(b)(3)). The policy must be communicated to all employees, and complaints must be treated confidentially and anonymously to foster an environment in which individuals are comfortable reporting potential fraud and other violations. Management is required to monitor any reported violations to determine if items require resolution and reporting to the audit committee or board of directors.

31 Cybersecurity oversight

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Executive leadership has a fiduciary responsibility to ensure the organization builds and maintains a cybersecurity program that securely enables business operations and services. This program must align cybersecurity and regulatory requirements with the overall business strategy while managing risk, optimizing information security investments, and ensuring regulatory compliance via performance measurement and continuous monitoring. The upsurge in reported cyberattacks on banks and businesses, high-profile data breaches, and other damaging incidents underscore the urgency of the task, but corporate leaders, especially those without extensive cyber experience or expertise, may wonder how to execute this duty effectively. How can boardroom executives help the organization select, implement, and manage robust cybersecurity controls? In particular, what questions should they ask the chief information security officer (CISO) and cybersecurity staff to guide the adoption of the right policies, processes, organizational culture, technologies, and, most important, cyber team? Executives can provide the necessary high-level oversight by focusing their attention on five mutually reinforcing areas of cybersecurity:

- *Executive governance*—Build effective cyber oversight and accountability aimed at protecting your most valuable assets.
- *Cyber leadership*—Connect cybersecurity directly with your business objectives by elevating the CISO's role within the organization.
- *Human capital planning*—Design policies that attract, develop, and retain your cyber talent.
- *Cybersecurity controls*—Implement technologies and processes for proactive security that anticipates, prevents, protects against, and remediates cyberthreats.
- *Cyber-enabled innovation*—Make security a partner with your business and technology organizations to develop solutions that support business innovation and growth.

By asking the right questions to highlight and strengthen these five areas, corporate leaders can help their organizations nurture a cybersecurity program that enables the business.

Executive governance

An effective governance model will have several important features. First and foremost, it will clearly define who has responsibility—who is accountable—for the cybersecurity activities of the organization. Typically, accountability falls upon the CISO, who reports to the chief information officer (CIO), who in turn reports to the chief operations officer. Responsibilities can often become blurred, especially in large organizations, so it is important that the CISO and cybersecurity staff understand both their duties and expected outcomes.

Performance measures are essential for holding people accountable. Most organizations understand this, but too often they try to measure all aspects of cybersecurity equally, creating a lot of "noise" that reduces rather than enhances understanding of risks and vulnerabilities. Consequently, in devising performance metrics, organizations should identify their most valuable assets, such as high-impact information systems that are critical to the organization's day-to-day operation and data repositories that store intellectual property, source code, customer information, or other sensitive corporate data. Important assets might also include customer-focused networks that support business-critical operations, physical infrastructure, and even high-profile corporate executives. Not every asset is equally valuable, so organizations should prioritize their cybersecurity investments and activities to protect the assets that are most critical to sustaining the business. Performance metrics will hold the cybersecurity staff accountable by measuring how well the organization's critical assets are being protected.

The governance model should also establish a well-defined risk appetite that can incorporate both centralized and federated approaches. Not every product and business line within an organization will have the same risk appetite for their operations or functions. For example, in one business line, an always-available help desk may be an absolute necessity, while another business group might tolerate more down time with little impact on its business. The organization's cybersecurity policies and standards should have the flexibility to accommodate these different requirements.

By focusing cyber activities on their most valuable assets, organizations can align their cybersecurity activities more closely with their business objectives; this, in turn, will enable them to allocate their cyber resources in the most efficient way to reduce overall corporate risk. The performance measures will not only increase security in the targeted areas, but they also will create return-on-investment metrics that can guide future investments and decision-making.

Cyber leadership

Organizations need cyber leaders who can speak the language of business and help executives understand the connection between cybersecurity and the business. This represents a more demanding, elevated role for CISOs. CISOs traditionally have focused on the technical requirements of cybersecurity—the protection of data, networks, and systems—often without fully understanding their organization's core business functions or the business impacts of their cyber activities. At the same time, the organization's business leaders have not fully understood the challenges and intricacies of implementing a smart cybersecurity program. This can lead to inefficient cybersecurity investments and a cybersecurity program that exposes the organization to greater business risk than corporate leaders realize.

To support CISOs in their expanded role, boardroom executives should ask whether organizational processes facilitate dialogue between CISOs and business leaders. Similarly, they should ask whether CISOs have the business training and experience to understand the organization's business operations and priorities. These capabilities will enable CISOs to report cyber risks in business terms; and with this information, corporate executives can provide guidance based on business risk and risk appetite. Some risks will be deemed more acceptable than others. The CISO should provide executives with regular updates regarding:

- existing cyber risks to the enterprise
- programs and progress for addressing/ remediating risks
- status of risks previously deemed acceptable
- changes in the threat environment that may impact business risk.

By bringing the CISO into boardroom conversations, organizations can make the security function a potent force for business improvement. Rather than representing an obstacle to innovation, as CISOs have often been viewed in the past, they become partners with business executives and technical staffs in innovation, problem solving, and change.

Human capital planning

Attracting, developing, and retaining cybersecurity talent has become increasingly difficult, due largely to a shortage of qualified professionals. Many organizations are caught up in an endless cycle of luring cyber employees from partners and competitors, an escalating battle that results in few winners. How can your organization become a place where cyber talent wants to work?

One of the keys to strengthening human capital planning is to understand that cybersecurity is more than a technical challenge, so finding the right people means identifying people with either the knowledge or potential to develop business knowledge and other skills that can inform their cybersecurity activities. This also means organizations should create career paths for cybersecurity staff that do not pigeonhole them strictly as technologists. Instead, an ideal career path will allow them to expand their business and management talents, along with their technical capabilities, so they have more opportunities for corporate advancement. For many organizations, this may require revising or even creating new labor categories for cyber employees—in terms of both compensation and career trajectory—to reflect their vital role as business enablers. Such changes will create a solid foundation to help attract, develop, and retain cyber staff.

In addition, organizations may also want to consider creating research and development opportunities within their cybersecurity groups. This will improve both the hiring and retention of skilled workers who want to participate in developing new technologies and products, keeping them more engaged and energized versus working in a purely operational environment. Their enthusiasm and innovative solutions will strengthen the organization's cybersecurity posture and, perhaps, lead to new product offerings as well.

Cybersecurity controls

An organization's cybersecurity controls represent the front line in the battle to anticipate, prevent, protect against, and remediate cyberthreats. Overseeing this vast set of cyber processes and technologies can be overwhelming, and so it is helpful for corporate executives to focus on three general categories:

- *Baseline controls.* These are the foundational controls that are required for nearly any cybersecurity program. They include:
  - *Asset management* to identify and track your most valuable assets—that is, your business's "crown jewels." This can be a significant challenge, particularly in a large enterprise environment. Consequently, a

foundational control required for any cybersecurity program is to understand your assets, such as where your most sensitive data resides and how it is transported and processed. This knowledge will guide the creation of controls standards and requirements that offer the right level of security for your business. Some important questions executives may want to ask are: What data is considered sensitive? How do we classify our sensitive corporate data and assets? Where are they located? Do we have an accurate inventory of all our assets? Have we defined controls standards that address the cyber needs of those assets?

- *Identity and access management (IDAM)* to control who has access to specific data, systems, and networks. Organizations must be able to answer fundamental questions about who has the right to access sensitive data and how those access rights are granted, monitored, and eventually revoked as needed. Executives might consider asking: Who is able to access our company's sensitive data, such as corporate email and data repositories, as well as information on laptops, tablets, smartphones, and other devices? Who is able to change or bypass security controls? Who is able to access our networks and systems remotely? Who tracks the number of employees, contractors, and others who have access to sensitive data?
- *Configuration management* to ensure that your infrastructure and assets are configured—and the configuration is maintained—to provide the level of security required by your organization. This is a more complex challenge than many realize. As an example, maintaining a corporately managed or outsourced web server requires your organization to know: How was the server configured when it was built? How quickly could the organization deploy a critical security fix? Is there a well-defined process to test/evaluate a fix before putting it into production? Such questions will apply to all of your assets.
- *Policy and standards* to formalize and capture the vision and direction of an organization's leadership, while also helping create a more robust and fault-tolerant program. An ad hoc approach to operating a security organization may work well for a while, but can cause an organization to struggle when faced with the departure of key staff members and experts. Capturing cybersecurity policies, standards, as well as the procedures and processes, is essential to creating a sustainable program.
- *Security monitoring* to provide security staff with real-time visibility into the health and activity of networks, systems, and data. Understanding how your assets behave—including your people—is essential to rapidly detecting and stopping data leakage before it can cause damage to your organization. Data-protection strategies start with being able to understand how your data is moving and your assets are behaving in near real-time across your enterprise. For example, would your organization know if corporate data was removed from a server via a USB device or exfiltrated using a Web-based data transfer service, email, or other means?
- *Incident response* to identify and respond quickly to attacks and breaches, including the ability to remediate and restore normal functions. Even the best cybersecurity controls cannot prevent all incidents. Consequently, your organization should have the ability to respond rapidly once an incident is detected. Would your organization know how to identify a single asset on your enterprise network that appeared to be leaking data? How

long would it take to detect the breached asset? At what point would corporate executives be notified of a potential cyberbreach? When would you involve external legal counsel and law enforcement? How often are your incident response plans tested? Will your incident response and forensics procedures hold up in court?

In addition to asking the high-level questions suggested for each control area, executives should ask the CISO whether the organization has sufficient resources, training, and discipline to achieve its cybersecurity goals.

- *Emerging controls.* Your organization should also be positioning itself to adopt the next-generation of controls for increasing security and reducing cyber risk. Making sure that your cybersecurity program is exploring the features and capabilities of these emerging controls can also strengthen your human capital strategy to keep your cyber talent happy by giving them opportunities to explore cutting-edge technologies and strategies on behalf of your business. Among the still-maturing technologies that your cybersecurity team should be paying attention to are:
    - *Cyber data analytics* that analyze the vast amount of data generated by your users and systems to uncover anomalous activity and identify potential threats, thus helping anticipate attacks and prevent intrusions by even the most sophisticated threats.
    - *Insider threat program* to detect, prevent, and manage rogue behavior by employees through a variety of mechanisms, such as employee education, white listing, and behavior monitoring.
    - *Next-generation data protection* that uses cutting-edge technology—such as "tokenization" and/or digital rights management (DRM)—to provide protection at the data level. These technologies hold the promise of more securely allowing your organization to share data with strategic business partners, and they enable you to take advantage of more efficient ways to process and store data, such as private and public cloud environments and an increasingly mobile workforce.
    - *Predictive threat intelligence* to enable your organization to predict, rather than just respond to attacks, by focusing on monitoring the threat actors directly versus waiting for indications that an attack against your organization is already underway. This can be accomplished by leveraging third-party threat intelligence providers, building your own internal program, or a combination of the two. Your decision should be based upon your need to predict and prevent attacks and your available resources. Building a threat intelligence capability requires dedicated staff with the right levels of expertise, technology platforms to monitor the "dark web" where threat actors operate, and the ability to collate, analyze, and generate actionable threat intelligence reports.

Again, executives should ask their CISOs what they are doing to track, develop, or incorporate these emerging controls into their organization's cybersecurity program.

- *Security control framework.* Given the complexity and myriad of possible cybersecurity controls (this discussion covers only a select few), your organization should consider an established security control framework to organize and align your security controls and guide investments in new controls. An organization can create its own framework of standards and best practices or it can adopt/modify one of several established standards, such as:
    - *ISO 27000 series of security standards.* These provide international standards for baseline corporate security practices in numerous areas, including infosec controls, infosec governance, infosec metrics, infosec risk management, cybersecurity, network security,

information and communications technology (ICT) business continuity, and incident management, as well as sector-specific guidance for telecommunications, financial services, and health care.

- *The National Institute of Standards and Technology (NIST) cybersecurity framework.* The NIST framework incorporates standards, best practices, and creative ideas developed by NIST in collaboration with industry and government cybersecurity experts. It provides a foundation upon which each organization can build a robust framework that reflects its individual culture, processes, and requirements.
- International frameworks such as *Control Objectives for Information and Related Technology (COBIT)* and *Information Technology Infrastructure Library (ITIL)* practices, as well as a variety of regulatory control frameworks developed by industry-specific organizations.

By creating a cybersecurity framework, an organization will also create the documentation required by regulators to ensure the proper security processes and controls are in place. In addition, a robust framework can provide an organization's partners with assurance that it has implemented effective security controls. Overall, the framework should be oriented to help the organization connect cyber risk with business risk.

Cyber-enabled innovation

As a business enabler, an effective cybersecurity program not only supports current business, it also facilitates the integration of innovative next-generation technologies, products, and services. In an organization that recognizes this key connection between security and business, the CIO, chief technology officer (CTO), and CISO will work closely together on their respective agendas. As CIOs, CTOs, and business leaders explore new approaches, products, services, and technologies, they need a security perspective—one that understands the cybersecurity implications of planned changes—to help guide strategy. Consequently, corporate executives will want to ensure that their organizations promote collaboration among the CISO, CIO, CTO, and other business leaders charged with developing new products and technologies. In addition, the CISO should be empowered to stay ahead of emerging technologies and formulate future-looking design patterns, requirements, and standards, so that the business can securely tap into those next-generation technologies. Whether they are moving to virtualization or the cloud, developing mobile strategies for customers and employees, developing new products, expanding online services, or adopting other innovative solutions, organizations will achieve greater success by making the CISO an integral part of business strategy and planning.

Conclusion

Cybersecurity oversight poses a complex challenge for boardroom executives. Those tasked with this responsibility often make the mistake of immediately focusing on their organization's cybersecurity controls. In fact, the starting points for a discussion of cybersecurity should be governance, leadership, and human capital planning. Organizations need a cyber governance model that (1) links cybersecurity with business operations and services; (2) defines who is accountable; and (3) incorporates performance measures to ensure accountability and a focus on protecting the organization's most valuable assets. At the same time, the CISO and security staff should have both the technical skills and the business knowledge to help leaders understand how cyber risks may impact the business. Close collaboration between the CISO and business leaders will enable the organization to identify and deploy the most cost-effective cybersecurity controls—all in alignment with the organization's specific business requirements and risk appetite.

Ultimately, this collaboration will spur greater innovation as the CISO assumes an elevated role in the organization's leadership to make cybersecurity not just a defender of networks and data, but an enabler of business.

32 Cybersecurity law

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Cybersecurity has engulfed many risk managers lately because of the ubiquitous and transformative nature of the threat. Every business uses computers, the vast majority of which are hooked up to the Internet, whether in an explicit fashion, such as e-commerce websites, or in more subtle ways, such as plant equipment seeking software updates. Further, because an overall security program is only as good as the weakest link in the system, companies must also be wary of third parties—whether suppliers or customers—who have access to company networks. And once a clever criminal has gained access to a company's system, whether through a metaphorical front or back computer door, that criminal can seek to enter through more sensitive electronic doors within company computer systems to compromise personal data, steal trade secrets, or wreak retribution for perceived slights.

Cybercrime is difficult to understand. It is not a single strategy but a host of rapidly evolving and adapting approaches. It can come from close within, such as an insider with network access credentials using a thumb drive, or from borders far away. And it is a completely silent crime that by its very nature is hard to monitor.

Yet, conversely, once cybercrime has been discovered, modern regulators force public disclosure and accompanying scrutiny. Securities and Exchange Commission (SEC) regulations require the public disclosure of material cyberbreaches. Other regulations impose duties to notify individuals when their personally identifiable information has been compromised. These disclosures are embarrassing, undermine the credibility and brand of a company, and threaten the withdrawal of future business.

Within this difficult construct, what is the legal role of a member of a board of directors with respect to cybersecurity? The overwhelming majority of US public companies are incorporated under Delaware law—and state jurisdictions elsewhere often mimic Delaware analyses. Delaware recognizes roughly four fiduciary standards; however, only one applies in the ordinary day-to-day business of a company when a change-of-control, through a merger or acquisition or similar transaction, is not on the horizon. That uniform standard is the "Business Judgment Rule," and it focuses on three duties: acting in good faith, with due care and loyalty. Accordingly, this rule mandates that a director be free of personal conflicts of interest and, perhaps more broadly applicable, be reasonably well informed (as an "ordinarily prudent person" should be in a like position) about the state of affairs of the corporation.

As a result, boards have an obligation, at the risk of lawsuits from stockholders, to be reasonably well informed about a company's business. Conversely, most members of boards of directors were nominated for their position because of their business experience, which generally means they often are older than management and not necessarily technologically savvy.

As directors prepare to fulfill their duty of care in an informed way, what are the issues that matter today? The following list of questions and issues was created to help outside directors understand the cybersecurity issues that matter to boards today based on information from panel discussions and individual directors. Not every topic needs to be visited quarterly, but a board member should have some general understanding of how the company is approaching each area.

Who is in charge of your cybersecurity plan, and which parts of your company are involved?

The Roman philosopher Cicero once famously asked, "Who guards the guards?" Companies in the past have often swept cybersecurity underneath the responsibility of the chief information officer (CIO). However, the CIO is precisely the individual with responsibility for architecting information technology (IT) systems. Having a cybersecurity function, particularly one with "red team" functions reporting to the CIO thus would be the functional equivalent of having an internal audit function report directly and only to a chief financial officer (CFO).

Two emerging paradigms are to have:

- a chief information security officer (CISO) who reports potentially to the CFO, or chief operating or administrative officer, or in smaller organizations the CEO, but with a dotted line to a delegated committee of the board; or
- some companies have adopted a chief security officer (CSO), which encompasses both physical security and cybersecurity, and a CISO may be a direct report to a CSO.

Irrespective, boards should question organizational charts where the CISO (or equivalent) reports to the CIO, thereby creating a potential for undermining the autonomy of the CISO function. A board must also think about the role of a chief privacy officer and the degree to which a chief privacy officer and CISO interact and have potentially overlapping, but still critically separate, duties.

What is the role of board oversight in cybersecurity?

Does the board of directors receive regular briefings on cybersecurity or only on an "as-needed" or exception basis? Has the board delegated cybersecurity monitoring to a board committee, often either the audit committee or a risk management committee?

As a general rule, the amount of information that a board receives should be commensurate to a particular subject's relative importance to the overall business. Cybersecurity has the potential to instantly cripple business systems while wrecking a company's public image. Accordingly, under the duty-of-care principle, a board should regularly receive updates on cybersecurity. Such briefings should cover many of the topics addressed in this chapter from a recurring programmatic perspective, as well as any episodic events, such as known breaches or breach attempts.

Boards should be careful to avoid delegating cybersecurity in full to a committee. While as with any committee topic a committee may be best positioned to delve into details and tease out clarity at a level that is not feasible for an entire board, the relevant committee should spend sufficient time to understand its implications—and thus cybersecurity should not be a "check-the-box" perfunctory agenda item for the audit committee—and either the relevant committee chair should regularly report to the full board or, more optimally, ask the appropriate company manager, such as the CISO, to do so.

In addition, board composition is an increasingly important component in this area. Just as boards now routinely as a matter of regulation have a financial expert, boards need to consider whether one or more of their members is sufficiently educated and savvy on cyber issues to represent the board as a whole when reviewing detailed issues. If the board lacks this competency, they should consider including this skill-set when next considering director nominations.

Who are your likely adversaries (state-sponsored, competitive, criminal, etc.), and what crown jewels do you most need to protect from them?

The idea of state-sponsored cyberthreats may seem far-fetched to many boards. However, many industries, such as the financial industry in particular, have been the target of state-sponsored threats. Still other industries have come under propaganda attacks, or worse, from foreign governments. Some governments also blur the line between state-sponsored computer espionage and linking it to their domestic industries.

Companies that have crucial competitive informational advantages in the form of trade secrets, including manufacturing know-how and processes, must also be wary of direct competitors overseas. Finally, any company that has personally identifiable information, including human resources (HR) information such as social security numbers of its employees and the financial information of its customers, must understand its security posturing in protecting this information.

Obviously not all company information needs to be protected at the same level of security. Certain systems may be too old or too big and full of marginally important information to place expensive security measures on—however, it is crucial that such systems have strict gates between those systems and other more sensitive parts of a company's overall network.

Accordingly, a board needs to ask: What are the most important information components of the company and where and how are these components stored and protected? What has management done to assess the risk map of the company's information crown jewels? Is the company in a particular industry, such as defense, technology, or finance, where attacks have occurred with greater regularity among its peers?

Do you have an incident response plan? Have you done a tabletop exercise?

Many companies long ago drafted disaster response business interruption mitigation plans for earthquakes, hurricanes, or other natural disasters. Having a similar plan, even if only at a relatively high level, for a cyberbreach is a fundamental first step in the response process. Designate a team ahead of time, including technical, public relations, and legal advisers. Have draft press releases for the most likely scenarios vetted and on the shelf for possible short-notice release. Understand the internal working group and levels of authority for responses, particularly if one or more individuals are not contactable because of vacation or travel. While boards and management alike often are subsumed by the day-to-day operations of making quarterly numbers, a small amount of advance planning can avoid massive confusion and the public appearance of disorganization if and when an incident occurs.

What does you network map look like (physical assets, cloud resources, physical and digital security tools and protocols, etc.)?

Part of the risk-mapping process is to understand where and how data is stored.

In a world increasingly reliant on cloud computing storage, it may surprise board members where and how vital trade secret data is stored. A board should at least understand at a high level the security protocols and whether certain data should reside within more security confines, whether digitally, physically, or both. To what degree does the company outsource its IT functions, and where geographically do those functions reside? Are the IT function and the cybersecurity function outsourced to the same third-party contractor? Can certain functions be retained by US or Western personnel to administer certain sensitive networks/areas?

Furthermore, companies historically have bifurcated cybersecurity from physical security. A more collaborative, integrated approach is required to efficiently mitigate the cyberthreat. Physical security managers should understand first and foremost their own security systems and potential cyber vulnerabilities therein. Physical security and cybersecurity managers need then consider the interlocking nature of protection—a company may well choose to place certain information on physically secure computers, potentially in redundant locations, which are not in any fashion networked linked and thus can be used for business reconstitution or absolute protection from network intrusion/compromise. Physical security is a key component of such an alternative.

Who has access to sensitive data, and what is the risk of an insider event?

Does the company have an active program that is regularly monitored and updated, on which employees have access to certain data? All too often, particularly in companies in nontech industries, individuals may have access to wide swaths of a network. Or an IT department may implement a compartmentalization protocol but fail to update it as employees join the enterprise, making it a single-point-in-time exercise, rather than one that is continuously refreshed. And, infamously of late, what is the IT department's own protocols for its individuals? For certain functions or access, there should be a two-person rule, which may increase cost to complete a certain task but also helps ensure redundancy and integrity of the process. Finally, to what extent does the company have the ability to archive access attempts and/or network activity in order to be able to retrospectively forensically recreate a user's actions after the fact?

What are your physical and digital security protocols following employee termination?

Although many companies believe they are well-oiled machines, when it comes to HR transitions, including termination, oftentimes small details can erode post-termination security while, conversely, terminated employees may be the most prone to threaten a company's information assets. Although network logins may be turned off, what about physical card readers and applications on personally owned devices, particularly in "bring your own device" environments? Also, how about third-party systems (such as HR or enterprise software systems that may have web login functionality)? Consider having HR briefly present to the board on what protocol exists, and then have the CISO briefly summarize any "red team" efforts to undermine that protocol and whether it is effective or not.

How do you interconnect with and share data with your supply chain and other business partners, and does your company have a vendor risk management program?

A board should understand the overall risk picture of third parties. What are the types of data that are routinely transmitted back and forth and what measures are in place to assure their integrity? Has the company engaged third-party consultants to audit both the company's and third parties' systems? Does the company require that third parties indemnify the company for harms that may come to pass?

Does your company receive and share information about cybersecurity threats?

What organizations does your company belong to? Has it shared information with state or federal government authorities, and what is the degree of cooperation involved? Sharing proprietary data creates perception challenges in an era when populations, particularly outside the US, are wary of potential monitoring of private behavior. Does your company have a confidential or publicly available policy on the extent of its cooperation, beyond that which is legally required through subpoenas and similar actions? Does the company rely on third-party contractors for additional cyber-resources and has the company vetted these providers to ensure they are working cooperatively or, conversely, have safeguards in place to ensure that any shared information is carefully disseminated and does not risk inadvertent public disclosure of confidential public information?

What kind of insurance do you have to deal with potential security incidents?

As with any complex contract, the devil is in the details of insurance policies and their riders. At the very least, the board should understand at a high level what is and is not included in the company's business insurance profile to avoid unnecessary surprises based on inaccurate assumptions once the harm has come to pass. Also, does the insurance include third-party indemnification claims in cases where a cyberthreat may not only cause harm to the company directly but also to customers or suppliers?

33 Navigating the opportunities and pitfalls of social media channels

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Successful public companies cannot afford to ignore social media's outsized influence in today's world. With 73 percent of Internet users active on social media, organizations recognize the tremendous opportunities social media presents to interact directly with customers, employees, investors, and the public at large. Not all, however, have prepared sufficiently for the potential pitfalls that social media creates. It is the responsibility of boards of directors and management teams to understand both the opportunities and risks inherent in social media, whether or not their companies are active participants.

Examples of corporate social media blunders are abundant. Legal, regulatory, and compliance violations are among the most pressing fears that boards and managements share about their companies' participation on social media, and rightly so. In July 2012, Netflix's CEO, Reed Hastings, came under scrutiny as a result of a single, seemingly innocuous Facebook post. In the post, Hastings told his Facebook "friends" that the company had exceeded one billion hours of viewing time. While Hastings saw the post as a harmless remark to his followers, the Securities and Exchange Commission (SEC) investigated the incident as a possible violation of Regulation Fair Disclosure laws. While the SEC decided not to proceed with any enforcement action, it provided a stern warning to public companies about selective disclosure via social media.

Since then, the SEC has issued clarifying guidance for public companies' use of social media. In short, investors need to be informed in advance where they can access material financial information via social media (a notification and link to social media channels used for disclosure should be posted prominently on the company's corporate and/or investor website). More recently, the SEC has provided guidance on the use of social media to communicate with investors as a result of its increasing use by activist investors in proxy contests. On sites where the number of words or characters is limited, for example, Twitter, companies must include a link to a full proxy legend in every post, and the content of any posts must follow all traditional proxy rules. The important thing to note here is that SEC guidance with respect to social media continues to evolve, and repeating behavior that was acceptable in the past may not ensure current compliance. No one wants their company to be the "test case" for new SEC law.

It can also be tempting for executives to use the informal nature of social media to promote their companies, but again, boundaries must be observed. In one well-publicized case, Whole Foods CEO John Mackey used an alias while posting on Yahoo! Finance message boards to champion Whole Foods' successes and make negative comments about its rival, Wild Oats Markets. An SEC investigation followed. Although Mackey was cleared of legal wrongdoing, he caused himself and the company significant embarrassment and reputational damage.

Social media also opens the door for influential customer feedback—not all of which may be welcome. Recently, General Mills tried to change its online legal policy so that customers' online interaction with the company would disqualify them from being able to litigate. Following widespread criticism of these changes on social and mainstream media, General Mills reversed its policy and apologized. Social media is by its nature a public forum, and any attempt to restrict users' ability to comment freely will invariably be met with a sharp public rebuke. Companies engaged in social media should understand this dynamic before inviting any two-way dialogue.

Despite these and many other examples, the motivation for companies to participate on social media is well-established. Seventy-seven percent of the Fortune 500 maintains an active presence on Twitter, and 70 percent a corporate Facebook page. The primary drivers center around enhancements to marketing and recruitment efforts, ranging from attracting new employees, launching or testing new products, to establishing or reinforcing a leadership position within a company's industry. Companies are also increasingly using social media to engage with investors and have found it to be a powerful tool to monitor opinion and communicate during a crisis. With clear goals and a well-designed program, social media can be a highly effective communications channel.

At the board level, public company directors should ensure that management teams have a comprehensive social media plan in place, including policies to govern social media conduct and contingencies for dealing with social media–related mishaps. The rest of this chapter outlines the key elements of any such plan.

Be proactive

In developing a social media plan, crisis preparedness is essential. Pre-crisis, organizations should take the time to develop the following components: a general use policy, an inventory of the company's existing presence, and proactive messaging guidelines.

Social media policy: avoiding employee-related mishaps

In coordination with management, legal counsel should write a general use social media policy that clearly delineates between professional and personal use. The line between personal and professional can be hard to distinguish, with platforms that are used for both, making this a particularly difficult area to police. Clear policies are a must.

In just one of many examples of the line being blurred, New York Mets pitcher Matt Harvey recently made headlines when he tweeted a photograph of himself giving the middle finger to the camera using his personal Twitter handle, causing significant unpleasantness for his employer. Following the uproar, the tweet was deleted—as was his entire personal Twitter account—no doubt at the strong urging of the Mets organization. The delineation between personal and professional use of social media is often a distinction without a difference, meaning companies must be more vigilant than ever and be prepared to act quickly when individual employees are not reflecting corporate values.

One way to make that distinction clearer is to provide transparency, and many publicly-traded companies showcase their social media policies online. For example, Best Buy has a particularly concise and up-to-date, policy—promoting common sense without using legal jargon. It is available for public review on its corporate website. When drafting a policy, companies should be thorough and clear to prevent misunderstanding and misuse. Best practices include providing specific language that employees can use if they would like to discuss their jobs on social media. For example: "References to [the company] should be limited to a brief company description, as provided below: [...]." The policy can go so far as to provide standard boilerplate language, so that employees know exactly what they are allowed to use. A simple list of "dos and don'ts" is also a very effective tool. Refer to Table 1 to review an abridged version of the "dos and don'ts" list that appears in Best Buy's policy.

Companies should also clearly specify consequences for violations, including termination, in the policy. When doing so, organizations should be sensitive to First Amendment rights, and companies with union employees should be mindful of any restrictions on limiting employees' right to organize. Differentiating public versus private usage in a social media policy is especially important as it applies to free speech. Just because a person has a right to speak freely does not mean that he or she has a right to release confidential company information, copyrighted information, trade secrets, nonpublic financial information, and so on. Once completed and distributed, the usage policy should be supplemented with regular training and informational update sessions.

An inadequate or poorly communicated social media policy can increase the risk of internal issues spreading quickly from social to mainstream media. Previously limited to a small audience of co-workers and friends, activities such as "I Quit" videos, when posted on social media and therefore in the public domain, can cause broad reputational damage to an organization. Recently, a 25-year-old employee quit her job at a technology company by posting a video on YouTube. Almost immediately, it went viral on social media, leading to unflattering coverage of the company's culture and work environment on *ABC News* and *The Today Show*.

Remember that a sound social media policy is just a subset of a company's guidelines governing employee behavior. It does not replace or supersede other policies, such as those dealing with discrimination, workplace conduct, confidentiality, or securities trading. After distributing the social media policy, companies should create a monitoring protocol with a designated group watching

Table 1 Abridged version of Best Buy's "Dos and Don'ts" list as it appears in its Social Media Policy, as of May 2014

What You Should Do:	What You Should Never Disclose:
• Disclose your affiliation. • State that it's YOUR opinion. • Protect yourself; be careful about what personal information you share. • Act responsibly and ethically; do not misrepresent yourself. • Honor our differences; live the values. Best Buy will not tolerate discrimination.	• The numbers: Non-public financial or operational information. • Personal information about our customers. • Legal information. • Anything that belongs to someone else. • Confidential information.

to ensure employees are complying. This will help mitigate the risk of violations going unnoticed until they become "viral." For example, human resources representatives should check professional social media sites like LinkedIn to verify that the company is referred to appropriately and consistently by employees posting on the site and create alerts so that every time the company name is mentioned online, designated point people are notified. Early detection of violations that lead to swift action can significantly reduce the risk of a major crisis.

What currently exists?

While sometimes overlooked, another important aspect of preparing a social media plan is evaluating what already exists. Are there one or more Facebook pages, Twitter handles, YouTube channels, or company LinkedIn pages already utilized? Is the branding and message consistent? Are subsidiaries using these channels without guidance and oversight from the parent company? Are individual employees creating corporate sites? Do competitors or third parties control company brands? A thorough audit of an organization's social media presence should be done and reviewed on an ongoing basis.

After cataloging the "official" company platforms, a running list including login/access information and company sponsors should be maintained by the social media team, and any unofficial or community platforms flagged. In a crisis situation, these pages, official and unofficial, will need to be diligently monitored. A recent search for General Motors' Facebook pages pulled more than 50 different GM pages, not including its subsidiary companies' pages. During a crisis situation like GM's ignition switch recall, managing customer complaints on all of these pages can be difficult if a central, coordinated team does not have access or authority to manage the sites and the ability to respond quickly to inquiries and complaints as they arise.

The social media team should also ascertain whether the company does *not* have a presence on major social media platforms. When an issue arises, it is difficult to establish an account in real-time and begin responding credibly. During Hurricane Sandy, many relied on Consolidated Edison's Twitter account to receive service updates after power outages began. At the time, ConEd's activity on social media was minimal, comprising only a five-month-old Twitter account with minimal tweets and few followers. That changed quickly during and after the hurricane, when customers took to Twitter en masse to find and share information, and ConEd was frequently criticized for its lack of sophistication on social media. Inexperience showed, through an absence of real-time responses and unfamiliarity with the medium, adding to the reputational damage the company suffered. ConEd now maintains active monitoring on its Twitter account during normal business hours but should have established its credentials in social media *before* the crisis hit. That said, not all companies will be prepared, and the following should be kept in mind for those making their first real foray into social media during an active crisis situation:

- The discussion and corporate responses will be associated forever with that social media account.
- Regard all communications via social media as permanently "on the record." Generally, it is bad form to delete Tweets. They cannot be fully deleted and (like anything posted to the Internet) are always available through archiving tools.
- Similarly, although a company can delete a social media account, screenshots are still obtainable on the Web. More important, if an account is deleted after a crisis dies down, then what will happen in the next crisis situation? Creating a new account exclusively to discuss a specific crisis is not a sustainable or advisable strategy.

Prepare to engage

In a crisis situation, proactive communication may offer the company its best chance to influence the conversation, or at a minimum avoid a secondary crisis from arising within social media. For example, Target disclosed its 2014 data breach early and transparently by creating a dedicated section on its website and postings on its social media pages. Target was commended for its forthcoming communications, as are others who have handled contentious issues in an up-front and proactive manner. While the underlying issues at Target and its response to the breach had significant repercussions, the company's deft handling of social media did not further inflame the issue.

Companies should be aware that they can appear evasive if they do not communicate consistently on social media during a crisis. If left dormant or used irregularly, a lack of information via social media can exacerbate an issue. Carnival Cruise Lines (an affiliate of Costa Concordia, the ship that was wrecked in Italy in 2012, killing 32 people), decided to stop posting on its social media channels after the accident out of respect for those who were affected by the incident. Carnival then generated resentment when it began posting again less than a week later—implying that the crisis was over and causing a secondary social media–driven crisis.

Developing clear guidelines for proactive messaging, and incorporating them into an overall social media strategy, is imperative to allow management the option to get in front of an impending crisis. Guidelines should contain template social media posts that can be ready for use. These posts should anticipate possible company vulnerabilities and be layered into the scenario planning components of a company's larger crisis communications strategy.

Be ready to react

Reactive engagement is another important component of any sound social media plan. An actual crisis requires a combination of both proactive and reactive responses. In many circumstances, customers, media, or investors will dictate social media discussion topics, all of which may require a reactive response.

Companies should anticipate and prepare in advance to react quickly on social media, using the same channel in which an unsolicited inquiry or comment was made. Formats appropriate for one social media channel (Facebook, which allows for long postings or Q&A style documents) may not be appropriate for another (Twitter, with its 140 character limit). Care should be taken to avoid "canned" responses that make the company appear ignorant of the style of a particular channel. Responses that are too similar or phony can aggravate social media users. Customizing responses with personal details, like mentioning a user's first name in a response, can be vital to credibility. If John Smith posts a public complaint on a company Facebook page, a prepared statement should begin with "Hi John, we're sorry to hear that . . ." This demonstrates an understanding of the informal nature of the medium and makes any further interaction more authentic.

In April 2014, Stonyfield Farms issued a voluntary recall on a select group of YoBaby yogurts. After posting a proactive statement to its Facebook page with a link to more information on its website, the Stonyfield team responded to individual complaints on its Facebook page. Responses were personalized. They used each individual's name and clearly demonstrated that the Stonyfield team heard the complaints. In sensitive situations like this one (a safety issue), the company must show that it recognizes the seriousness of the issue, cares about its customers, and provides solutions (redirect to more information), not explanations.

In general, substantive complaints should be handled by taking the conversations offline whenever possible. Short responses should be prepared in advance to facilitate this. If a customer complains via Twitter, the company should Tweet back, "We're sorry @JohnSmith, please send us a direct message so we may try to assist. Thank you!" (Note that Twitter will not allow a company to contact a user directly if the user does not "follow" the company—meaning the initial exchange likely will occur in full public view.) Remember that virtually all social media posts are public and live forever in archived databases, even if the accounts are later deleted, making it desirable to take specific customer interactions offline.

Critically, the avenue to which the company points unhappy users must be able to handle and respond to a rapidly escalating volume of complaints. If a customer service team is traditionally prepared to handle issues by phone, then social media users can be directed to that means of taking their communication offline, for example, "Please call (800) xxx-xxxx so we may try to assist you." Realize that any information posted is being distributed broadly. In many cases, companies or individuals may impulsively share a phone number via social media on their own, and if the company is unequipped to handle the volume, chaos ensues. During a heated rant on Twitter, former Miami Dolphins offensive lineman Richie Incognito directed his 90,000 Twitter followers to call his lawyer if they had an issue with him and provided his attorney's direct phone line. The Tweet was deleted a few hours later, after what must have been a stressful afternoon for his attorney's receptionist. In a prank that aired on NBC's *The Voice* in April 2014, country singer Blake Shelton tweeted pop singer Adam Levine's personal cell phone number—to over six million people. That number is no longer in service. Needless to say, organizations should be cautious when sharing phone numbers via social media.

Alternatively, companies can direct social media users to the portion of a company website that can handle complaints. For example, the American Airlines "About" section on Twitter includes a link to its customer relations webpage. ("Please click here if you require a formal response to a complaint.") By clicking the link, users leave social media, and the conversation is directed offline.

Don't be afraid to eavesdrop

Although it occurs behind the scenes, monitoring social media chatter is the backbone of any social media strategy. In a crisis situation, monitoring the current state of play will determine the appropriate course of action.

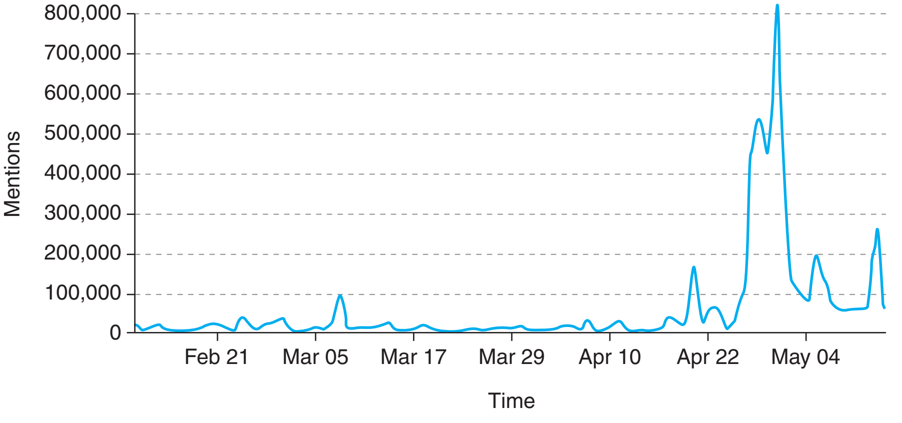
Monitoring protocols should produce activity reports that offer clear summaries and analysis, and provide management with an understanding not only of what is being said but also whether it is significant. This is easier said than done. Comprehensive social media monitoring reports should weigh the more authoritative users and reflect their significance versus lesser users. Reports should compare current volume of chatter to that of previous days, weeks, or an appropriate time frame to put activity in context. It is also important to compare volume of mentions with competitors or peers who have experienced a similar issue. Essentially, quantitative data is only helpful if framed within a qualitative context.

During a crisis, include in a social media monitoring report:

1. Summary of the mentions captured
2. General sentiment and tone of the mentions
3. Volume of the mentions, framed within a designated time period (see Figure 1 on next page for an example chart)
4. Identity of key commentators

Insight gleaned from monitoring helps determine an appropriate and proportionate social media response. In March 2014, a WestJet Airlines passenger left a very offensive, sexist note for the female pilot. When the pilot posted a picture of the note on her personal Facebook page, the issue went viral. The pilot received overwhelming support on social media, and WestJet quickly broadcast its support of the pilot through social media and traditional media channels. WestJet's robust response undoubtedly was informed by the knowledge that the issue had spread widely through social media, allowing the company to engage in real-time.

Figure 1 Volume of mentions



Conclusion

Social media can be extremely difficult to control. Executives are appropriately concerned about a range of risks that could affect their companies. By developing a comprehensive social media strategy, companies can mitigate the risk of a crisis escalating in social media. Management should make sure that their companies are able to identify and respond to crises via social media. Organizations should monitor social media chatter actively to create real-time awareness of issues and be prepared to act both proactively and reactively to manage a crisis. With a game plan in place, boards and management can feel confident that if an issue arises, an appropriate social media plan exists to handle it.

PART IV

SHAREHOLDER ACTIVISM

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this guide available at:
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34 Key strategies of activist investors

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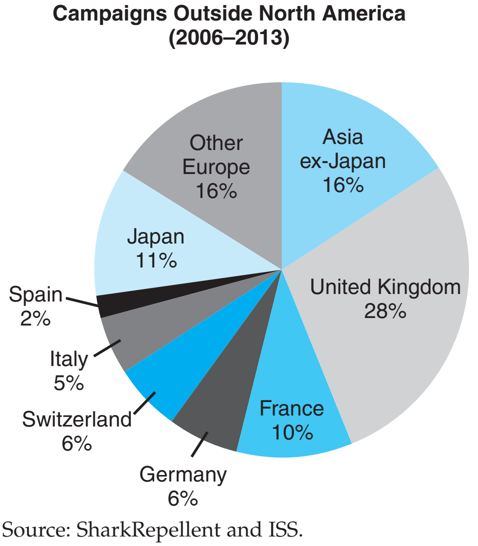
Shareholder activism has morphed from an occasional threat facing corporate management and boards to a sweeping trend that has spread to companies in all sectors and of all sizes and, increasingly, across geographic regions. Globally, the pace of public campaign activity has steadily risen over the past five years from 161 campaigns in 2009 to 259 in 2013.[1] Although most campaign activity occurs in the US, shareholder activism has a foothold in the UK and is gaining traction in other regions. (See Figure 1.) Activist investors have also engaged with target companies behind closed doors, particularly in Europe where nearly 45 percent of all campaign activity may be private according to a study by Becht, Franks, and Grant (2010).[2]

A driving force behind the rise in shareholder activism is the outperformance of activist hedge funds, which, as an asset class, have generated a nearly 20 percent annual return since 2009, relative to 7.7 percent for hedge funds as a whole. This outperformance has spurred large capital flows into new and existing activist funds, and assets under management in such funds have grown by nearly 40 percent in the past twelve months alone. The outperformance of "pure-play" activist funds has also led many traditional investment managers to adopt a more active stance with respect to their investments. As a result, the number of "occasional activists" has risen sharply, and the activist shareholder playbook is gradually becoming a standard part of the asset manager's tool kit.

This transformation of the activist investor landscape has overturned a key belief about shareholder activism—that only smaller firms are vulnerable to activist campaigns. Between 2011 and 2013, the number of targeted companies with a market capitalization greater than $1 billion nearly doubled from 56 to 104 globally. Several factors have led to the rising frequency of campaigns against large-cap firms. Many smaller and underperforming firms have already been targeted, particularly in the US. Larger funds have given activist investors the financial capacity to take meaningful equity

Figure 1 Trends in global shareholder activism



Source: SharkRepellent and ISS.

stakes in larger firms. Activist investors have also exploited with increasing sophistication the intense media scrutiny that large-cap companies are subject to, writing open letters to boards and management, releasing detailed presentations in support of their agenda, and even using social media to publicly pressure their target companies.

Traditional institutional investors are also increasingly receptive to activists' agendas and are engaging with and occasionally publicly supporting them in pushing for change at their portfolio companies. With the advent of annual "say-on-pay" votes in the US and UK, these investors have also begun to vote more frequently against management. This has allowed activist investors to pursue firms where it would otherwise be difficult for a single activist investor to gain influence without the leverage provided by institutional investors who are sympathetic to the activist's agenda.

Based on an analysis of campaigns between 2011 and 2013 targeting companies with a market capitalization greater than $1 billion, maximization of shareholder value is cited as the most frequent campaign objective, with board-related objectives also becoming increasingly common. (See Figure 2.) Activists have become vocal about both acquisitions and financial policy issues and frequently campaign for increased shareholder distributions as well.

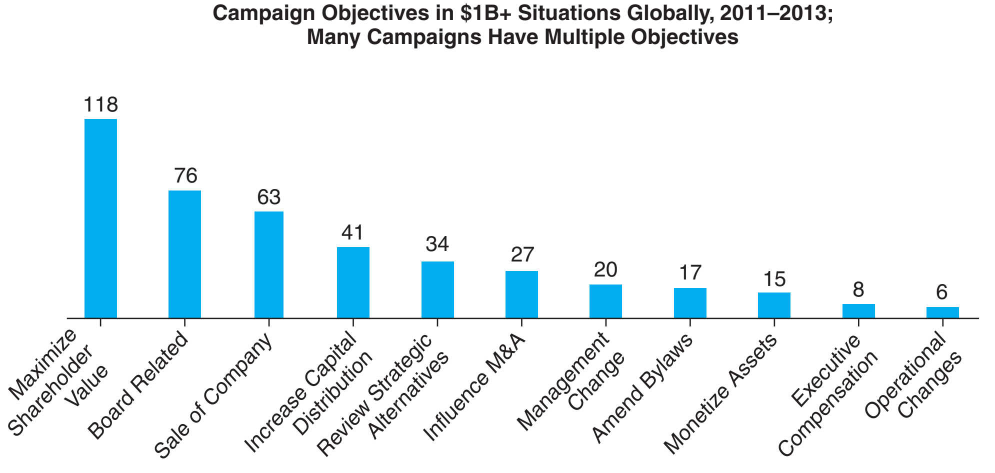
Targeting strategies of activist funds

To shed light on the strategies used by activist investors to identify companies for targeting, we conducted an analysis of over 1,600 shareholder activism campaigns that sought to maximize shareholder value or gain board representation in S&P 1500 companies between 2006 and August 31, 2013. The findings and methodologies are described in more detail in Khorana, Hoover, Shivdasani, Sigurdsson, and Zhang (2013).

Influence of share price performance

Historically, firms subject to shareholder activism tend to have stock returns and valuation multiples that lag those of their peers—targeted firms displayed stock price underperformance of eight percent in the six months prior to being targeted and had firm value-to-EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) multiples that were two times below their industry peers.

Figure 2 Most frequent campaign objectives

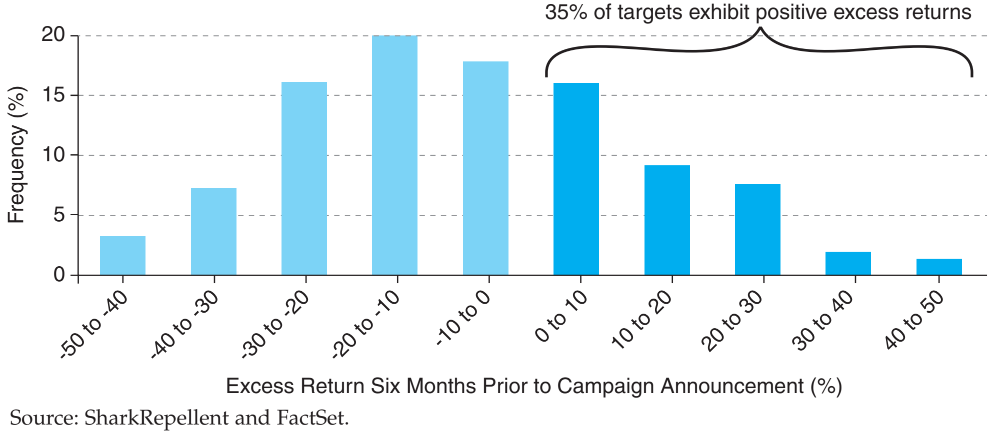


Source: SharkRepellent and ISS.

However, there is wide dispersion in performance—more than a third of the targeted firms actually experienced stock price outperformance prior to being targeted. Therefore, share price outperformance does not insulate a company from activism. The trend of activists targeting well-performing companies is intensifying, particularly in the US, where 56.7 percent of activist campaigns against S&P 1500 companies in 2013 involved companies that had outperforming share prices.

This pattern is also evident in valuation multiples. US activist campaigns in 2010 and 2011 involved companies that traded at median firm value-to-EBITDA multiples that were 0.9 times lower than their industry peers. By 2012, this gap had narrowed to

Figure 3 Pre-campaign stock returns for targets of shareholder activists (2006–2013)



Source: SharkRepellent and FactSet.

0.7 times and disappeared entirely in 2013. It appears that the low-hanging fruit of underperforming firms was largely picked in the first wave of shareholder activism, and we are now seeing a second wave of activism unfold where activist investors are setting their sights on well-performing firms.

Not all industries or geographies are at the same point in these activism waves. For example, in Consumer and Information Technology, the two sectors most frequently targeted since 2006, targets are now more likely to be well-performing firms than in other sectors, where campaign activity has been relatively muted to date. Hence, the sectors that experienced the most campaign activity are entering a new phase in which the activist shareholder's agenda has transitioned from turning around underperforming companies to driving change at well-performing companies. This shift partially reflects a departure from concerns over valuation, performance, and simpler balance sheet issues to more complex issues of corporate strategy such as whether to spin off entire operating segments.

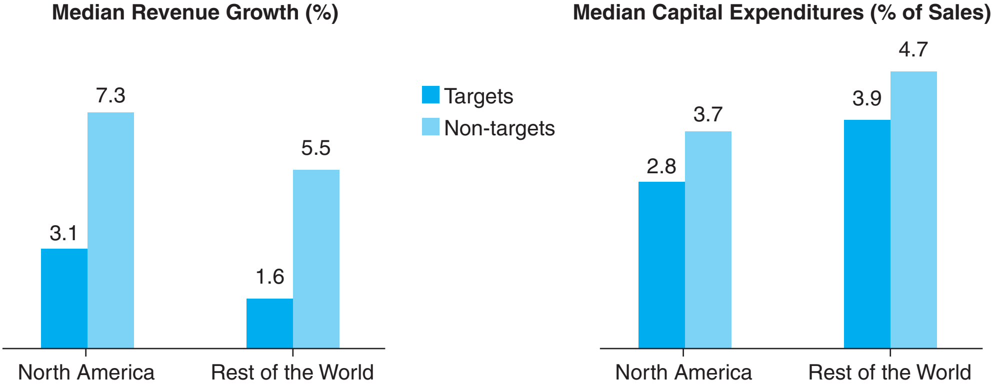
Lack of top-line growth

Weak top-line growth is a significant driver of shareholder activism in both the US and globally. US firms that were targets of activist campaigns had grown revenues by about three percent prior to the activist efforts—a sharply lower rate than their industry peers, who averaged revenue growth of over seven percent. The difference in growth is even sharper for non-US targets, which grew at 1.6 percent annually while their peers grew at 5.5 percent—a more than threefold difference in revenue growth. A similar picture emerges based on activist targets' investment in growth, as measured by capital expenditures. While their industry peers invested an average of 3.7 percent of sales in their business, firms that were targeted only invested 2.8 percent. (See Figure 4.) This suggests that firms are more susceptible to activist overtures when they are investing little in future growth prospects and highlights the need for companies wishing to avoid activist pressure to develop credible growth plans when organic opportunities for growth may be lacking.

Conservative financial strategy

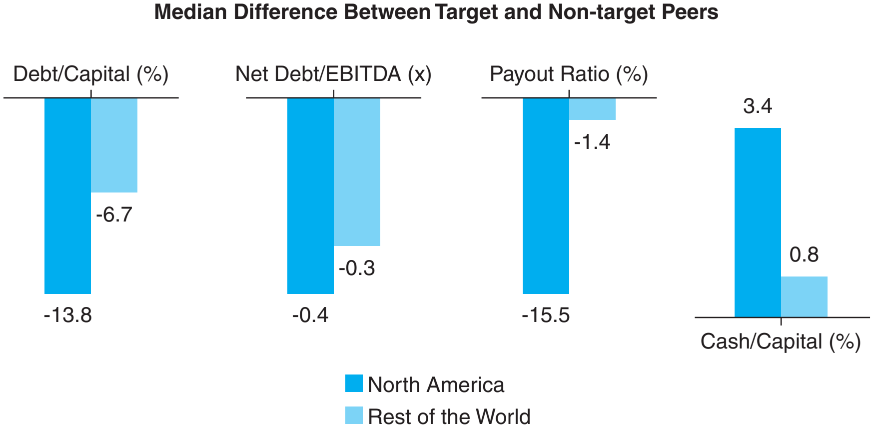
While conservative financial strategies provide management the flexibility to pursue future expansion plans and a buffer for unexpected events, they increase the risk of shareholder activism. Within the US, firms targeted by shareholder activists had lower leverage ratios, lower payout ratios, and higher cash balances than their industry peers. Companies with low top-line growth

Figure 4 Muted revenue growth and low investment for activist targets



Source: SharkRepellent, ISS, and FactSet.

Figure 5 Activists target financial conservatism, particularly in North America



Source: SharkRepellent, ISS, and FactSet.

and substantial but undeployed financial capacity are particularly prone to activist intervention. (See Figure 5.)

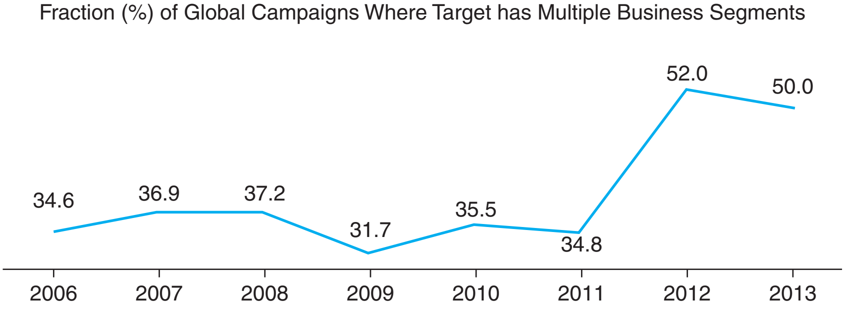
Capital structure considerations tend to be less strongly associated with activism outside North America, with non-US targets holding only slightly more cash than peers and with payout ratios that are only modestly lower than their peers. Part of this difference is attributable to the fact that, in the US, activists proactively target companies rather than seize upon corporate events. Shareholder activism outside North America is more often "event-driven" in the sense of being precipitated by an upcoming shareholder vote. In fact, nearly a third of shareholder campaigns outside North America were preceded by triggering events such as mergers, equity issuances, asset sales, management shuffles, or other operational or strategic decisions. By contrast, though US firms also face event-driven activism risk, the incidence of activism in North America tends to be driven more by activists' perception of firm performance and financial policy.

Financial conservatism has been a more important driver of activism for fast-growing firms—the gap between their leverage, payout ratios, and cash holdings vis-à-vis their peers is wider than at firms that were targeted at a time when their growth prospects were limited. Therefore, robust growth does not insulate a company from activism if its financial policies may be viewed by shareholder activists as being overly conservative. The same is true of stock returns—a conservative financial strategy may precipitate an activist campaign even if the target's stock has outperformed peers, especially in the favorable debt environment of recent years, which has encouraged activists to seek large shareholder distributions from mature companies that follow a conservative financial strategy.

Conglomerate business model

Firms with diversified business models and multiple operating segments are increasingly exposed to shareholder activists, particularly if they trade at a conglomerate discount and if certain segments may be viewed as being noncore. Since 2006, firms with conglomerate business models have become more frequent targets of activism than those with pure-play business models. In fact, a majority of activist targets in 2012 and 2013 were multi-segment firms. (See Figure 6.)

Figure 6 Activists are also targeting multi-segment firms



Source: SharkRepellent, ISS, and FactSet.

Activists' focus on diversified firms reflects in part a general reluctance of some management teams to divest businesses even though there may be recognition that these do not represent core businesses. In light of these trends, management teams of multi-segment firms should be particularly proactive in assessing the value creation potential from corporate restructuring actions and developing strategies to minimize the extent to which their valuations suffer from a potential conglomerate discount.

Conclusion

Shareholder activism has spread to firms of all sizes in all regions and is here to stay. In this environment, we believe it is of utmost importance for boards and executives to stay abreast of the demands of their increasingly assertive shareholder base. Continuously engaging with investors, carefully considering their outsider's perspective, and clearly articulating the firm's strategy are all key steps to being "white paper ready" and to being prepared to address an activist agenda that is not consistent with the firm's strategy. Most important, developing and executing on a credible strategy to optimize a company's growth trajectory and its operating and financial performance are of paramount importance to avoid being second-guessed by activist investors.

Notes

1 For a detailed discussion and analysis of shareholder activism, please see our Citi Financial Strategy and Solutions Group (FSG) report, *Rising Tide of Global Shareholder Activism*, Ajay Khorana, Elinor Hoover, Anil Shivdasani, Gustav Sigurdsson, and Mike Zhang, 2013.

2 "Hedge Fund Activism in Europe," European Corporate Governance Institute, Marco Becht, Julian Franks, and Jeremy Grant, 2010.

35 Advance preparedness—dealing with activist hedge funds

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This year has seen a continuance of the high and increasing level of activist campaigns experienced during the last 14 years, from 27 in 2000 to over 250 in 2014, in addition to numerous undisclosed behind-the-scenes situations. Today, regardless of industry, no company can consider itself immune from potential activism. Indeed, no company is too large, too popular, or too successful, and even companies that are respected industry leaders and have outperformed peers can come under fire. Among the major companies that have been targeted are Amgen, Apple, Microsoft, Sony, Hess, P&G, eBay, Transocean, ITW, DuPont, and PepsiCo. There are more than 100 hedge funds that have engaged in activism. Activist hedge funds have approximately $200 billion of assets under management. They have become an "asset class" that continues to attract investment. The additional capital and new partnerships between activists and institutional investors have encouraged increasingly aggressive activist attacks.

The major activist hedge funds are very experienced and sophisticated, with professional analysts, traders, bankers, and senior partners that rival the leading investment banks. They produce detailed analyses ("white papers") of a target's management, operations, capital structure, and strategy designed to show that the changes they propose would quickly boost shareholder value. These white papers may also contain aggressive critiques of past decisions made by the target. Some activist attacks are designed to facilitate a takeover or to force a sale of the target, such as the failed Icahn attack on Clorox. Prominent institutional investors and strategic acquirers have been working with activists both behind the scenes and by partnering in sponsoring an activist attack, such as CalSTRS with Relational in attacking Timken; Ontario Teachers' Pension Fund with Pershing Square in attacking Canadian Pacific; and Valeant partnering with Pershing Square to force a takeover of Allergan.

Many major activist attacks involve a network of activist investors ("wolf pack") who support the lead activist hedge fund, but attempt to avoid the disclosure and other laws and regulations that would hinder or prevent the attack if they were, or were deemed to be, a group that is acting in concert. Not infrequently, at the fringe of the wolf pack are some of the leading institutional investors, not actively joining in the attack but letting the leader of the pack know that it can count on them in a proxy fight. Major investment banks, law firms, proxy solicitors, and public relations advisers are now representing activist hedge funds and are eagerly soliciting their business.

Among the attack devices used by activists are:

(a) aggressively criticizing a company's announced initiatives and strategic actions and presenting the activist's own recommendations and business plan;
(b) proposing a precatory proxy resolution for specific actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value";
(c) conducting a proxy fight to get board representation at an annual or special meeting or through action by written consent (note that solicitation for a short slate is very often supported by ISS and, if supported, is often successful, in whole or in part, and ISS is also increasingly showing support for "control" slates);
(d) orchestrating a "withhold the vote" campaign;
(e) seeking to force a sale by leaking or initiating rumors of an unsolicited approach, publicly calling for a sale, acting as an (unauthorized) intermediary with strategic acquirers and private equity funds, making their own "stalking horse" bid, or partnering with a hostile acquirer to build secret, substantial stock positions in the target to facilitate a takeover;
(f) rallying institutional investors and sell-side research analysts to support the activist;
(g) using stock loans, options, derivatives, and other devices to increase voting power beyond the activist's economic equity investment;
(h) using sophisticated public relations, social media, and traditional media campaigns to advance the activist's arguments, including procuring "on the record" support from third parties;
(i) hiring private investigators to establish dossiers on directors, management, and key employees and otherwise conducting aggressive "diligence";
(j) litigating to obtain board records and materials and to block transactions.

Current Securities and Exchange Commission (SEC) rules do not prevent an activist from secretly accumulating a more than five percent position before being required to make public disclosure and do not prevent activists and institutional investors from privately communicating and cooperating.

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. In addition to a program of advance engagement with investors as discussed below, it is essential to be able to mount a defense quickly and to be flexible in responding to changing tactics. To forestall an attack, a company should continually review its business portfolio and strategy and its governance and executive compensation issues sensibly and in light of its particular needs and circumstances. Companies must regularly adjust strategies and defenses to meet changing market conditions, business dynamics, and legal developments.

This outline provides a checklist of matters *to be considered* in putting a company in the best possible position to prevent or respond to hedge fund activism.

Advance preparation

Create team to deal with hedge fund activism

- A small group (2–5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm
- Continuing contact and periodic meetings of the team are important

- A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used
- Periodic updates of the company's board of directors

Shareholder relations

- The investor relations officer is critical in assessing exposure to an activist attack and in a proxy solicitation. The regard in which the investor relations officer is held by the institutional shareholders has been determinative in a number of proxy solicitations. Candid investor relations assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board.
- Review capital return policy (dividends and buybacks), broader capital allocation framework, analyst and investor presentations, and other financial public relations matters (including disclosed metrics and guidance).
- Monitor peer group, sell-side analysts, proxy advisers like ISS, activist institutions like CalSTRS and TIAA-CREF, Internet commentary, and media reports for opinions or facts that will attract the attention of attackers.
- Be consistent with the company's basic strategic message.
- Objectively assess input from shareholders—is the company receiving candid and direct feedback?
- Proactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers; build credibility with shareholders and analysts before activists surface and attempt to "educate" the sell-side.
- Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders, paying close attention to activist funds that commonly act together or with an institutional investor.
- Maintain regular, close contact with major institutional investors; CEO, CFO, and independent director participation is very important; regularly engage with portfolio managers as well as proxy-voting departments.
- Monitor ISS, GL, CII, and TIAA-CREF corporate governance policies; activists try to "piggyback" on process issues to bolster the argument for management or business changes.
- Monitor third-party governance ratings and reports for inaccuracies and/or flawed characterization.
- Major institutional investors, including BlackRock, Fidelity, State Street, and Vanguard, have established significant proxy departments that make decisions independent of ISS and GL and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision makers and point persons are, and how best to reach them. It is possible to mount a strong defense against an activist attack that is supported by ISS and GL and gain the support of the major institutional shareholders.
- Maintain up-to-date plans for contacts with media, regulatory agencies, and political bodies and refresh relationships.
- Monitor conference call participants, one-on-one requests, and transcript downloads.
- Continue regular temperature-taking calls pre- and post-earnings and conferences, and exercise caution and oversight with respect to large format or "group" investor meetings.

Prepare the board of directors to deal with the activist situation

- Maintaining a unified board consensus on key strategic issues is essential to success; in large measure an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance and to create divisions on the board by advocating that a special committee be formed.
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation, and the portfolio of businesses in light of possible arguments for spin-offs, share buybacks, increased leverage, special dividends, sale of the company, or other structural changes.
- Schedule periodic presentations by the lawyer and the investment banker to familiarize directors with the current activist environment.
- Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO.
- Boardroom debates over business strategy, direction, and other matters should be open and vigorous but kept within the boardroom.
- Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target.
- A company should not wait until it is involved in a contested proxy solicitation to have its institutional shareholders meet its independent directors. A disciplined, thoughtful program for periodic meetings is advisable.
- Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors may particularly question the "independence" of directors who are older than 75 or who have served for more than 10 to 15 years.

Monitor trading, volume, and other indicia of activity

- Employ a stock watch service and monitor Schedule 13F filings
- Monitor Schedule 13D and Schedule 13G and Hart-Scott-Rodino Act filings
- Monitor parallel trading and group activity (the activist "wolf pack")
- Monitor activity in options and derivatives, as well as corporate debt and other nonequity securities

The activist white paper

The activist may approach a company with an extensive high-quality analysis of the company's business that supports the activist's recommendations (demands) for:

- return of capital to shareholders through share repurchase or a special dividend
- sale or the spin-off of a division
- change in business strategy
- improve management performance (replace CEO)
- change in executive compensation
- change in cost structures
- merger or sale of the company
- change in governance: add new directors designated by the activist, separate the positions of CEO and Chair, declassify the board, remove poison pill and other shark repellants, and permit shareholders to call a special meeting (or lower thresholds for same) and act by written consent in lieu of a meeting.

The white paper is used by the activist in private meetings with shareholders, sell-side analysts, and the media and is ultimately designed for public consumption

Responding to an activist approach

Response to nonpublic communication

- Assemble team and determine initial strategy. Response is an art, not a science.
- No duty to discuss or negotiate (no outright rejection, try to learn as much as possible by listening, and keep in mind that it may be

desirable at some point to negotiate with the activist and that developing a framework for private communication and nonpublic engagement may avoid escalation).

- No duty to disclose unless leak comes from within.
- Response to any particular approach must be specially structured; team should confer to decide proper response.
- Keep board advised (in some cases it may be advisable to arrange for the activist to present its white paper to the board or a committee or subset of the directors).
- No duty to respond, but failure to respond may have negative consequences.
- Be prepared for public disclosure by activist.
- Be prepared for the activist to try to engage directly with shareholders, sell-side analysts, business partners, employees, and key corporate constituencies.

Response to public communication

- Initially, no public response other than "the board will consider and welcomes input from its shareholders."
- Assemble team; inform directors.
- Call special board meeting to meet with the team and consider the communication.
- Determine board's response and whether to meet with the activist. Failure to meet may be viewed negatively by institutional investors. Meeting may result in activist using the meeting to mischaracterize the company's position.
- Avoid mixed messages and preserve the credibility of the board and management.
- Gauge whether the best outcome is to agree upon board representation and/or strategic business or other change in order to avoid a proxy fight.
- Be prepared and willing to defend vigorously.
- Appreciate that the public dialogue is often asymmetrical; while activists can, often without consequence, make personal attacks and use aggressive language, the company cannot respond in this manner.
- Remain focused on the business; activist approaches can be all consuming, but continued strong performance of the business, though not an absolute defense, is one of the best defenses. When business challenges inevitably arise, acting in a manner that preserves and builds credibility with shareholders and with the rest of investment community is of paramount importance. Maintain the confidence and morale of employees, business partners, and key constituencies.
- The 2012 defeat by AOL of an activist short-slate proxy solicitation supported by ISS shows that investors can be persuaded to not blindly follow the recommendation of ISS. When presented with a well-articulated and compelling plan for the long-term success of a company, they are able to cut through the cacophony of shortsighted gains promised by activists touting short-term strategies. The AOL fight showed that when a company's management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen.
- The recent amendments, and then full withdrawal, by Carl Icahn of his attempt to force Apple into leveraging its balance sheet and paying out $150 billion to its shareholders, showed that investors can be convinced not to support an activist attack that is not in the long-term best interests of the company's shareholders (Icahn later restated his support for continued buybacks). In this connection, it is noteworthy that on March 21, 2014, Larry Fink, Chairman and CEO of BlackRock, wrote to the CEOs of the S&P 500:

> Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their part by persuasively communicating their company's long-

term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.

It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.

We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments—in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology—that will sustain growth.

BlackRock's mission is to earn the trust of our clients by helping them meet their long-term investment goals. We see this mission as indistinguishable from also aiming to be a trusted, responsible shareholder with a longer term horizon. Much progress has been made on company-shareholder engagement and we will continue to play our part as a provider of patient capital in ensuring robust dialogue. We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.

36 Shareholder proposals: recent trends and developments

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Securities and Exchange Commission (SEC) Rule 14a-8 (the Rule) governs the procedures for a shareholder to submit a proposal to be included in a company's proxy statement at an annual or special meeting of shareholders. This chapter first summarizes the basic regulatory concerns that arise under Rule 14a-8, then looks at the significant recent trends and developments in the shareholder proposal arena, and finally provides some observations on the process.

It is worth noting that the Rule does not apply to shareholders who solicit their own proxies, rather than having the proposal on the company's proxy card. Such shareholders bear the cost of the preparation and filing of their own materials, the printing and mailing to shareholders, and the solicitation of proxies. By and large, these insurgents are seeking shareholder support for board representation, rather than the corporate governance, environmental, and social issues most commonly the subject of Rule 14a-8 proposals. While proposals may be drafted to implement binding changes to a company's by-laws depending on relevant state law, virtually all proposals are precatory (nonbinding or advisory), and there is no requirement that the company adopt any change should a proposal receive the required shareholder support. However, failing to do so violates the proxy voting guidelines of many major institutional shareholders, as well as those of the two major independent proxy advisory services, ISS and Glass Lewis. The consequence of this inaction is generally a vote against (or withheld on) some (depending on committee membership) or all of the director nominees up for election at the following shareholder meeting. Depending on a company's shareholder profile and the nature of the proposal, this could have real consequences for companies with a majority vote standard for the election of directors.

Precatory shareholder proposals typically require a majority of votes cast, excluding abstentions and broker nonvotes in order to pass. However, some companies include abstentions in the calculation, providing a higher bar for a proposal to pass. Shareholder proponents are calling on companies to take a uniform approach in which all matters presented to shareholders be decided by a simple majority of the shares voted "for" and "against" and not treat abstentions as effective votes against a proposal.

The Rule allows companies to include a statement explaining why and how they recommend shareholders vote on the proposal. Companies should seek the benefit of advisors to assist in the drafting of this statement, which needs to be carefully researched and written as it can have a material effect on the voting outcomes of some shareholder proposals.

Who is eligible to submit a proposal under Rule 14a-8?

The eligibility criteria for a shareholder to be eligible to submit a proposal under Rule 14a-8 are very modest—the holder must have continuously held at least $2,000 in market value, or one percent of the company's securities entitled to be voted on the proposal at the shareholder meeting, for at least one year as of the date the shareholder submits the proposal.

Valid proof of such ownership can be easily evidenced by shareholders of record (ie shareholders listed directly on the register maintained by the issuer's transfer agent). However, for beneficial owners (ie street name holders) such proof requires a written statement from the record holder, such as the shareholder's bank or broker, verifying that the shareholder owned such shares at the time of the proposal submission. It is very rare that a company is able to exclude a proposal based on a shareholder's lack of evidence that it meets the requirements.

A shareholder may submit no more than one proposal for a particular shareholder meeting, but it is not uncommon for major companies to receive two or three or even more proposals from different owners.

Deadlines

Under the Rule, the deadline for a shareholder to submit a proposal for a company's annual meeting is 120 days prior to the anniversary of the previous year's proxy mailing. The deadline for a shareholder who wants to bring their own matter or director candidate to a vote from the floor or in an opposition proxy statement may also be stipulated in the company's by-laws—the so-called "advance notice by-law provisions." Typically, deadlines for these are closer to the meeting, such as 60 to 90 days prior to the anniversary date of the meeting as opposed to the mailing date for Rule 14a-8 proposals. Furthermore, unless so restricted, these deadlines are governed by state statutes. These deadlines generally will be clearly referenced in the prior year's proxy statement. It is strongly suggested that these by-law provisions be reviewed on an ongoing basis to ensure that there are no possible ambiguities, that they provide sufficient notice for a company to react, that they are not overly restrictive to a shareholder's ability to provide the required notice, and that they also account for the possibility that the annual meeting date may change significantly in any particular year.

Resubmitting a proposal

The Rule also provides guidelines allowing companies to exclude proposals that are identical or substantially the same as ones that have been included in the company's proxy materials within the past five years, based on the previous levels of shareholder support the proposal received.

In order to have the proposal excluded at any meeting within three years of the last time the proposal was in the company's proxy, the proposal must have failed to receive the following levels of shareholder support:

- three percent of the vote if proposed once within the preceding five calendar years;
- six percent of the vote on its last submission to shareholders if proposed twice previously within the preceding five calendar years; or
- less than 10 percent of the vote on its last submission to shareholders if proposed three times or more within the preceding five calendar years.

These levels allow for the repeated resubmission of proposals receiving minimal shareholder support.

Getting a shareholder proposal excluded

If a shareholder fails to meet the procedural or eligibility requirements summarized above, the company may exclude the proposal from its proxy, provided that the shareholder is notified of any defect in his or her submission and given time (14 days) to cure such deficiency. The company may also apply to the SEC for "no action relief" to exclude the proposal on the basis of a number of criteria laid out in the SEC statute. Some of the most common exclusions used are as follows (see SEC Rule 14a-8 for more complete list of exclusions):

1. the proposal violates state, federal, or foreign laws or SEC proxy rules
2. the proposal relates to a personal grievance or special interest
3. the company would lack the power or authority to implement the proposal
4. the proposal deals with a matter relating to the company's ordinary business operations
5. the proposal is related to director elections and would either:
   (i) disqualify a nominee who is standing for election;
   (ii) remove a director from office before his or her term expired;
   (iii) question the competence, business judgment, or character of one or more nominees or directors;
   (iv) seek to include a specific individual in the company's proxy materials for election to the board of directors; or
   (v) otherwise could affect the outcome of the upcoming election of directors.
6. the matter of the proposal conflicts with a company-sponsored proposal or duplicates another proposal previously submitted by another shareholder
7. the proposal contains substantially the same subject matter that was previously submitted and did not receive a specified percentage of the vote.

Most of the letters filed by companies are based on the contention that the proposal in question relates to ordinary business matters.

Table 1 Most frequent proponents under the Rule in 2014

Proponent	Number of proposals
John Chevedden	104
New York State Common Retirement Fund	54
Ken Steiner	39
AFL-CIO	26
Jim McRitchie	26
New York City Pension Funds	26
United Brotherhood of Carpenters	25
Trillium Asset Management	23
New York City Funds	22
Calvert Asset Management Co.	21

Frequent filers

Shareholder proposals are predominantly submitted by holders falling into one of three categories: (1) public pension funds; (2) the so-called "corporate gadflies," that is, individuals who hold relatively small share amounts in numerous companies and routinely file a large number of proposals each year, generally focused on one or two issues; and (3) socially- and environmentally-conscious funds. Table 1 shows the most frequent proponents in 2014.

Most common proposals

According to ISS, there have been a total of 926 shareholder proposals filed so far in 2014, up from 912 for the entire 2013 calendar year. Shareholder proposals in any given year are concentrated on a limited number of issues. In Table 2, the most common 2014 proposals—most of which were the most popular in 2013 as well (see Table 3)—are compared.

These proposals are discussed in more detail in the following sections.

Political spending proposals

These proposals generally ask the company to disclose all of its political spending, including payments to trade associations and other tax-exempt organizations used for political purposes, claiming shareholders need comprehensive disclosure to be able to fully evaluate the political use of corporate assets. Some election-related proposals seek a direct prohibition of political donations or seek policies linking corporate giving and company values.

While these proposals are relatively new, compared to most of the other issues on the list, they have clearly become the most common over the past two years. While none of them have yet passed, support has been as high as 47 percent. The proxy advisors and institutions do not commonly support proposals that seek to limit a company's

Table 2 Most common shareholder proposals under the Rule in 2014

Top shareholder proposals voted in 2014	Number of proposals in 2014*	Number of proposals in 2013
Political and lobbying activities	84	85
Independent board chair	62	61
Majority vote for the election of directors	28	31
Act by written consent	27	26
Stock retention/holding period	27	37
Pro rata vesting of equity awards	20	31
Greenhouse gas emissions	19	6
Declassify the board of directors	15	32
Proxy access	13	13
Shareholder ability to call special meetings	13	11
Report on sustainability	13	14

Source: Institutional Shareholder Services Inc.

*Number of proposals includes pending, voted, withdrawn, omitted, and not presented proposals as of July 9, 2014.

Table 3 Most common shareholder proposals under the Rule in 2013

Top shareholder proposals voted in 2013	Number of proposals	Average support
Report on political contributions/lobbying	75	28.3%
Independent board chairman	61	32.0%
Stock retention/holding period	37	23.8%
Declassify the board of directors	32	78.7%
Majority vote for the election of directors	31	59.0%
Pro rata vesting of equity awards	31	33.0%
Act by written consent	26	40.9%
Reduce supermajority vote requirement	21	70.5%
Report on sustainability	14	33.1%
Proxy access	13	32.5%

Source: Institutional Shareholder Services Inc.

activities, but they are generally in favor of proposals seeking greater disclosure, particularly at issuers where there has been a controversy.

Independent board chairman

While there is a degree of acceptance among many institutions that a combined CEO/chairman role may be warranted and beneficial to shareholders in some situations, shareholders generally want independent lead directors to provide independent board leadership.

The proxy voting guidelines of ISS and Glass Lewis dictate a vote against a nonindependent chair in the absence of a separate, independent lead director who has a prescribed set of responsibilities. An activist may also target the lack of an independent chair during periods of sustained and significant underperformance or some negative event involving risk oversight, accounting scandal, or other negative newsworthy event. An important point to note here is that the definition of independence that the company uses, probably in compliance with the exchange where the company is listed, is not always consistent with that used by the proxy advisors and some institutions.

Shareholder proposals seeking to force the appointment of an independent chair are perennially among the most prevalent, but generally do not pass.

Majority vote

Shareholder proposals seeking to change the vote standard required for the election of a director to a majority, rather than plurality, continued to receive high levels of support from shareholders. The principle behind majority voting is almost universally supported by institutions and the proxy advisors.

Most large-cap companies, who were the original targets of these shareholder proposals, have adopted some form of majority voting. Many of these companies implemented the change when faced with the submission of a shareholder proposal that was likely to pass. The majority of smaller companies still retain plurality voting as the governance-focused activists have not yet targeted these companies to the same extent on this issue yet.

Shareholder ability to act by written consent and shareholder ability to call special meetings

Although there are practical differences between the written consent and special meeting provisions, they are both a vehicle for shareholders to propose business, usually the replacement of directors, at any time of the year, not just at the annual meeting. We have combined the discussion of these two issues, particularly as voting policies and patterns on each of these proposals suggest that institutions look at them through the lens of whether a company already has one or the other in place.

There are two principal advantages to companies to giving shareholders the right to call a special meeting versus the ability to act by written consent:

1. *An ownership threshold*—To prevent abuse and waste of corporate resources by small shareholders, companies typically set an ownership floor in the range of 10 percent to 25 percent to call a special meeting. While ISS policy dictates a 10 percent ownership threshold, most institutions with independent voting policies will generally allow a much higher level and will only view anything above 25 percent as excessive and entrenchment. Glass Lewis is a little more lenient than ISS on the ownership criteria, preferring the limit to be between 10 percent and 15 percent, depending on company size. There is no such requirement for a written consent.
2. *Greater control of the time line*—Shareholders can file and mail written consent solicitation materials at any time, while the company can set the time line for a special meeting.

ISS and Glass Lewis both generally support shareholder proposals allowing written consent and shareholder ability to call a special meeting. These firms, along with many of the major institutions, will vote against a written consent proposal if the company has a special meeting provision with a reasonable ownership threshold required to call the meeting.

Stock retention/holding for executives or directors

Shareholder proposals seeking to adopt a policy requiring that senior executives retain a significant percentage of shares acquired through equity compensation programs until reaching normal retirement age or terminating employment with the company have not been successful to date, with all being defeated.

Proponents argue retention requirements that link executive compensation with long-term performance by requiring senior executives to hold a significant percentage of shares obtained through equity compensation plans until they reach retirement age will better align the interests of executives with the interests of shareholders and the company.

Declassification/destagger proposals

Shareholder proposals seeking to eliminate staggered board structures have received overwhelming support from all types of investors. Currently 12.11 percent of the Fortune 500 and 41.99 percent of the Russell 3000 have staggered boards.

Proponents argue that a classified board makes it more difficult to change control of a company through a proxy contest. Because only a minority of the directors is elected each year, a dissident will be unable to win control of the board in a single election and would need two years to gain control of the company unless there are vacancies in the other classes. They often cite studies and statistics claiming companies with staggered boards have lower valuations, attract lower premiums as acquisition targets, and are less likely to attract proposals. The major push on this topic has come from an advocacy group, the Shareholder Rights Project, run by a Harvard professor and backed primarily by some public pension funds.

Management often argues that classifying the board will assure continuity among directors and stability of the board. A classified board encourages directors to look to the long-term best interest of the company and its stockholders by strengthening the independence of nonemployee directors against the often short-term focus of certain investors and special interests. In addition, a classified board allows for a stable and continuous board, providing institutional perspective both to management and other directors. A classified board reduces vulnerability to potentially abusive takeover tactics by encouraging persons seeking control of the company to negotiate with the board and thereby better positioning the board to negotiate effectively on behalf of all stockholders. These arguments do not resonate with most shareholders.

Proxy access

"Proxy access" refers to the right of a shareholder to include his or her own nominee(s) on the company's proxy card and avoid the costs associated with conducting his or her own proxy solicitation, which can be significant.

First, the by-laws need to be amended, either through shareholder support of a binding Rule 14a-8 proposal or by voluntary board action. Once the by-laws have been changed, a shareholder who meets the criteria outlined in the by-laws can submit his or her nominees to the company to be included in the next proxy statement.

Shareholder proposals to get a company to amend the by-laws to allow proxy access are still relatively infrequent, only appearing in meaningful numbers starting in 2012 as a result of an amendment to the SEC rules that went into effect in 2011. Each Rule 14a-8 proposal to effect the first step needs to outline the criteria for a holder to be able to submit nominees under proxy access at that company and specify the number of nominees that may be submitted by such qualifying holder.

The proposals that have been submitted have been essentially bifurcated, with the majority calling for a holder or group having held one percent of the shares for one or two years being able to submit nominees comprising up to 20 percent of the board. A smaller number of proposals submitted called for a three percent holding for three years.

As Table 3 illustrates, the majority of proxy access proposals in 2013 were not approved. A closer look though reveals a strong correlation between the ownership threshold and the level of support. Most institutions and the proxy advisors have not supported the one percent proposals, believing that it opens up the process to too many shareholders that may have self-interested agendas. Support for these proposals has generally been very low, mostly in the single digits. The three percent/three-year proposals however, have gained far greater acceptance and have hit support rates above 50 percent, as high as 64.5 percent.

Supermajority vote requirements

Shareholder proposals seeking to eliminate any voting requirements in the company's charter and by-laws that call for a greater than simple majority vote, and replace these with a simple majority of the votes cast, are strongly supported by the proxy advisory firms and governance professionals. While these proposals generally receive high levels of support, voting outcomes are mixed.

Proponents argue super-majority voting requirements have been found to be a blocking and entrenching mechanism that does not serve the best interest of shareholders.

Management frequently argues supermajority voting requirements on fundamental corporate matters help to protect shareholders against self-interested and potentially abusive transactions proposed by certain shareholders who may seek to advance their interests over the interests of the majority of the company's shareholders. Supermajority voting requirements encourage interested shareholders to negotiate transaction terms that take into account the interests of all of the company's shareholders and that do not sacrifice the long-term success of the company for short-term benefits.

Updating the Rule 14a-8 proposal process

In March 2014, SEC Commissioner Daniel Gallagher opined on the shortcomings of the Rule 14a-8 process and offered some interesting suggestions to the areas where he was most critical that we believe are worth sharing.

He first commented on the low ownership threshold required to submit a proposal that allows corporate gadflies and shareholders with minimal holdings and a special interest to "hijack the shareholder proposal system." Companies have to incur significant costs, often well into the $100,000s and more on advice from lawyers, bankers, and governance experts to analyze and respond to the proposal. He also noted that only one percent of the shareholder proposals filed last year were filed by "ordinary institutional investors." To remedy the deficiencies in the current shareholder proposal regime, to the extent that shareholder proposals are here to stay, Commissioner Gallagher suggests that the ownership requirement be increased to a specified percentage of the outstanding shares and that the required holding period be lengthened. He also suggests that so-called "proposal by proxy"—where a person with no shares acts on behalf of another holder—should either be banned or be subject to an even greater ownership requirement. Commissioner Gallagher also suggests that the subject matter of proposals be more carefully policed and limited, and that higher voting thresholds be required for proposals to be resubmitted.

Recommendations

The costs and distraction associated with fighting these proposals can be significant. It is highly advisable that issuers faced with a shareholder proposal that the board deems to not be in the best interest of the company, consult with an attorney experienced in the arena and a thorough process is undertaken to first attempt to exclude the proposal and then to craft a message and strategy to defeat it. Other advisors, such as proxy solicitation firms, can be invaluable with providing data on the voting tendencies of specific shareholders, policies of the proxy advisors, and leading the campaign to win shareholder votes.

37 Engaging with proxy advisory services

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In 2015, Institutional Shareholder Services (ISS) celebrates its 30th anniversary. Since the founding of ISS, proxy advisory firms (PAFs) have created an important institutional investor service. In so doing, they have become significant actors in shaping corporate governance, often to the consternation of corporate executives and board members.

ISS and Glass Lewis (the latter founded in 2003) are the dominant proxy advisory firms in the US and globally. They provide standardized "proxy reports" to hundreds of clients on thousands of companies globally, including vote recommendations. They also implement customized policies for clients and provide proxy voting management systems and services to institutional investors, including separate governance risk ratings by ISS (called the ISS Governance QuickScore).

Among other services are those provided by ISS Corporate Services, an ISS subsidiary that ISS says is walled off from its core institutional investor research/recommendation team. ISS Corporate Services provides data and analysis, helping companies navigate ISS. Glass Lewis does not offer a similar service, but the firm does partner with Equilar, which offers Glass Lewis research to issuers as well as extensive executive and director pay analytics and other research.

It is critical for public companies with dispersed ownership, listed on US exchanges, to be familiar with both of these firms, and engagement with the firms can be helpful. In almost all cases ISS and Glass Lewis affect a significant share of voting at public company annual and special meetings. Some governance and investor relations executives think of ISS as effectively their companies' largest shareholder when it comes to proxy votes.

At the same time, it is a mistake to overestimate the importance of ISS and Glass Lewis. Many of the largest investors subscribe to both services (whose recommendations often conflict) and/or have been growing their internal capacity. Firms should seek to talk directly to their largest holders on complex or difficult voting issues and not overstate the PAF role as intermediary. For most large US companies, ISS and Glass Lewis are highly significant but not determinative of vote outcomes. Moreover, the proxy services themselves look for evidence that companies are engaging shareholders, especially on tough issues.

The market for proxy advisory services is competitive. While there is little question that ISS and Glass Lewis in practice help shape certain governance practices in the US and elsewhere, to a significant degree the firms follow their clients, seeking to be in tune with prevailing views on corporate governance (to the extent possible in a highly diverse client base), if leaning in toward the leading edge.

Other US-based proxy recommendation services include Proxy Mosaic, a newer firm that offers client-driven proxy voting research as well as proxy voting policy development; Egan-Jones Proxy Services, owned by Egan-Jones Ratings Co., which also provides credit ratings; and the Marco Consulting Group, which provides Taft-Hartley funds a range of services.

Overseas PAFs that cover US companies include Pensions & Investment Research Consultants Ltd. (PIRC) and Manifest (UK-based firms that will cover S&P 500 companies for their clients) and IVOX, a firm based in Germany. Finally, companies should be aware that other providers of corporate governance and sustainability information may produce research that affects proxy voting decisions, including MSCI products GovernanceMetrics and Intangible Value Assessment.

Ownership of ISS and Glass Lewis

In April 2014, Vestar Capital Partners, a private equity firm, acquired ISS from MSCI, Inc. MSCI had acquired RiskMetrics Group, which included ISS, in 2010. RiskMetrics acquired ISS in 2007 from a group that included Warburg Pincus, which itself bought ISS from Thomson Corp. (now Thomson Reuters). ISS was founded by Robert A. G. Monks and Nell Minow.

Despite frequent changes in ownership over the last 14 years, the research/analytic leadership within ISS has been relatively stable. While the organization's policies have evolved as governance and institutional shareholder views have evolved, there has been substantial continuity in the ISS approach.

Glass Lewis ownership changed hands twice in 2007. Its founders sold it to Xinhua Finance (part of China's state-run news agency), which shortly thereafter sold the firm to the Ontario Teachers Pension Plan (OTPP), and ownership is now shared between OTPP and Alberta Investment Management Corp.

Controversy on the PAF role

Proxy voting recommendations by ISS and Glass Lewis have long placed the firms in the crosshairs for criticism, particularly from companies. Debate has intensified as the importance of proxy voting in firm governance has increased, although a countervailing factor has been somewhat decreased reliance on PAF recommendations at investment managers and pension funds that have enhanced their in-house capacities.

Some level of controversy is inherent in the proxy advisory firm role, at least for firms that make vote recommendations and/or implement broad proxy voting policies and therefore are decision-makers. Clients expect critical analysis (as well as research and data) from PAFs, and institutions have expressed a preference for proxy research firms that make voting recommendations. Certain matters (most notably in proxy fights) can be enormously contentious.

ISS in particular has been a lightning rod, in significant part due to its larger influence but also because of the ISS Corporate Services business, which critics have said poses conflicts of interest. ISS says ISS Corporate Services operates independently of ISS and that it has managed the conflicts of interest effectively. ISS stresses that advice to corporate clients does not influence recommendation outcomes and that ISS Corporate Services is walled off from the ISS research and recommendation service.

More generally, critics complain that the proxy advisory firms are not shareholders, owe no fiduciary duty to shareholders, and gain their business to a significant degree on compliance considerations of asset managers and asset owners.

US regulation affecting PAFs

The debate includes the question of how proxy advisory services and/or their clients, particularly investment advisers, should be regulated with regard to proxy voting. The Securities and Exchange Commission (SEC) and the Department of Labor (the latter with regard to Employment Retirement Income Security Act [ERISA] funds) regard the proxy vote as an asset of the fund. The SEC requires an investment adviser that exercises voting authority over client proxies to ensure there are policies and procedures in place that are reasonably designed to ensure voting in the best interest of the client.[1] In two 2004 no-action letters, the SEC indicated that investment advisers may rely on proxy advisory firms if certain conditions are met.[2]

New SEC staff guidance published in June 2014 clarifies aspects of the earlier documents.[3] The new guidance provides additional description of due diligence expected of investment advisers in oversight on third-party proxy voting providers where the PAF has some discretion in vote decisions, even if the PAF decision can be changed by the adviser. The guidance also discusses treatment of conflicts of interest, clarifying requirements for the PAF to disclose conflicts to its clients. It is not clear that the new guidance will significantly change proxy voting dynamics, but it may add to pressure on certain investment managers to exercise greater authority in this area, deferring less to PAFs.

The new guidance says investment advisers should demonstrate compliance with the Proxy Voting Rule by, for example, sampling votes (perhaps focusing on more complex matters) to determine that the proxy advisory firm (to the extent voting discretion is delegated to the firm) "has the capacity and competency to adequately analyze proxy issues." Elements of this analysis could include evaluation of the adequacy and quality of the PAF staff and the robustness of its policies and procedures, including as to whether recommendations are based on current and accurate information.

Since the advent of say-on-pay votes in 2011, more companies have filed with the SEC supplemental materials prepared for investors specifically disputing ISS (and sometimes Glass Lewis) recommendations, including the factual basis for the recommendations. The SEC guidance may further encourage this trend, as it suggests an investment adviser responsibility to investigate instances of known factual inaccuracies to probe whether the PAF has the "capacity and competency" described above. A company effort to flag a material factual error by a PAF may be helpful if the company does identify a clear factual error. However, often companies really are attacking the analytical framework or rigor rather than clear factual inaccuracies. The effectiveness of focusing on this in communications with investors is open to question. Larger investors in some cases have tired of attacks on ISS and Glass Lewis, regarding some of the attacks as weak and tendentious, and would like to focus on the particular investor's core concerns on the underlying matters at issue.

PAF best practice approaches in Europe and Canada

In 2013, the European Securities and Markets Authority (ESMA) considered the need for regulation of proxy advisory firms. ESMA concluded that regulatory intervention was not required, but it recommended that the "proxy advising industry" develop a code of conduct focused on identifying, disclosing, and managing conflicts of interest, and for fostering transparency to ensure accuracy and reliability of advice. As a result, leading PAFs have been working together on development of such a code, applicable in

Europe but with implications for global operations of ISS and Glass Lewis, both of which are participating in the effort.

The Canadian Securities Administrators in April 2014 published for comment a proposed "Guidance for Proxy Advisory Firms." The guidance is also not binding but recommends best practice to promote transparency and understanding of all market participants and covers conflicts of interest, promotion of transparency and accuracy of proxy voting recommendations, disclosure of processes for development of proxy voting guidelines, and communications including with clients and market participants more generally.

Engaging with proxy advisory firms

Companies in general engage with proxy advisory firms in three types of situations:

- normal course governance issues that will affect voting at noncontested meetings (for example, on election of directors, say-on-pay, compensation plans including equity compensation plans, nonbinding shareholder proposals)
- proxy fights and contested transactions
- PAF policy development efforts.

Both ISS and Glass Lewis as a general matter now express willingness to engage with companies on specific company governance matters, although Glass Lewis will not do so during a solicitation period (once your proxy statement has been published) except (1) if their analyst chooses to reach out to a company to clarify a factual matter; (2) in a forum broadly open to Glass Lewis institutional subscribers, principally a Glass Lewis "Proxy Talk"; or (3) where a company reports a data discrepancy in a published report.

Both ISS and Glass Lewis have appointed an internal liaison to facilitate engagement. ISS has published FAQs on engagement.[4] Glass Lewis has published a "Primer for Issuers."[5] Both these key web resources include links to other pages expanding on key aspects of interest to issuers.

Engaging on normal-course company-specific governance matters

Normal-course engagement takes the form of:

- "off-season" meetings and other exchanges
- "in-season" meetings and other exchanges
- review of data and/or reports.

Company/PAF engagement can be initiated by the company or by the PAF. Both ISS and Glass Lewis reach out to companies at times, although ISS has been more active in this regard. ISS encourages companies to provide it with specific company contact information to assist when ISS wants to reach out.

A number of companies seek to meet with ISS and/or Glass Lewis in the "off-season" (ie outside the proxy solicitation period).

ISS says it will do so when it believes a meeting will assist it in producing high-quality research. In practice, ISS usually has been open to meetings outside proxy season (which ISS considers to run from February 15 to June 30 in the US), although at times ISS prefers to meet by telephone rather than in person, and ISS reserves the right to turn down meetings, based in part on its own scheduling pressures. ISS warns that during the proxy season, analysts generally engage with issuers only where initiated by ISS or on contentious issues. As time limitations dictate this approach, the greater difficulty engaging during the core US proxy season affects companies no matter what their fiscal year/annual meeting cycle.

Glass Lewis says it would be happy to have a conference call or meeting with any public company to discuss general corporate governance issues outside of a proxy solicitation period (although Glass Lewis also references its own "proxy season blackout period" in which time constraints may preclude a meeting). The Glass Lewis "Primer for Issuers" web page (mentioned above) includes a link to request a meeting, along with specific instructions.

Both ISS and Glass Lewis say the issuer should clearly set forth the agenda for any such meeting. Companies should carefully evaluate who will participate in a meeting, recognizing that in certain circumstances an independent board member (such as the lead director) may be appropriate and effective, although in many situations the right executive participants may be the right team for PAF engagement.

Both services also have formalized processes around engagement on reports and data, and both services do revise proxy reports at times based on corrections of factual data. ISS says no company is "entitled" to review its reports before publication, but as a courtesy it generally provides companies in the S&P 500 index with the opportunity to review draft reports, with a short time line for response. ISS seeks factual corrections, adding: "this is not an opportunity for the issuer to lobby for a particular voting recommendation, but to check the facts that are being included in our report." ISS provides S&P 500 companies specific instructions on how to respond to the draft report.

ISS "does not normally allow pre-publication reviews of any analysis relating to any special meeting or any meeting where the agenda includes a merger or acquisition proposal, proxy fight, or any item that ISS, in its sole discretion, considers to be of a contentious or controversial nature." ISS requests issuers that do not get an opportunity to review reports before publication, and that spot an error, to contact ISS immediately, and ISS does at times revise its reports and on occasion a recommendation, postpublication.

Glass Lewis does not provide any issuers with prepublication draft reports. It does have a form for notifying Glass Lewis of a data discrepancy in a published report on its "Primer for Issuers" web page (mentioned above), and it has a process for revising reports based on corrections and also sometimes revises voting recommendations. Glass Lewis is working with some company representatives on a potential approach on prepublication data review, although it is not clear when a new process may be in place.

ISS also invites all companies to verify data in its separate QuickScore product.[6] QuickScore seeks to rate companies on governance risk in various dimensions, and it is presented in summary form in proxy research reports as well as in more robust form in a separate product. (Summary scores are also available on Yahoo! Finance.)

Engagement on mergers and acquisitions and proxy contests

Glass Lewis does not engage with either side during the solicitation period in a proxy contest except as described above.

ISS typically seeks to meet with both sides in a proxy contest. Both ISS and Glass Lewis have separate mergers and acquisitions (M&A) teams, and engagement with ISS on a proxy contest (or any M&A transaction) is likely to involve the members of this team, who may have less focus on governance and more on underlying business dynamics. As such, companies may need to gear the engagement differently than is the case for governance discussions in a noncontested situation.

PAF policy processes

ISS has highly formalized processes around its proxy voting policies and its QuickScore product and invites input from corporations as well as institutional investors. In recent years, the ISS global proxy policy formulation process[7] has invited participation in a survey, and the firm also has held a series of roundtables and conference calls. When ISS proposes new policies, it opens a 30-day comment period. Typically, ISS initiates the process in July with the survey, which closes in August. ISS releases survey results, as well as proposed policy changes, seeking comment on the latter in late September and early October. ISS seeks to finalize policy updates in November.

Glass Lewis invites issuer engagement on policies on an informal basis, but does not have the same formalized role for corporate participation in policy development.

Notes

1 SEC, Proxy Voting by Investment Advisers, Release No. IA-2106, January 31, 2003, the "Proxy Voting Rule."

2 *Egan-Jones Proxy Services*, SEC Staff Letter (May 27, 2004), and *Institutional Shareholder Services, Inc.*, SEC Staff Letter (Sept. 15, 2004).

3 SEC Staff Legal Bulletin No. 20 (IM/CF), June 30, 2014.

4 http://www.issgovernance.com/contact/faqs-engagement-on-proxy-research/

5 http://www.glasslewis.com/issuer/

6 http://www.issgovernance.com/governance-solutions/investment-tools-data/quickscore/

7 http://www.issgovernance.com/policy-gateway/policy-outreach/

38 Tools for knowing your stockholder base

Arthur B. Crozier, Chairman Innisfree M&A Incorporated

In recent years it has become increasingly important for publicly-traded companies to have detailed, current information about who their stockholders are. In particular, the rise of activist investors and the escalating pressure to engage directly with institutional investors has made such information a critical priority for managements and boards of directors. While information regarding an issuer's stockholders is available through various public filings, such information is inadequate—dated and incomplete at best—in this time of high-volume, high-speed trading.

While firms offering stock monitoring services have been in existence since the 1980s, when their services were known as "shark watch" in response to the sharp increase in hostile mergers and acquisitions (M&A) activity in that period, they have become much more sophisticated and accurate.

This chapter describes the reasons why professional stock monitoring services are necessary in the US, why publicly available information is inadequate, an overview of the stock monitoring process, and, finally, the benefits of a stock monitoring program.

Why professional stock monitoring services are necessary

The need for such services arises from the way in which securities are held in the US. Professional investors, and most individuals, do not hold their shares in their own names on a company's stock ledger. Instead, they use custodian banks and brokers that hold the shares in their own names through the central share certificate depository, The Depository Trust Company (DTC). Since the law of a company's state of incorporation requires that all issued and outstanding shares must appear on the company's stock ledger, DTC uses a nominee, Cede & Co., to hold bare legal title to the shares held by its bank and broker custodial participants on each company's stock ledger. Consequently, the company's stock ledger, standing alone, provides little assistance in determining who actually owns its shares since generally at least 90 percent of the outstanding shares appear there as being owned by Cede & Co.

DTC, for a fee, however, does make available to the issuer on a daily or weekly basis a listing of the number of shares held by each of its bank or broker custodial participants. This Securities Position Report, as discussed below, is the bedrock of stock monitoring, enabling the tracking of movements among custodians and thereby ideally identifying buyers and sellers as well as other activity regarding the stock, such as the likely level of stock lending.

Unlike in other jurisdictions, such as the UK, US issuers do not have the ability to compel disclosure of the actual beneficial owners of shares behind custodians. As previously mentioned, publicly available information is inadequate, and so an issuer that needs to know what is happening in its stock needs to hire an experienced professional who can interpret the movements among the custodians as revealed in successive Security Position Reports and other available information.

Publicly available information is inadequate

Various regulations require certain investors to publicly file their investments. The most common such filing, Form 13F, must be filed within 45 days of the end of each calendar quarter by institutional investment managers that exercise investment discretion over more than $100 million in US exchange–traded stocks. With respect to each such stock, the institutional investment manager must disclose, among other things, the number of shares as to which it has sole or shared investment authority, as well as sole or shared voting authority, as of the last day of each calendar quarter.

The obvious limitation to relying on Form 13F to understand the shifting dynamics of a company's stockholder base is the dated nature of the information. Further, not all investors a company needs to be concerned about are institutional investment managers required to file a 13F. In addition, investors do not need to disclose in their 13F filings synthetic positions, such as total return swaps or over-the-counter call options, both of which are frequently used by hedge funds. It is important to note, moreover, that such synthetic positions do not count in calculating the value of the investment for determining whether the investor needs to file under the Hart-Scott-Rodino Act (HSR), another potential tip off to an issuer that a nonpassive investor is acquiring shares.

Perhaps most important in light of the rise in shareholder activism, institutional investment managers can request to file 13Fs confidentially regarding certain holdings if they can show to the SEC that such information is "confidential, commercial or financial information." Such confidential treatment cannot extend for longer than a year, at which point the manager must file an amended 13F for each calendar quarter in which it held the security. Usually, by that time the manager has already made known its plans to the issuer and the world or it is too late for the issuer to respond effectively.

Notwithstanding the filing requirements of Form 13F, if an investor acquires five percent or more of a class of a US publicly-traded company, it must file a Schedule 13D containing, among other things, the number of shares held and by whom, in the case of a group filing, the dates on which shares were bought or sold, and, most important, the purpose behind the investment and any "contracts, arrangements, understandings or relationships" with respect to the investment. While this information is of extreme importance to an issuer, this filing also has a fatal flaw for the issuer—the filing due date is 10 days after the investor crosses the five percent threshold. During that 10-day window, the investor can acquire as many shares as possible. Many issuers have been taken by shocking surprise to discover upon the filing that there is now an investor with hostile designs owning far more than five percent. There has been extensive debate over the past several years whether to significantly reduce the 10-day trading window, but there are no indications that the issue will be resolved in the near term.

Certain investors who acquire more than five percent of a class of securities of a US exchange–listed company in the ordinary course of business without the purpose or effect of changing or influencing the control of the issuer may file a Schedule 13G in lieu of a Schedule 13D. The 13G disclosure requirements are less stringent, and the filing due date is even more disadvantageous to an issuer seeking to track ownership of its shares. A qualified institutional investor must file within 45 days of the end of the calendar year in which it owns more than five percent or within 10 days of the end of the calendar month in which it crossed 10 percent ownership. Investors required to file 13Fs must still disclose their ownership on that form on a timely basis. Certain other investors with a passive investment objective, but who are not qualified institutional investors, acquiring more than five percent of a US exchange–traded equity security can also use Schedule 13G, but the applicable filing deadlines are also of little benefit to the issuer.

While these public filings, standing alone, are inadequate for a company seeking detailed, informed information about its stockholders, they can be extremely helpful to a stock monitoring program, as described in the next section.

Overview of the stock monitoring process

As noted above, the bedrock of the stock monitoring process is the Security Position Reports issued by DTC. By examining the increases and decreases among the various custodial holders, an experienced stock monitoring analyst can often identify who are the buyers and sellers on a particular day because many institutional investors utilize only one custodian. Further, hedge funds generally use fewer than three custodians. It is rare for mutual funds, pension funds, and hedge funds to change custodians on a regular basis. Investor-custodial relationships are generally long-standing since custody services are one of many other services provided by the custodian to the investor, thereby inhibiting frequent changes.

From years of observation and information gleaned from various public filings, stock monitoring firms have databases containing information regarding the custodians used by professional investors. While many professional investors use more than one custodian, in most cases there is a pattern to their holdings that can be identified. Pattern recognition is a particularly important skill for a good stock monitoring analyst.

It is customary when starting a stock monitoring program to order Security Position Reports as of the most recent 13F filing date and the dates of any other recent public filings. The stock monitoring analyst will then true up the custodians on that date to the various institutions' reported filings. This step enables the analyst to establish a baseline with confirmed information and reduce the uncertainty caused by the fact that multiple investors may hold at a single custodian.

That uncertainty is particularly an issue with hedge funds since as a group they tend to hold at a very limited number of prime brokers. Accordingly, a good stock monitoring analyst will look at other available sources of information, such as inbound calls to IR departments and participants at sell-side conferences, in order to narrow down the possible investors at particular custodians.

Experience is a critical factor in delivering accurate stock ownership information. While the stock monitoring firms have developed much more sophisticated analytical tools than they had in "shark watch" times, there is still a significant element of art, along with science. After years of watching movements by particular investors or extensive training by someone who has that experience, an analyst can interpret far more than a simple examination of increases and decreases at custodians would reveal.

Stock monitoring is not a do-it-yourself project. As shown above, it requires a comprehensive database of custodial holdings, strong analytical skills, a sophisticated understanding of trading mechanics, and experience.

The benefits of a stock monitoring program

More than ever before managements and boards need to be concerned about and understand shifts in their shareholder base and to have such information quickly, far sooner than through a 13F filing. For example, if an investor began to accumulate a position on the first day of a calendar quarter, a company relying only on 13Fs would not know about that accumulation for four and a half months.

The most obvious benefit is to help understand market sentiment regarding the company and thereby calibrate the investor relations program. Are new investors buying the stock because they know and understand the company's story? Are existing shareholders selling because they no longer believe the company's story or because they are value investors and believe the stock has reached their internal target price? The answers to those types of questions will then drive the IR strategy. For example, if investors are selling because they do not understand the story, the company should undertake a more fulsome and active communications strategy to ensure that remaining investors continue to be comfortable with their investment. In such circumstances, it could also lead to a more informed targeting program designed to attract investors who do understand the story and are willing to pay fair value as a result. If the company does undertake a targeting program, stock monitoring will provide confirmation whether or not the program is effective.

Stock monitoring can also provide more timely insight into the level of open short positions, another sign of market sentiment, rather than relying on the semimonthly announcements by the stock exchanges. By comparing total shares settled in custodians on a particular day to the corresponding trading volume, a stock monitor analyst can determine the approximate amount of shares lent out on the day (the necessary predicate for a short sale), if there was higher aggregate settlement volume than would be normal in light of the trading volume. Because a short seller in the ordinary course borrows shares and then immediately sells them on the open market, the borrowed shares never settle in the short seller's custodial account; rather they settle into the open market buyer's custodial account after exiting the lender's custodial account. Consequently, a stock monitoring program cannot identify the short seller.

Given the recent trends in activist investing, where it seems as if no company is safe, stock monitoring can be an effective early-warning system providing management and the board invaluable time in which to prepare an effective strategy to deal with an activist investor. As noted above, an activist investor can hide its accumulations by filing confidential 13Fs, using synthetics to mask its accumulations and buying aggressively in the 10 days after crossing the five percent ownership level before disclosing its ownership position and intentions in a 13D filing.

Given the complexities involved in monitoring accumulations by activist hedge funds, especially the limited number of prime brokers used by activists and their frequent use of synthetic positions, it is important for a company that feels it is vulnerable to use a stock monitoring firm that has a strong expertise in this area. Given the ramifications, an incorrect identification of an activist hedge fund in the stock has far more severe consequences than a misidentification of a fundamental institutional investor.

If an activist investor is accumulating a position, the stock monitoring program also provides a valuable service by providing a comprehensive analysis of the entire shareholder base. That analysis, by breaking the shareholder base down into relevant categories, such as institutions that subscribe to the leading proxy voting advisory firms, those that do not use an advisory service, retail investors, insiders, and so forth, enables the company to assess its vulnerabilities and strengths. That assessment then leads the development of an appropriate response strategy, including the level of engagement with the activist and other shareholders and the communications program.

A very effective tool arising out of the shareholder composition analysis is a vote projection showing the likely outcome of a proxy fight, usually over the election of directors, an activist's ultimate threat. By providing a candid, well-informed assessment of the directors' likelihood of being re-elected or the likely outcome of votes on other proposals on the agenda, the board can make a well-considered judgment on how to proceed, particularly whether to settle with the activist and, if so, on what terms.

While a stock monitoring program can alert a company to serious threats, it can also demonstrate that perceived threats arising from unusual trading activity are not well founded. It is not uncommon for companies to see elevated trading volumes driven by market rumors, announcements of corporate events, or no readily ascertainable reasons. Given the prevalence of program and other high-speed trading strategies, however, trading volume does not necessarily translate into real buying and selling activity. Under those circumstances, stock monitoring, by looking into actual settlement of shares out of selling custodians and into buying custodians, will reveal how much of the trading volume represents the actual number of shares sold and bought and how much represents churn, the buying and selling of the same share of stock among numerous short-term traders during the day. On very high-volume trading days, it is not uncommon for actual buy-sell activity to represent only 20 percent of trading volume.

Stock monitoring can also enable senior management to direct its shareholder engagement activities efficiently. It is not unknown for an investor to greatly exaggerate the size of its position in a company to secure a meeting with senior management. A good stock monitoring program enables the company to identify such investors and treat them appropriately.

Conclusion

A stock monitoring program is an essential tool for publicly-traded companies seeking to understand the shifting dynamics of their shareholder base and to effectively and efficiently engage with shareholders, particularly in light of the increased level of shareholder activism. Given the complexities involved, companies cannot undertake such programs internally, but need to retain an experienced provider.

39 Understanding/messaging with institutional investors

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Engagement with the investment community has transformed remarkably over the past several years. A significant reason for this has been the change in how institutional investors are viewing corporate governance and what it means to their investment thesis. In the past, many institutions either "voted with their feet," voted exclusively with management's recommendations, or allowed proxy advisory firms to hold sway over shareholder votes during proxy season. Today many institutions have created corporate governance teams that may engage with a company on a host of issues and engage with activists or proposal proponents in contested situations. To be clear, institutions continue to often vote along proxy advisor lines, particularly regarding votes on compensation, but more and more, investors are taking a broader view of the initiatives to be voted upon and are being proactive in their evaluation of the issues at hand.

As a result of this change, management teams should view investment community engagement as a deeper relationship-building process that can improve the odds of a successful proxy voting outcome. To help stave off potential proxy issues, the proxy off-season creates an underappreciated opportunity to inform and educate institutions on a company's unique corporate governance principles and overall capital allocation philosophy and to explain outliers that may not fit proxy advisors' specific guidelines.

The heightened investment community engagement can also have the benefit of preventing potential shareholder activism by: (1) understanding any concerns of the shareholder base and addressing those before an activist forces a company to defend its strategy and policies; and (2) developing credibility as an engaged board and management team with the corporate governance staff at institutions.

What a company should know before it engages

Preparing for engagement with the investment community is as critical as the interaction itself. The first step in the engagement process is to know with whom a company should be engaging.

When it comes to corporate governance and activism issues, institutions are increasingly separating the investment duties of portfolio managers from the corporate governance group or proxy committee that may make the voting decision. It is vitally important that a company understand who ultimately makes the voting decision at each institution with which they engage. In most cases, this information will be readily supplied by the institution or can be supplied by a third party advisor.

The second step in the engagement process is to understand the thought process the particular institution has concerning corporate governance issues. Most institutions publish their proxy voting guidelines online. Some are more detailed than others and most have a series of issues where the guidelines may state that the voting determination is made on a "case-by-case" basis. This "case-by-case" basis is also prevalently used in the voting guidelines of the proxy advisory firms' voting guidelines.

Although many large institutions publish their proxy voting guidelines, these may be somewhat opaque concerning certain situations (the "case-by-case") or may not address certain situations at all if they are relatively new. Since 2004, registered management investment companies, other than a small business investment company registered on Form N-5, are required to file reports with the Securities and Exchange Commission (SEC), not later than August 31 of each year, containing the registrant's proxy voting record for the most recent twelve-month period ended June 30, pursuant to Section 30 of the Investment Company Act of 1940 and Rule 30b1-4 thereunder (17 CFR 270.30b1-4).

This allows companies to access the specific voting history of many of their institutional holders before engaging with them on a specific governance matter. Many companies use third-party services (investor or public relations advisors or proxy solicitors) to help them search for this data so that they can have a better understanding of how an institution is thinking and voting on a specific issue at other companies, as well as understanding how that institution may have voted on the company's own ballot in prior years.

How to engage

Once the background information on the institution has been ascertained, a company is now in position to begin engagement. It is important to remember that this process must be ongoing in order to be effective; as corporate governance views continue to evolve, a company that has not faced scrutiny for several years may suddenly find itself subject to shareholder proposals or a negative vote on directors simply due to a sudden change in performance or change in views by the governance advocates.

Further, the engagement process is about interacting with shareholders, not necessarily winning an argument. Even if a company's views on a subject differ from an investor's, the process of engagement is meant to demonstrate that a company has participated in a thoughtful process when coming to its view. This shows the investor that the company has an involved board of directors and management team. Establishing this credibility with an investor can pay special dividends should the company encounter a difficult vote on a proposal or if it becomes subject to an activist campaign.

In order to establish this credibility, when engaging with an institution on governance matters it is advisable to include an independent board member on the engagement team, particularly with large passive institutions. By giving these institutions access to an independent board member, it allows them to hear what the thought process and philosophy concerning governance is at the board level.

The messaging during these meetings should concentrate on the process the board uses to consider governance issues. If a company has a classified board, plurality voting, or non-independent chair, they should be prepared to discuss the reasons why in a positive manner. Although many institutions have expressed displeasure with these practices, it is important during the conversations with shareholders to show that the board regularly considers these structures and has a rationale for why they believe that they enhance shareholder value over the long run. Messaging during these engagements should always reinforce that the board's philosophy consistently considers maximizing shareholder value.

The timing of these meetings is also important. Proxy season typically runs from March through June, and during these months the corporate governance groups at various institutions are extremely busy. Although they will almost always take time for a call, it is more likely that they will be able to focus on the engagement if it is held during the proxy off-season, as during the season they may have to spend time on companies with current issues.

Finally, although not an investor, it is also advisable to reach out to Institutional Shareholder Services (ISS) during the proxy off-season. Although the influence of ISS has been lessened as more institutions take a more thoughtful approach to voting, their influence is still considerable, particularly on "say-on-pay" votes. In that area it is estimated that a negative ISS recommendation can impact an average of 30 percent of the votes, although this percentage will differ depending upon the makeup of a company's shareholder base. ISS will engage with companies, and this engagement should be conducted in the same manner as engagement with an institution.

Increased engagement in the era of activism

Activist funds are fast becoming a mainstay on Wall Street. These firms have outperformed all other hedge funds by strategy in 2012 and 2013, and the investment community has rewarded them with more assets under management than ever before. According to Hedge Fund Research, assets managed by activist funds have almost tripled over the past five years to approximately $93 billion in the first quarter of 2014, increasing approximately $28 billion dollars in 2013 alone.

Their investment power is making them increasingly influential with companies, shareholders, and the media. These economic activist shareholders, which traditionally targeted smaller underperforming companies, have targeted much larger companies in the past two years, as well as companies that have performed well but where an activist sees an opportunity for increased yield through a share buyback, dividend, or sale.

The largest and perhaps most daunting development in the activism space is the increasing support institutional shareholders are now giving activists. According to FactSet, in contests for board seats that went to a vote in 2013, 17 were won by activists, 12 by management, and 1 was split. This was only the second year activists had won more contests than they had lost since tracking began in 2001. Through July 2014, companies and activists had won seven contests each, but the number of settlements, 37, already surpassed all of 2013. Many of these settlements occurred because companies did not feel they had the institutional support to win a vote.

In addition to economic activists, there has also been an increase in corporate governance activism. By July of 2014, there were 901 shareholder proposals brought by these activists at companies, surpassing the total of 840 proposals brought in all of 2013. Although many of these proposals do not pass, they often serve as a red flag to economic activists, who may judge poor votes as symptomatic of displeasure among the shareholder base and an opportunity for them to promote their agenda.

Many economic activist investors target companies where they have both an investment thesis and where they believe, based on their own intelligence on the company's investors, that they have a path to victory. Establishing a relationship with the institutional investor community and establishing confidence in the board by engaging with the voting decision-makers and corporate governance groups at these institutions is invaluable in helping to prevent an activist from believing that they have that path to victory.

Engagement in the face of activism—getting your story out: the three Cs

Companies must understand that the traditional means of shareholder outreach to portfolio managers through investment conferences and on earnings calls is no longer enough to keep activists at bay. As a result, companies need to re-think the way they approach the engagement process and must develop a more cohesive and fulsome communications narrative that incorporates certain elements of corporate governance in advance of activism overtures.

When dealing with investor activism, it is critical that a company proactively engage with all members of the investment community to ensure that investors understand, accept, and, most important, believe in the company narrative. There are three elements to communicating a company's story: content, conversation, and collaboration.

Content begins with the investor relations officer and chief communications officer making sure the corporate website says what the company wants it to say—it is where shareholders, journalists, allies, and adversaries first go to learn about a company. According to a recent Thomson Reuters survey, 84 percent of institutional investors use the investor relations website as a source of research information. Further, if a company wants the message it posts to be broadly shared, studies indicate that adding images and video make the website far more likely to be viewed.

Conversation can begin after the website is optimized. Companies should examine their social media policies and strategies to make sure everyone knows what can and cannot be communicated, what's public, and what's privileged. Then the company can begin to engage.

Many executives are leery of social media. They are right to be cautious. Social platforms are not without risk. Companies can't control the conversation on social media platforms versus on a company's own website. But if companies don't engage, their voices won't be heard.

Increasingly, journalists at mainstream publications are turning to social media to find leads and sources. If a company is not participating on social platforms, it is creating an out-of-sight, out-of-mind risk and is increasing the chance that its viewpoint will not be reflected in the journalists' articles.

Collaboration begins once the corporate message is defined and disseminated to as many influencers as possible. The company can begin developing influencers of its own by building relationships and support with third parties.

Bloggers, who sometimes have greater sector expertise than traditional journalists, are the oldest part of the social media spectrum and, therefore, are the most easily forgotten—until needed in a crisis. However, it is a best practice to engage with bloggers before they are needed.

Engaging with bloggers does not mean sending them press releases. If a company can cultivate an influential blogger by offering that person exclusive information or access to executives, and by so doing raise the blogger's profile, the company can create a powerful ally in a contest with activists. And a blog can not only inform and influence mainstream articles but, as more institutional voting decision-makers rely on key trade and industry blogs for information, they that can influence votes.

Today, stakeholders are living online. Therefore, companies should have their online strategies baked into the broader communications strategy.

Engaging with activists

If the event arises, companies should always be open to engaging with known activist investors just as they would engage with any shareholder. The specific engagement process will depend on a number of factors, including (1) whether the initial approach by the activist is private or public; (2) the activist's history; and (3) those involved with engaging the activist—management, board, or a combination.

If an activist investor makes his or her position public through a filing, letter, or some other forum, it is imperative that the board and management respond swiftly and with deference. While the tendency is often for companies under attack to either retreat or not reply at all, this passive approach will only exacerbate the situation. The first engagement with an activist investor often sets the tone for how productive the follow-on interactions will be and whether the situations will develop into a contest, settlement, or simply a disengagement by the activist.

Early contact with activist funds fosters a sense of collaboration and ensures both sides understand the other's position. The company can use this as an opportunity to evaluate the argument and assess the validity of the claim, it will also afford the company an opportunity to reach out to its investor base, even if the activism is currently private, to understand if the argument the activist is making will have support. It is important not to be dismissive; if the situation results in a proxy contest, the background section of the proxy statement will highlight all interactions between the activist and the company. A company does not want the perception that they were dismissive of a large shareholder.

Engaging with an activist does not necessarily mean that the company should feel forced to agree with them. If a company feels confident in its position, based on conversations with its shareholder base, it is OK to say so. If the activist engagement goes public, it is important to show other investors that the board and management are always open to the views of shareholders, while at the same time making an argument against the activist's position.

A look ahead on engagement

Engagement with investors has changed a great deal over the last several years and that trend will continue. Companies should always keep up with the latest trends in corporate governance as well as what changes to the rules are pending at the SEC. In the future, it is expected that the CEO Pay Ratio rule, prescribed by Dodd-Frank and expected to be implemented in 2015 or 2106, may cause a wave of shareholder proposals. The recent rules prescribed by the SEC relating to proxy advisory firms may also have an effect on how institutions vote in the future. Although the rules may continue to change, there is little doubt that the trend toward increased and more effective engagement with investors will continue.

PART V

INTERNATIONAL PERSPECTIVES/ "HOT BUTTON" ISSUES AND DEVELOPMENTS

Electronic version of this guide available at: nyse.com/cgguide

NORTH AMERICA

Canada

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Corporate governance in Canada is founded on a system of legal rules that involve a single-tier board model similar to, and influenced by, the systems seen in the United Kingdom and the United States. Overlaying this is an extensive array of best practices that are promoted by securities regulators, stock exchanges, institutional shareholder groups, the media, and professional bodies. These practices have been influenced by the high proportion of public corporations in Canada that have a dominant or controlling shareholder, either through equity ownership or the ownership of multiple voting rights, and the economic clout and organization of Canadian institutional investors, including the Canadian Coalition for Good Governance (CCGG), a national institutional investor organization that has pursued an organized program of advocating its views on best practices without resorting to proxy battles. Legal rules are less prescriptive than in the United States, generally taking a comply-or-explain approach reflective of practice in the United Kingdom and other jurisdictions. While the Supreme Court of Canada recently affirmed that a board of directors in Canada owes its fiduciary duties to the corporation rather than any single constituency, pressure from the media, investor rights advocates, and other groups has led to voluntary adoption of many practices by companies that are not addressed by legal rules and that reflect the desire on the part of particular stakeholders to have a more direct say on matters of importance to the corporation.

Many of the topical issues in corporate governance in Canada today reflect a particular effort on the part of shareholders, both institutional and activist, to exercise more influence. Institutional investors have lobbied for greater voting influence through the adoption of majority voting for directors and say-on-pay and other voting initiatives. These efforts and the impact of increased shareholder activism in Canada in recent years has prompted a re-examination of Canadian proxy rules and the impact of proxy advisory organizations by regulators, and the adoption of advance notice provisions for nomination of directors by companies. In addition, the Ontario Securities Commission (OSC) is proposing to introduce new disclosure rules respecting the representation of women on boards and director tenure.

Majority voting and individual voting for directors

Effective June 30, 2014, all companies listed on the Toronto Stock Exchange (TSX) are required to have majority voting for directors, whether through adoption of a policy or under their constating documents or governing statute, although there is an exemption for majority-controlled companies (where a single person or company owns 50 percent or more of the voting securities). Since December 31, 2012, TSX companies have been required to provide for individual voting for directors rather than slate voting and to disclose whether or not they had adopted a majority voting policy and, if not, explain why. TSX companies are also required to issue a press release of director election results promptly following the shareholder meeting. Majority voting means that in a director election that is not contested, where more votes are withheld from voting on the election of a director than are voted in favor, the director must promptly tender a resignation and the board must announce within 90 days whether or not the resignation is accepted. By the fall of 2011, when the TSX conducted a survey of 200 of its listed companies, approximately 76 percent of those surveyed had voluntarily adopted a majority voting policy.

The question whether to extend majority voting requirements and individual voting for directors more broadly has been studied by the OSC and is currently being considered as part of a public consultation on a request for comments on the Canada Business Corporations Act published by Industry Canada on December 11, 2013 (the CBCA Consultation). While individual voting for directors has widespread support and is the common practice in Canada, it is unclear to what extent majority voting will be extended beyond TSX listed companies. Circumstances where directors have failed to receive majority approval have been very rare but are increasing. There are also concerns about the impact it may have on the ability of smaller companies to recruit talented directors and the possibility of "failed elections"—where no directors are elected or an insufficient number of directors are elected with the attributes necessary to meet statutory director residency requirements or requirements to have an audit committee made up of at least three independent directors.

Say-on-pay

Canadian companies are not subject to an obligation to hold a nonbinding, advisory shareholder vote on executive compensation (say-on-pay). Although many other jurisdictions have passed legislation mandating say-on-pay votes, in some cases on a binding basis, and although a consultation paper issued by the OSC in January 2011 and the recent CBCA Consultation have sought views on whether to require advisory say-on-pay votes, there are no proposals to adopt similar legislation in Canada.

There are many reasons why say-on-pay is not required in Canada, although none are determinative. Executive compensation levels have, in general, been lower than in other jurisdictions. Canadian companies have a long history of engagement with their shareholders on matters of interest, including executive compensation practices. Executive compensation disclosure practices have improved. Institutional shareholder support for say-on-pay has not been unanimous, as one large pension fund, the Ontario Teachers' Pension Plan, has stated that it does not favor say-on-pay voting. Canadian companies generally were less adversely affected by the most recent economic downturn than companies in other countries. The widespread use of individual voting for directors means that shareholders can express dissatisfaction with compensation practices by withholding votes for the election of members of the compensation committee without needing a separate say-on-pay vote.

Despite the absence of any legislative requirement, the number of companies that have voluntarily adopted say-on-pay has gradually increased every year. Adopters have been almost exclusively larger companies listed on the TSX. Although the number of say-on-pay adopters has increased each year, average approval levels have gradually declined, and the number of companies with either failed say-on-pay votes or approval levels below 70 percent has increased. Such trends, as well as media reports following the few instances where say-on-pay voting has highlighted excessive pay concerns at a few companies, have slowed the rate of voluntary adoption by Canadian companies.

Canadian proxy rules

The increased emphasis on voting by shareholders on dilutive transactions, individual voting for directors, voluntary adoption of say-on-pay, and shareholder activism has placed increasing pressure on the Canadian proxy voting system. Gaps in the system were highlighted in 2012 when TELUS Corporation's proposal to eliminate its dual-class share structure was opposed by a US hedge fund that used an empty voting strategy to oppose TELUS's initial proposal.

The Canadian Securities Administrators (CSA) issued a consultation paper in August 2013 regarding the proxy voting system in Canada. The paper sought feedback on the system for determining voting entitlements for securities held through intermediaries on behalf of beneficial owners, including consideration of the impact of share lending, documentation errors, and the nature and extent of over-reporting and over-voting. It also sought information on the possibility of implementing an end-to-end vote confirmation system so that beneficial owners could receive assurance that their votes were received and recorded as cast. A roundtable discussion on the issues with representatives from the issuer, institutional investor, brokerage, and proxy advisory communities was held in January 2014. Separately, the CBCA Consultation is also examining facilitation of board and shareholder communications, including increased transparency of share ownership.

Any changes to the Canadian proxy rules are unlikely to change certain features that distinguish it from other jurisdictions, including:

1. the ability of a company to send materials directly to beneficial owners who do not object to disclosure of their identity and holdings
2. the ability of a company to set a deadline for the deposit of proxies up to two business days before the date of the shareholder meeting
3. the practice of companies and dissidents not having joint access to beneficial owner voting responses prior to the meeting.

Proxy advisory firms

In response to complaints respecting the activities and influence of proxy advisory firms, the CSA published a consultation paper in June 2012. The paper focused on concerns respecting potential conflicts of interest, a perceived lack of transparency, potential inaccuracies and limitations on the ability of companies to engage with proxy advisory firms, corporate governance implications, and the extent of reliance by institutional investors on the recommendations provided by proxy advisory firms.

Comments were divided. Issuers and their advisers agreed with the concerns identified, while institutional investors and proxy advisory firms noted the useful and cost-effective services they provide. Proxy advisory firms also indicated that they have appropriate policies and procedures in place to address the concerns identified.

In light of the feedback received, the CSA decided to adopt a policy-based approach of providing guidance on recommended practices and disclosure for proxy advisory firms. The guidance addresses the need for proxy advisory firms to identify, manage, and mitigate conflicts of interest, implement appropriate practices to promote transparency and accuracy of vote recommendations, and communicate with their clients regarding their practices.

Advance notice provisions

Canada has experienced increased shareholder activism as large well-financed activist funds have pursued shareholder activist campaigns as a business. This increase in activity has prompted Canadian companies to examine their defensive strategies. Many have recently adopted a long-standing US practice of including a company by-laws provision requiring advance notice to the company of any intent to propose nominees for director. Only a handful of Canadian companies had adopted such requirement prior to 2012. However, many Canadian companies have done so since.

Although modeled on US provisions, Canadian advance notice provisions require a person to provide notice of director nominees not more than 65 and not less than 30 days prior to the meeting date, compared to a minimum of 60 to 90 days or 90 to 120 days prior notice under US provisions. While such provisions have largely been supported by institutional shareholders and proxy advisers, increasing concern that certain aspects of such policies may be unduly restrictive are prompting institutional investors to re-examine their views.

Women on boards

Effective December 31, 2014, many public companies in Canada will be required to comply with new disclosure requirements which seek to encourage them to increase the number of women on boards and in senior management.

The springboard for this new rule was a consultation paper issued by the OSC in July 2013. In January 2014, following receipt of over 92 written submissions and a public roundtable discussion, all of which generally supported the initiative, the OSC issued proposed rule changes. In July 2014, securities regulatory authorities in many of the other provinces and territories in Canada republished the proposed rule changes for comment. The final version of the disclosure rule was issued in October 2014 by securities regulators in all jurisdictions in Canada other than Alberta, British Columbia, Prince Edward Island, and Nunavut.

Under the new disclosure rule, a company subject to continuous disclosure requirements in one or more of the participating jurisdictions, other than a company listed on the TSX Venture Exchange or investment fund, is required to disclose annually the number and percentage of women directors and women who are executive officers, together with any targets the company has adopted regarding the number or percentage of women in such positions and the progress made in achieving those targets. The company is also required to disclose whether it has a written policy for the identification and nomination of women candidates for director or explain why it does not. If such a policy has been adopted, the company must provide a summary of the policy and its objectives, implementation measures, the annual and cumulative progress made on achieving the objectives, and whether, and if so how, the board or nominating committee measures the policy's effectiveness. The company must disclose whether it considers the level of representation of women on the board in identifying and nominating candidates for director and the level of representation of women in executive officer positions when making executive officer appointments, or explain why it does not. Companies are also required to disclose whether or not the company has adopted term limits for board service or other board renewal mechanisms and, if not, why not.

Conclusion

While Canadian corporate governance rules take a comply-or-explain approach instead of adopting prescriptive rules, most companies not only choose to comply with such standards but also voluntarily adopt best practices that go well beyond them.

Mexico

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Mexico's legal framework underwent a substantial revision in the last couple of years. Amendments to the Mexican Constitution and several laws and regulations were passed in connection with fundamental areas such as education, labor, and tax, as well as in sectors critical to the Mexican economy, including banking, telecommunications, and energy. Although the benefits of these reforms in Mexico's business and corporate environments are not expected to materialize in the short term, a few examples of their impact to corporate governance are already in place and may give a hint of what is to come in the future.

Mexican stock corporations: overcoming paternalism

On June 13, 2014, amendments to the General Law on Commercial Companies (*Ley General de Sociedades Mercantiles*, or LGSM) were enacted, which, despite not being revolutionary or innovative per se, are significant due to the role such amendments play in the policy underlying commercial legislation in general and more concretely in the structuring of adequate governance provisions.

In the 80th year since its enactment, the LGSM is often criticized for being overly protective of minorities and unreasonably intruding into business aspects pertaining to Mexican stock corporations (*sociedad anónima*, or SA), but most of all, for perpetuating an outdated regulation of commercial entities that is inconsistent with the developments achieved in the business world during the last decades. It was not until the enactment in 2006 of the Law on the Securities Market (*Ley del Mercado de Valores*, or LMV) that "investment promoting stock corporations" (*sociedad anónima promotora de inversión*, or SAPI) were introduced as a modality of the traditional SA, aimed to foster the private equity market with a corporate vehicle that was not only less restrictive than the SAs but also more compatible with structures used by investors in other jurisdictions.

The latest amendments to the LGSM substantially replicate the legal framework applicable to SAPIs and make it available to SAs, which effort may be construed as one of the first steps taken by Mexican legislators in a long path leading to a legal framework similar to those applicable in jurisdictions where the parties to contracts (and ultimately the market) determine the terms of commercial relationships. Among other matters, SAs now enable investors to: (1) freely determine the voting and economic rights of shares; (2) freely restrict the transfer of shares; and (3) enter into shareholders' agreements and implement deadlock, drag-along, tag-along, registration, and similar rights. Furthermore, these amendments also lower the minority thresholds required to: (1) initiate civil actions against directors; (2) postpone the voting of matters on which shareholders consider themselves not fully informed; and (3) oppose shareholders' resolutions. Additionally, the LGSM now requires directors to maintain confidentiality on all nonpublic matters and information obtained during their tenure and for one additional year thereafter.

Mexican REITs: raising an industry standard

The amendments to the regulations applicable to securities issuers (*Disposiciones de carácter general aplicables a las emisoras de valores y a otros participantes del mercado de valores*, or Issuers Regulations) enacted on June 17, 2014, represent a limited but welcome effort to raise the corporate governance standards applicable to Mexican real estate investment trusts (*fideicomisos de inversión en bienes raíces*, or Fibras). Said amendments introduce minority rights applicable to Fibras, forbid related parties or parties that have a conflict of interests from voting in certain matters, and establish certain restrictions in connection with the leverage and debt service coverage ratios of Fibras.

Among others, the amendments to the Issuers Regulations set forth that the vote of the general meeting of the holders of the certificates issued by a Fibra (*certificados bursátiles fiduciarios inmobiliarios*, or CBFIs) is required in order to approve: (1) related party transactions or those that may otherwise imply a conflict of interests, in case the relevant transaction represents 10 percent or more of the relevant Fibra's trust estate; (2) any amendments to the compensation paid to the manager of the Fibra or to the members of its technical committee (the manager and parties related to the settlor, the manager, the trust's subsidiaries, and any holders of CBFIs that have a conflict of interests are expressly forbidden from casting their vote in connection with these matters and those specified in the previous item); (3) the removal of the manager of the trust; (4) the issuance of new CBFIs; and (5) policies pursuant to which the Fibra may enter into or assume indebtedness and any amendments thereto (also subject to certain statutory restrictions further discussed below).

Additionally, the amendments to the Issuers Regulations provide that the technical committee of Fibras must approve: (1) any transaction representing five percent or more of the relevant Fibra's trust estate; (2) operating policies in connection with parties related to the settlor, the manager of the trust, and the trust's subsidiaries; and (3) individual related party transactions or transactions that imply a conflict of interests (which must be entered into on an arm's-length basis and require the affirmative vote of the majority of the independent members of the technical committee).

As to financial responsibility, the amendments to the Issuers Regulations (1) forbid Fibras from incurring in liabilities in excess of 50 percent of the book value of the relevant Fibra's assets and impose the obligation to maintain at least a 1.0 debt service coverage ratio (during the following six quarters), and (2) require Fibras to have a committee composed in its majority by independent members of the technical committee in order to oversee that mechanisms and controls are established to verify that the indebtedness incurred or assumed by the relevant Fibra conforms to applicable law.

Directors, officers, and bankruptcy: Vitro's Wake

Important amendments to the Mexican Bankruptcy Law (*Ley de Concursos Mercantiles*, or LCM) were enacted on

January 10, 2014. Besides introducing several substantive and procedural innovations for the benefit of creditors (eg subordination and a longer look-back period applicable to intercompany and related party liabilities, stricter requirements to cram down legitimate third-party liabilities, consolidated insolvency procedures for corporate groups, clear-cut rules for debtor-in-possession financing, strict limitations to the length of the conciliatory stage of the procedure), said amendments introduced important fiduciary duties and penalties applicable to directors and officers of insolvent entities.

Pursuant to the amendments to the LCM, directors and officers may be liable for damages and lost profits caused to an entity in case the latter is insolvent and when any of the following hypotheses is verified by their conduct: (1) adopting decisions involving the entity's property, despite having a conflict of interest; (2) knowingly favoring a shareholder or group of shareholders in prejudice of the rest of the shareholders; (3) in absence of a legitimate cause and by virtue of their position, obtaining economic benefits for themselves or on behalf of third parties, including any shareholder or group of shareholders; (4) preparing or disclosing information having knowledge of its falseness; (5) causing the omission from registration of transactions performed by the entity, or altering or ordering the alteration of records with the purpose of concealing the true nature of the transactions performed, affecting the entity's financial statements; (6) ordering or accepting the recording of false data in the accounting records of the entity; (7) destroying or amending systems, accounting records, or supporting documents of accounting records of the entity with the purpose to conceal the relevant records or evidence; (8) altering accounts or the terms of agreements, recording inexistent transactions or expenses, exaggerating the real ones, or willfully carrying out any illegal action or transaction, if an indebtedness, loss, or damage to the entity's property is caused and an economic benefit is obtained for themselves or third parties (including related parties); and (9) in general, acting willfully or in bad faith, or carrying out illegal actions.

Additionally, the amendments to the LCM introduce a penalty of imprisonment for 3 to 12 years that may be imposed on members of the board of directors, sole administrator, CEO, and officers of an entity that has been declared insolvent, if (1) through the altering of accounts or the terms of agreements they knowingly cause the registration of inexistent transactions or expenses, or (2) they willfully carry out any illegal action or transaction, if a damage to the entity's property is caused and an economic benefit is obtained for themselves or third parties (including related parties).

Moreover, mimicking the "business judgment rule" applicable in other jurisdictions, the amendments to the LCM exclude directors' and officers' liabilities, when acting in good faith, they (1) comply with the requirements set forth in applicable law or the entity's by-laws for the approval of matters on which the board of directors is competent to decide; (2) adopt decisions based on information provided by officers, external auditors, or independent experts, when their capacity and credibility "offer no motive for reasonable doubt"; (3) select the most adequate alternative to the best of their knowledge, or the possible damage to the entity could not have been foreseen, in either case, based on the information available at the time they made their decision; and (4) comply with the resolutions adopted by the shareholders, provided said resolutions are not illegal.

Entities are forbidden from including in their by-laws any benefits, considerations, or liability waivers that limit, release, substitute, or offset the aforementioned liabilities of directors and officers; however, they may retain insurance policies or guaranties covering damages and lost profits, except in case of actions carried out willfully or in bad faith or that are otherwise illegal.

LATIN AMERICA

Brazil

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Corporate governance standards and practices have improved in Brazil over the last decade, along with the initial public offering market rebound since 2004.

General framework

The Corporation Law (Law 6404/1976), as amended, set forth the rights, duties, and responsibilities of shareholders, directors, and officers.

The Securities Market Law (Law 6385/1976), as amended, created the Brazilian Securities Commission (CVM) and established its rule-making, surveillance, and enforcement powers.

BM&FBOVESPA, the São Paulo Stock Exchange, has established the Novo Mercado and other separate listing segments to enhance corporate governance practice beyond corporate law and is also a self-regulating entity with surveillance powers.

Brazilian companies are also governed by their by-laws, which stipulate their management and shareholder rights.

Novo Mercado and other BM&FBOVESPA listing segments

In addition to the traditional listing segment and Bovespa Mais (organized over-the-counter [OTC] market), BM&FBOVESPA has established three special corporate governance segments. Level 1 permits the issuance of preferred nonvoting shares; Level 2 requires preferred shares to hold restricted voting rights; and the Novo Mercado prohibits the existence of preferred shares. Under the listing agreements of these segments, companies undertake to adopt the following main practices:

Level 1: chairman and CEO separation; improved disclosure (eg quarterly cash flow statements); wide distribution of shares in public offerings; minimum 25 percent of share capital free float; adoption of securities trading policy and code of conduct; annual corporate events schedule.

Level 2: restricted voting rights to preferred shares in certain key decisions or in any matters that may involve conflicts of interest; board of directors of at least five members, unified maximum two-year term, and minimum of 20 percent of independent directors (as defined in the listing rule); tag-along rights for noncontrolling shareholders at the same price paid to the controlling shareholders; mandatory tender offer at economic value in case of delisting from the segment; board opinion on tender offers; prohibition against limiting voting rights below 5 percent in the by-laws; resolution of disputes between the company and shareholders through arbitration; and the same undertakings of Level 1.

Novo Mercado: common voting shares only (no preferred shares) plus the same undertakings of Level 1 and Level 2.

Governance structure

Brazilian companies operate under a two-tier board system. The board of directors is elected by the shareholders and is responsible for setting out the general guidelines and business policies, electing and supervising executive officers, and choosing and removing independent accountants, among other responsibilities. The board of executive officers is responsible for the day-to-day management of the company and is vested with exclusive power to act on behalf of the company. One third of the directors may also serve as executive officers, but there is no corporate law requirement to elect independent directors.

Directors are elected at the shareholders meeting. Each voting share has one vote. CVM established that shareholders representing at least 5 percent of the voting share capital of companies with share capital higher than R$100 million may request the adoption of cumulative voting. Noncontrolling shareholders holding shares for a period of at least three months are entitled to elect one board member by separate ballot based on preferred nonvoting or restricted voting shares representing 10 percent of the total share capital, or on 15 percent of the voting shares (for companies with preferred shares) or 10 percent of the total share capital (for companies with common shares only). If neither of these thresholds is reached, the noncontrolling shareholders may group their shares so as to elect one member jointly.

The fiscal council can be set up on a permanent basis or at the request of shareholders representing 10 percent of the voting shares or 5 percent of any class of nonvoting shares. Unlike a US audit committee, the fiscal council is a corporate body independent from management and external auditors. Its primary responsibility is to review and opine on the financial statements and on certain matters such as proposals for capital increases and corporate restructurings.

Except in case of large financial institutions, which are subject to a special requirement by the Central Bank of Brazil, neither the corporate legislation nor the BM&FBOVESPA listing rules require Brazilian companies to set up an audit committee. Nevertheless, several companies have set up audit committees to improve corporate governance, extend the mandatory rotation of independent accountants to ten from five years as permitted for companies with statutory audit committees meeting the CVM guidelines, or to comply with the US Sarbanes-Oxley Act (SOX) (companies with dual listing in Brazil and the United States). As the US Securities and Exchange Commission (SEC) has permitted Brazilian companies listed in the United States to adapt the fiscal council to satisfy the SOX audit committee requirements, some companies make use of this alternative.

While there is no legal requirement, an increasing number of companies have voluntarily created board committees to improve corporate governance standards.

Management compensation

The aggregate or individual compensation (including fringe benefits) must be approved at the annual shareholders' meeting. Companies generally approve the maximum aggregate compensation and authorize the board of directors to allocate it individually among its members and to the executive officers.

The CVM requires detailed analysis and disclosure of the compensation paid to directors and officers (including the stock-based compensation) in the last three years and for the current fiscal year in the *Formulário de Referência* (reference form, similar to an annual report on Form 10-K adopted by the SEC).

Any stock-based compensation plan must be approved by the shareholders. Stock-based plans establish the legal structure and key terms and conditions (including maximum corporate dilution, waiver of preemptive rights, and/or permission to use treasury shares), and normally delegate authority to the board of directors for approval of annual grants and review of the plan itself. While there is no rule or guidance from the CVM on the matter, plans usually require shareholder vote for material revisions.

Detailed information on the management proposal on management compensation and stock-based plans must be submitted to the shareholders on the same day of the call notice for the shareholders meeting.

Financial information and periodic reports

Brazilian companies must file electronically with the CVM the following main financial information and periodic reporting information:

- annual audited financial statements, accompanied by the management report, the report from the independent accountants, the report from the fiscal council (if operating), the capital budget (if any), the summary report from the audit committee (if any), and statements from the executive officers that they have reviewed, discussed, and agreed to the financial statements and the independent accountant's opinion. Disclosure must occur no later than three months after the end of each fiscal year.
- standard financial statements on form DFP, within the same time frame
- annual report on *Formulário de Referência*, up to five months after the end of the fiscal year. The *Formulário de Referência* must be updated upon filing of any request for registration of a securities offering or up to seven business days as from the occurrence of certain significant events.
- quarterly financial information on form ITR, accompanied by a limited review report from the independent accountants, within 45 days of the end of each of the first, second, and third quarters.

The quality of financial information has significantly improved since 2010, when the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board were first adopted, followed by creation of the Brazilian Accounting Standards Board (CPC). CPC standards introduced changes in Brazilian accounting practices (Brazilian GAAP), in furtherance of the convergence of Brazilian GAAP with IFRS.

Concurrently, the adoption of the *Formulário de Referência* in 2010 reshaped and enhanced disclosure on key issues such as risk factors, market risks, financial performance, off-balance sheet items, internal controls, governance, management compensation, ownership structure, and related party transactions. Inspired by the "shelf registration system" of the International Organization of Securities Commissions (IOSCO), the *Formulário de Referência* can be incorporated by reference in the offering note for any public offering of securities.

Companies that disclose financial statements or information abroad must also file them with the CVM.

Share trades by directors and officers

Brazilian rules impose restrictions and disclosure obligations on the trades with company's shares by directors and officers. Directors, officers, and other insiders bound by the company's mandatory material information disclosure policy generally cannot trade their company's stocks:

- while in possession of material nonpublic information
- during a "blackout" period of 15 days before disclosure of the quarterly (form ITR) and annual (form DFP) financial information by the company
- whenever the company is trading its own shares.

Insider trading is a criminal offense, punishable by imprisonment for one to five years and a fine of up to three times the unlawful advantage obtained. In addition, the CVM may also impose administrative sanctions, which may include a similar fine.

All shared trades in the company's securities or derivatives by directors, officers, and members of the fiscal council and other statutory bodies and their connected persons must be notified to the company within five days. Up to the tenth day of the subsequent month, the company must file with the CVM two forms, one reporting individual trades and positions and another reporting the consolidated trades and positions, aggregated by each corporate body. The consolidated form is publicly available.

ABRASCA code of self-regulation

Since 2011, the Brazilian Association of Publicly Held Companies (ABRASCA) has established the ABRASCA Code of Good Corporate Governance and Practices for Publicly Held Companies. The code is a self-regulation initiative based on the "apply-or-explain" approach, and contains principles, rules, and recommendations of corporate governance in matters involving the board of directors, board of executive officers, compensation, internal controls and risk management, code of conduct, control and disclosure of material information, relations with the capital markets, and corporate restructuring transactions.

Compliance with the ABRASCA code's principles, which offer the essence of regulations without getting into the rules' details, is mandatory. Companies are allowed to refrain from applying one or more rules so long as they explain the reasons in the *Formulário de Referência*. Each company must disclose in the *Formulário de Referência* the date of adherence to the code and declare compliance with its principles and other rules. ABRASCA created a technical team in charge of monitoring and investigations, as well as a self-regulation board responsible for enforcement.

Adherence to the code is voluntary and allows the use of the stamp of the "ABRASCA Seal of Good Practices." Although the code is fairly recent, it was supported by the adherence of a group of leading Brazilian companies, including BM&FBOVESPA, Bradesco, BRF, CEMIG, Cetip, Gerdau, Itaú, Klabin, Localiza, Santander Brasil, Souza Cruz, and Weg.

Brazilian takeover panel

Inspired by the UK Takeover Panel, in 2013 key market institutions led by BM&FBOVESPA sponsored the formation of the Takeover Panel Sponsors Association (ACAF) to organize, maintain, and administer the Brazilian Takeover Panel (CAF). Based on a voluntary self-regulation model, adhering companies must insert in their by-laws a commitment to submit to the Brazilian Takeover Panel tender offers or corporate restructuring transactions. Companies may also submit specific transactions on a case-by-case basis. The CVM and CAF entered into a cooperation agreement establishing that corporate restructuring transactions with related parties will be presumed regular by the CVM, if deemed in compliance with the principles and rules of CAF.

Bankruptcy and anti-corruption laws

The Bankruptcy and Company Reorganization Law (Law 11110/2005) was approved in 2005 to maximize asset value, protect creditor's rights, and provide effective mechanisms for reorganizing distressed companies, all of which are in line with international practices.

An Anti-Corruption Law (Law 12845/2013) entered into force in 2014. The new legislation imposes strict liability on companies and individuals who participate in acts of bribery. Penalties comprise administrative and judicial sanctions, and may include a fine of up to 20 percent of the company's gross earnings in the last fiscal year. Companies are expected to maintain compliance programs to prevent or reduce sanctions.

EUROPEAN UNION

France

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France has a relatively non-interventionist stance in respect of corporate governance, which allows listed companies to take a comparatively flexible approach. With legislative provisions in force only in relation to distinct areas or specific sectors, soft law, with the "comply or explain" principle at its heart, prevails.

Framework

Legislation

The European Commission has until now avoided introducing corporate governance legislation (save for in the financial services sector), preferring to issue nonbinding Recommendations instead. This has led to member states adopting divergent approaches. However, firmer action remains a possibility, and the European Commission has shown particular interest in two areas: reinforcing the "comply or explain" principle and directors' remuneration. Notably, the Council and the European Parliament have just adopted a Directive on disclosure of diversity on boards of directors information by large companies and groups.

National corporate governance legislation is principally found in the Commercial Code with provisions focusing primarily on the structure and composition of boards and to a lesser extent, diverse elements relating to directors' remuneration. In May 2013, the French government announced it would not introduce further corporate governance legislation, favoring rigorous self-regulation instead. It did, however, reserve the right to legislate in this area in the future.

Soft law

There is no legal obligation to adopt a specific corporate governance code, even though according to national legislation, listed companies which do not adopt such a code must explain their rationale. It is universal practice among French listed companies to follow the principal code (the AFEP-MEDEF Corporate Governance Code of Listed Corporations [AFEP-MEDEF code]) produced by two business associations. The AFEP-MEDEF code was updated in June 2013 to include a strict interpretation of "comply or explain" and a shareholder vote on executive remuneration. The MIDDLENEXT code is generally followed by smaller enterprises. The Commercial Code states that when a company refers to a corporate governance code of a business organization, the chair's report must explain which provisions of that code have not been followed and the reasons for non-compliance.

A High Committee is in charge of monitoring implementation of the AFEP-MEDEF code. The Financial Markets Authority publishes both best practice recommendations and an annual report that names companies that are not in compliance with the "comply or explain" principle or whose explanations are insufficient. Reputational damage remains the principal risk for non-compliance with the AFEP-MEDEF code.

Corporate rules

The by-laws and the internal board rules of a company may also contain corporate governance provisions.

Corporate and board structures

Corporate structures

The main legal entity for listed companies is the SA (*société anonyme*). There is, however, a growing number of high-profile companies across Europe converting to *societas europea*, such as Airbus, Allianz, and LVMH. The flexibility in board structure accorded to a *societas europea* is similar to that accorded to French listed companies.

Board structures

A listed company may choose between one of two board structures. The first, aligned to the Anglo-American model is a unitary board of directors (*conseil d'administration*); the second, similar to the German model, is a two-tier structure with a supervisory board (*conseil de surveillance*) and a management board (*directoire*). In a two-tier structure, the management board members are executive directors and the supervisory board members are non-executive directors. In 2013, 80 percent of CAC 40 companies (the capitalization-weighted ranking of the 40 largest listed companies in France) had a unilateral structure. The board may have several committees, including an audit committee (mandatory), a remuneration committee, and a nomination committee (both optional except for financial institutions).

Number of directors

Directors may be natural or legal persons, save for the members of a management board and the chair of a supervisory board. There are between three and 18 directors on a unitary or supervisory board, and a maximum of seven members on a management board of a listed company. The average number of directors on France's CAC 40 boards is 14.

Evaluation procedures

Boards are encouraged to undertake annual self-reviews and a formal evaluation once every three years.

Characteristics of directors

Status

As a general rule, directors are not employees of the company.

Term

The Commercial Code prescribes a maximum term of six years for directors, but this is limited to four years by the AFEP-MEDEF code. Terms should be staggered to ensure the smooth replacement of directors.

Number of directorships

The Commercial Code provides that no natural person may be a member of the board of directors or supervisory board of more than five French companies. The AFEP-MEDEF code takes a stricter view, recommending that the number of directorships for executive directors is limited to three listed companies or five in the case of non-executive directors; including foreign companies but excluding any companies forming part of the same group. The board should also approve any new directorships of its members.

Chair/CEO

In a two-tier structure, the chair of the management board is the CEO. Where there is a unilateral structure, the company may either combine or separate the offices of chair and CEO. The AFEP-MEDEF code prescribes that where the positions are combined, an explanation of the measures taken to preserve the balance of powers should be provided to shareholders. Listed companies overwhelmingly choose to combine the two functions (87.5 percent of CAC 40 companies in 2013). In recent years, a trend has developed toward reunifying the functions in those companies that had previously split them. According to the Financial Markets Authority, one way of explaining this trend is that during the financial crisis, listed companies wanted to have reactive and efficient strategic management.

Independent directors

France has the concept of a lead independent director that is particularly advantageous in the situation where the functions of chair and CEO are combined. Despite this, fifteen in forty CAC 40 companies choose to have such a director. Typical responsibilities of the lead independent director include identifying and managing conflicts of interest and organizing meetings without the presence of the chair.

France is experiencing a growing trend toward more independent directors on the boards of listed companies. The AFEP-MEDEF code provides that the number of independent directors should equal half of the board (excluding directors representing certain stakeholders) in widely-held corporations with no controlling shareholders or at least a third in other cases. The independence of non-executive directors representing major shareholders holding more than 10 percent of the share capital of the company is determined by the appointments/nominations committee and is kept under regular review.

The AFEP-MEDEF code sets out a number of criteria for independence, including that the director:

- has not been an employee or executive director of the company, its parent, or related companies in the previous five years
- has not been an executive director of an entity of which the company is a director in the previous five years
- has not been an auditor of the company in the previous five years
- is not a major customer, supplier, or banker of the company or group
- does not have any close family ties to executive directors.

Finally, a criterion that is often disregarded by companies assessing the independence of directors is that the director has been a director of the company for not more than 12 years. Some companies justify the decision not to consider length of service as an obstacle to a director's independence on the basis that the experience of the director takes precedence.

Key corporate governance issues

1. Remuneration

This is an area in which the legislator has intervened following a series of scandals. There are laws on termination payments that apply to all companies and laws relating to directors' compensation, which only apply to listed companies. There is also specific legislation for the financial services sector and in respect of pension schemes. In addition, the AFEP-MEDEF code contains provisions on remuneration.

Executive remuneration Executive remuneration may take the form of fixed and variable compensation, stock options, and/or performance shares. The remuneration committee proposes individuals' remuneration, which is then approved by the board of directors or supervisory board. The compensation must be appropriate, balanced, and fair. Fixed remuneration is generally reviewed at long intervals. Variable remuneration is based on criteria relating to short-term corporate and individual performance and is recommended to be awarded up to a maximum percentage of the fixed remuneration. Certain executive directors are required to hold a certain number of shares in the company, as determined by the board or supervisory board, until the end of their term of office. An executive director may be awarded stock options or performance shares upon meeting targets, provided that an employee corporate performance scheme exists. The director must hold the option or shares for a minimum period, and the exercise of all of the stock options and the acquisition of shares is restricted.

Non-executive remuneration Shareholders must approve a global amount of attendance fees for non-executive directors, which is then distributed among the directors relative to their various duties and responsibilities. No other remuneration is permitted, and, in particular, non-executive directors may not receive shares or share options free of charge.

Additional remuneration Golden hellos must be disclosed, and there are specific restrictions on golden parachutes. Severance payments must be conditional upon a set of demanding performance requirements. Noncompetition agreements and payments must be approved by the board and are subject to certain disclosure requirements.

Disclosure All of the executive directors' compensation should be disclosed immediately after the meeting of the board that approves it. The annual report must also contain detailed disclosure of remuneration, including the aggregate compensation and benefits paid during the previous financial year to each executive director by the company and the group. The AFEP-MEDEF code advocates the use of standardized tables to present this information.

Say-on-pay The 2013 version of the AFEP-MEDEF code introduces "say-on-pay": the board must present the compensation awarded to executive directors during the previous financial year at the Annual General Meeting (AGM) of Shareholders, following which an advisory vote of the shareholders is taken. One resolution is presented for the CEO or the chair of the management board and one resolution for the deputy CEOs or for the other members of the management board. In the event that the resolution is voted down, the board, acting on the advice of the remuneration committee, must discuss this matter at another meeting and immediately publish a notice on the company's website detailing how it intends to deal with the opinion of the shareholders expressed at the general meeting. It remains to be seen how this will operate in practice and if we will see shareholder activism in action.

2. Diversity

Female representation France has recently made significant progress in gender equality, introducing legislation that requires 20 percent of the board of a listed company to be female by the date of the company's 2014 AGM and rising to a 40 percent requirement in 2017. On December 31, 2013, on average, 28 percent of directors of CAC 40 companies were female. A further requirement will come into force in 2017: where the board of directors has eight members or fewer, the difference between the number of directors of each gender should be no higher than two.

Internationalization Recent years have seen the internationalization of French boards. The trend applies to both genders, but there has been a particularly marked increase in the number of non-French women joining boards. Currently, around a quarter of directors of listed companies are not French nationals.

3. Stakeholder representation

The Commercial Code provides that where employees hold at least three percent of the capital of a listed company, one or more directors should be appointed to represent the employee shareholders. Where a French domiciled company employs at least 5,000 people in France (or 10,000 worldwide), the number of directors representing employees must be at least two if there are more than 12 directors or one otherwise. By-laws may also contain requirements for shareholder and employee representation. The AFEP-MEDEF code provides that directors representing employees and employee shareholders have the same rights and responsibilities as other directors.

Outlook

Executive remuneration remains the primary hot issue, particularly with future intervention by the European Commission on the agenda. Further national legislation relating to corporate governance is not expected in the immediate future, although it remains to be seen whether the new provisions in the AFEP-MEDEF code (in particular, say-on-pay) will be embraced by listed companies.

Another hot issue has recently emerged. A working group has been established by the Financial Market Authority in the summer 2013 to discuss a possible regulation regarding the sale of significant assets by listed companies.

Germany

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In Germany, listed stock corporations (*Aktiengesellschaften*) traditionally have a two-tier board system, consisting of the management board and the supervisory board. According to Section 161 para. 1 sentence 1 of the German Stock Corporation Act (*Aktiengesetz*), the management board and the supervisory board shall declare annually, in their so-called "declaration of conformity," that the recommendations contained in the German Corporate Governance Code have been and are complied with, or which recommendations have not been or are not applied and why ("comply or explain"). The declaration of conformity must be made accessible on the website of the company on a permanent basis.

The German Corporate Governance Code presents essential statutory regulations for the management and supervision of German listed companies and contains internationally and nationally recognized standards for good and responsible governance. The Code aims to make the German corporate governance system transparent and understandable. Its purpose is to promote the trust of international and national investors, customers, employees, and the general public in the management and supervision of listed German stock corporations.

As a rule, the Code is reviewed annually against the background of national and international developments and is adjusted, if necessary. A current "hot button" issue in this context is—and has been frequently over the last few years—the rules on management board compensation.

German mandatory statutory rules on management board compensation and the recommendations of the German Corporate Governance Code

According to German statutory law, the supervisory board is exclusively responsible to negotiate for the company the terms and conditions of the service contracts of the members of the management board. It is regularly the chairperson of the supervisory board who is empowered to sign the service contract with the respective management board member. However, the terms and conditions of the service contract, in particular the entire remuneration package, must be approved by the full supervisory board with at least a majority vote.

As a general rule, when determining the total remuneration for each individual member of the management board (salary, participation in profits, reimbursement of expenses, insurance premiums, commission, incentive-based promises of compensation such as share subscription rights, and side benefits of any kind), the supervisory board must ensure that the total remuneration is reasonable in relation to the duties and performance of the member of the management board, as well as in relation to the situation of the company, and that it does not exceed the usual compensation without special reason. Also, the compensation structure of listed companies shall be aligned toward a sustainable corporate development. Variable compensation components shall therefore have a multiyear basis for assessment; the supervisory board shall arrange for a possibility of limitation in case of extraordinary developments. All of the above shall further apply accordingly to pensions, payments to surviving dependants of the deceased, and similar payments.

Further to these mandatory statutory rules, according to the German Corporate Governance Code, monetary compensation elements shall comprise fixed and variable elements. Both positive and negative developments shall be taken into account when determining variable compensation components. All compensation components must be appropriate, individually and in total, and in particular must not encourage unreasonable risks. The variable compensation components shall be related to demanding, relevant comparison parameters. Changing such performance targets or the comparison parameters with retroactive effect shall be excluded.

In addition, the Code recommends severance pay caps. Therefore, in concluding management board service contracts, the supervisory board shall take care to ensure that payments made to a management board member on premature termination of his or her contract, including fringe benefits, do not exceed the value of two years' compensation and compensate for no more than the remaining term of the employment contract. If the employment contract is terminated for a serious cause for which the management board member is responsible, no payments may be made to the management board member. The severance payment cap shall be calculated on the basis of the total compensation for the past full financial year and, if appropriate, the expected total compensation for the current financial year. Payments promised in the event of premature termination of a management board member's contract due to a change of control shall not exceed 150 percent of the severance payment cap.

Based on statutory rules, the total compensation of each of the management board members is to be disclosed by name, divided into fixed and variable compensation components. The same applies to promises of benefits that are granted to a management board member in case of premature or statutory termination of the function of a management board member or those that have been changed during the financial year. Disclosure is dispensed with if the shareholders' meeting has passed a resolution to this effect by three-quarters majority.

According to the Code, disclosure shall be made in the notes or in the management report. A compensation report as part of the management report outlines the compensation system for management board members. The outline shall be presented in a generally understandable way. The compensation report shall also include information on the nature of the fringe benefits provided by the company.

Recent amendments to the rules regarding management board compensation

In its annual review of 2013, the German Government Commission on the German Corporate Governance Code has implemented some remarkable amendments to the recommendations regarding the composition and remuneration of the management board. Specifically, the

Government Commission now recommends that German listed stock corporations place a cap on individual management board remuneration, both in terms of its total amount as well as in terms of its variable components. The system-inherent and individual caps should, however, continue to be defined individually for each company by the supervisory board.

In order to enhance the transparency and traceability of the decisions made by the supervisory board, the criteria regarding management board remuneration, which have to be taken into account, have been supplemented. For example, the Government Commission now recommends that, when defining a remuneration structure, the supervisory board shall consider the relationship between the compensation of the management board and that of senior management and the staff overall, particularly in terms of its development over time, whereby the supervisory board shall determine how senior managers and the relevant staff are to be differentiated. Within this context, there is now a new recommendation that, for pension schemes, the supervisory board shall establish the level of provision aimed for in each case—also considering the length of time for which the individual has been a management board member—and take into account the resulting annual and long-term expense for the company.

In order to improve comparability over time and with other companies, both for the supervisory board and the general public, the Government Commission recommends that important facts and figures on management board remuneration be prepared in a standardized fashion and by making use of model tables, which are henceforth provided for in the appendix of the Code. Namely, for financial years starting after December 31, 2013, and for each member of the management board, the compensation report shall present:

- the benefits granted for the year under review including the fringe benefits, and including the maximum and minimum achievable compensation for variable compensation components
- the allocation of fixed compensation, short-term variable compensation, and long-term variable compensation in/for the year under review, broken down into the relevant reference years
- for pension provisions and other benefits, the service cost in/for the year under review.

The Commission initially put this forward as a mere proposal to German listed stock corporations and upgraded it to a recommendation during the consultancy process. The reason is that, according to the Commission, the data to be included in the proposed tables are already available in companies and are already published in one form or another to a large extent. Consolidating and standardizing the way in which the data is presented would provide, according to the Commission, a better overview and improve comparability. In view of the potential organizational expense involved in the conversion, the recommendation regarding information in the remuneration report and the suggestion on the use of tables in companies should only be implemented beginning 2014.

Shareholder involvement within management board compensation

As set out above, it is the supervisory board of a German stock corporation that is exclusively responsible for determining the compensation of the members of the management board. So far, the shareholders' meeting of a listed company can only give a nonbinding say-on-pay vote in the annual general meeting (Section 120 para. 4 sentence 1 of the German Stock Corporation Act). The resolution of the shareholders' meeting does not give rise to either rights or duties; in particular, the obligation of the supervisory board to exclusively determine the entire compensation package of the members of the management board remains unaffected. The resolution cannot be contested in court. As a consequence, such vote does not have any influence on the management compensation package and is not challengeable in court.

Legislative plans to introduce a mandatory say-on-pay of the shareholders' meeting following the Swiss debate on excessive management salaries have been postponed in Germany.

Under the nonbinding say-on-pay environment in Germany, there is usually no proxy fight regarding the shareholders' vote on this particular agenda item. However, the management board often tries to obtain good voting results for all agenda items proposed by the boards and tries to ensure this by having direct contact with shareholders or proxy advisers before the annual general meeting takes place.

Summary

The supervisory board of a German stock corporation is exclusively responsible to negotiate the terms and conditions of the service contracts of the members of the management board, in particular the remuneration package. Rules on management board compensation are contained in both German mandatory statutory rules as well as—in the form of recommendations—the German Corporate Governance Code. In 2013, some remarkable adjustments to the remuneration rules of the German Corporate Governance Code were made, with the aim to further professionalize and strengthen the work carried out by the supervisory board by increasing transparency and to improve the basis for decision-making. In addition, the recent amendments to the Code are equally aimed at making the relevant remuneration proposals clearer and more comprehensible for all stakeholders, therefore making it easier to assess the governance of companies.

So far, shareholder involvement in Germany regarding management compensation is rather limited. The shareholders' meeting of a listed company can only resolve on a nonbinding say-on-pay vote in the annual general meeting. Recent legislative plans to introduce a mandatory say-on-pay of the shareholders' meeting have been postponed in Germany.

Italy

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The key corporate governance provisions for Italian listed companies are found in:

- the Italian Civil Code
- the Consolidated Financial Act (Legislative Decree No. 58/1998)
- Regulations No. 16191/2007 and No. 11971/1999 adopted by Consob, the Italian supervisory authority for listed companies
- the Corporate Governance Code adopted in 1999 by the Committee for Corporate Governance of Borsa Italiana S.p.A.—the company that is responsible for the organization and management of the Italian stock exchange and that is part of the London Stock Exchange Group—as last amended in 2011.

The Corporate Governance Code sets out high corporate governance standards in line with international best practices.

The Consolidated Financial Act sets out the "comply or explain" principle requiring listed companies to disclose information about their compliance with the Corporate Governance Code in an annual formal report on corporate governance.

The report must include, among other things: (1) some specific information about the ownership structure of the issuer; (2) rules for the appointment and replacement of directors; (3) the key features of the internal control and risk management system; (4) how shareholders' general meetings are regulated; and (5) the structure and functioning of the management and control bodies and internal committees.

In 2013, 223 (93 percent) of the 239 Italian listed companies confirmed their compliance with the Code in their corporate governance reports (source: Committee for Corporate Governance, Annual Report 2013).

The foregoing provisions implement the rules and recommendations provided at the European level (Directive 2007/36/EC on shareholders' rights in listed companies; Directive 2006/43/EC on the audit of annual accounts and consolidated accounts; Commission Recommendations 2004/913/EC, 2005/162/EC, and 2009/385/CE on director remuneration).

The Italian Civil Code provides for three different management and control systems:

- the "traditional system," in which the shareholders' meeting appoints a board of directors and a board of statutory auditors
- the "two-tier system," in which the shareholders' meeting appoints the supervisory body, which in turn appoints the corporate body vested with the management of the company
- the "one-tier system," in which the shareholders' meeting appoints a board of directors which in turn appoints, from its members, the supervisory body.

The following description covers only the traditional system, since the vast majority (over 95 percent) of Italian listed companies adopt it.

The shareholders' general meeting

The shareholders' general meeting is made up of the holders of the company's ordinary shares.

Competences of an ordinary general meeting include the appointment of directors and statutory auditors and resolutions regarding their liability, and the appointment of the external auditors. An extraordinary general meeting (for which higher majorities are required) is mandatory for amendments to the by-laws, including extraordinary transactions (eg share capital increases, mergers, and demergers).

Board of directors

The board of directors is responsible for the ordinary and extraordinary management of the company.

It must make decisions with full knowledge of the facts and autonomously with the aim of pursuing and creating value for the shareholders over the medium-long term.

The board can delegate certain functions to one or more directors (the chief executive officer/s) and/or to an executive committee of some of its members. By law, some matters cannot be delegated, such as the drafting of the financial statements.

Moreover, the Corporate Governance Code recommends that the entire board be entrusted with the primary responsibility for determining and pursuing the strategic targets of the company as well as the (1) examination and approval of the strategic, operational, and financial plans of the company; (2) evaluation of the general performance of the company; (3) resolutions upon material transactions; and (4) periodical evaluation of the performance of the board and its committees.

In light of the above, directors are designated as either: (1) executive, that is, those vested with management powers, or (2) non-executive, whose role is to enhance the board's discussion and to provide an independent, unbiased judgment on the proposed resolutions, particularly those where the respective interests of executive directors and shareholders may not be aligned, such as executive director remuneration and the internal control and risk management systems.

Although independence of judgment is required of all directors, some board members must meet specific independence requirements set out in the applicable laws and regulations and recommended by the Corporate Governance Code. In particular:

1. The Consolidated Financial Act requires that, in order to qualify as independent, a director shall not be:
   (a) under any legal disability, bankrupt, disqualified from public office, or incapable of exercising managerial functions
   (b) associated with the company, any of its subsidiaries, any parent company, or any companies under common control, or with the directors of any such entities through personal relations (eg marriage and kinship), a self-employment or employment relationship, or any other relationship of an economic or professional nature that might compromise independence.

2. The Corporate Governance Code requires that, in order to qualify as independent, a director must not have or have had any current or recent direct or indirect business relationship with the company or persons linked to the company, whether for themselves or on behalf of a third party, which might affect their independent judgment. The board must evaluate annually the independence of directors on a factual basis rather than legalistically, and the results of the evaluation must be disclosed in the annual report on corporate governance. Factors indicating lack of necessary independence include if the director:
   - (a) controls the company, directly or indirectly, or is able to exercise dominant influence over it, including through provisions of any shareholders' agreement
   - (b) is or has been in the preceding three fiscal years a significant representative of the company, of a strategically important subsidiary, or of a company under common control, or of a company or entity controlling or able to exercise considerable influence over the company
   - (c) has or had in the preceding fiscal year, directly or indirectly, a significant commercial, financial, or professional relationship:
     - with the company, one of its subsidiaries, or any of its significant representatives
     - with an entity or individual that controls the company or with any significant representatives of such entity
     - or is, or has been in the preceding three fiscal years, an employee of any of the foregoing
   - (d) receives or has received in the preceding three fiscal years, from the company, a subsidiary, or the parent company, any significant remuneration beyond fixed compensation as a director
   - (e) was a director of the company for more than 9 years in the last 12 years
   - (f) is an executive director in another company in which an executive director of the listed company is also a director
   - (g) is a partner or a director of a legal entity in the same network as the company's external auditors
   - (h) is a close relative of anyone falling within the above paragraphs.

An important role is also attributed to the chairman of the board of directors, who must ensure that the documentation relating to the board agenda is made available to directors and statutory auditors in a timely manner prior to the board meeting.

The Corporate Governance Code recommends the division of key management competences, particularly of the chair and CEO roles. Where these two offices are held by the same person, the code recommends the appointment of a "lead independent director" to be the representative of non-executive and independent directors within the board.

Composition and election

The number of directors and their term of office are established by the by-laws or by the general meeting.

The general meeting appoints the board through a slate election system. At least one director must be appointed from the minority slate that obtained the largest number of votes, and the relevant director must be free of any direct or indirect link with the shareholders who filed or voted in favor of the slate that obtained the majority of votes.

Gender balance must be on a ratio of at least 1:3 (either way).

Furthermore, the applicable laws and regulations and the Corporate Governance Code require that there be a minimum number of independent directors on the board. In particular:

- the Consolidated Financial Act requires that at least one director (or two, if the board consists of more than seven members) must meet the independence requirements in that act

- the Corporate Governance Code requires that an adequate number of non-executive directors (usually 3 or 4) must meet the Code's own independence requirements
- Consob Regulation No. 16191/2007 requires that a majority of the directors of a company which is subject to management and coordination activity (*attività di direzione e coordinamento*) by another listed company must meet the independence requirements under the Corporate Governance Code.

Committees

In addition to the executive committee, the board of directors can establish committees with initiative and advisory functions.

The Corporate Governance Code requires the establishment of:

- A "control and risk committee": this supports the analysis and decisions of the board relating to internal control and risk management and the approval of periodical financial reports. Under the Consob Regulation No. 16191/2007, this committee is mandatory for companies that are subject to management and coordination activity by another company.

This committee is part of the internal control and risk management system recommended by the Corporate Governance Code in order to provide consistency between the effective management of the company and the objectives defined by the board of directors, promoting an informed decision-making process. In particular, the system is to focus on ensuring the safeguarding of corporate assets, the efficiency and effectiveness of management procedures, the reliability of financial information, and the compliance of management with laws and regulations, including the by-laws and internal procedures.

The internal control and risk management system must be focused on two key aspects: (1) identification, evaluation, and monitoring of business risks, and (2) integration and coordination among the bodies and corporate functions involved in such system.

The board of directors must define the guidelines of the control system and periodically evaluate its adequacy.

- A "remuneration committee": this submits proposals or opinions to the board concerning the remuneration of executive directors and for the periodic assessment of the adequacy, the overall consistency and the actual implementation of the remuneration policy for directors and key managers of the company. A director cannot participate in meetings of the remuneration committee in which proposals are formulated to the board of directors relating to his/her own remuneration.

In line with the recommendations of the European legislative bodies, the Corporate Governance Code recommends that the remuneration of directors and key management personnel be established with a view to attracting, retaining, and motivating people with the professional skills necessary to successfully manage the company. The remuneration of executive directors and key management personnel is to be defined in such a way as to align their interests with pursuing the primary objective of the creation of value for the shareholders over the medium-long term.

With specific regard to banks and banking groups, Banca d'Italia, the Italian central bank, has recently launched a public consultation on proposed amendments to the existing Regulation of March 30, 2011, on remuneration policies, aimed at implementing Directive 2013/36/EU (Capital Requirements Directive IV). Although the consultation closed in January 2014, the new rules have not yet been published. The new rules are aimed at providing—in the interest of all stakeholders—remuneration systems that are linked to the bank's results and structured taking into account the capital and liquidity requirements of such companies.

- A "nomination committee": this formulates opinions and recommendations to the board regarding the board's size, composition, and professional skills, and submits specific proposals if the company approves the adoption of an executive director succession plan.

The remuneration and the nomination committees are frequently combined in a single committee entrusted with both functions.

Each committee usually comprises at least three directors. The Corporate Governance Code requires committees to be composed of non-executive directors, the majority of which (including the chair) must meet the independence requirements. Committees of listed companies subject to management and coordination activity by another company must comprise only independent directors.

Oversight of related party transactions is, under Consob's Regulation no. 17221/2010, entrusted to a committee of independent directors (which can be either an ad hoc committee or one of the other internal committees). The committee must opine on the benefit to the company of the relevant transaction as well as on the appropriateness and fairness of its terms.

The proposal for a directive approved by the European Commission on April 9, 2014, aimed at strengthening the voice of shareholders, requires the approval of the shareholders' meeting for related party transactions of particular significance.

Board evaluation

In order to strengthen the functioning of the board of directors, in 2011, the European Commission published a Green Paper underlining that the board should annually evaluate its work, taking into account its composition, organization, and functioning.

In Italy, such recommendation is also contained in the Corporate Governance Code, which requires the directors to carry out, at least annually, an assessment on the functioning, size, and composition of the board and of the internal committees.

In 2013, 183 (77 percent) of the 239 listed companies confirmed that they had carried out such self-evaluation (source: Committee for Corporate Governance, Annual Report 2013).

Board of statutory auditors/auditing

The board of statutory auditors is the body entrusted with supervisory duties over the company and, in particular, over:

- the compliance of the management of the company with the general law and the by-laws
- the observance of principles of good management
- the adequacy of the company's organizational structure, as well as the adequacy and effectiveness of the internal control and risk management system
- the actual implementation of corporate governance rules as provided by the Corporate Governance Code.

The audit of annual and consolidated accounts is carried out by independent external auditors appointed by the shareholders' meeting. The external auditors must be appointed for nine years, and the key audit partners responsible for carrying out the audit must rotate from the audit engagement within a maximum period of seven years from the date of appointment. In this context, the board of statutory auditors:

- submits proposals to the general meeting regarding the external auditors to be appointed
- supervises the financial reporting process and the adequacy of the company's accounting system, the audit of annual and consolidated accounts and the independence of the external auditors.

Statutory auditors have the right at any time, jointly or severally, to carry out inspections and investigations, and to ask directors for information on specific transactions or business.

The board of auditors is composed of three or five statutory auditors, appointed by means of a slate voting system. The chairman of the board must be a member elected from the slate filed by the minority shareholders and must be free of any direct or indirect link with the shareholders who filed or voted in favor of the slate that obtained the majority of the votes. Again, gender balance must be on a ratio of at least 1:3 (either way).

The following apply to statutory auditors:

1 professionalism requirements, such as enrollment in the register of chartered accountants and/or specific expertise in the management or auditing of companies
2 independence as provided by the Consolidated Financial Act and the Corporate Governance Code
3 integrity requirements, that is, the absence of convictions for crimes against economic, financial, and public interests.

Spain

Carlos Paredes, Partner Uría Menéndez

Corporate governance of listed companies in Spain is primarily regulated by corporate legislation, which is mainly composed of the Companies Law, approved by Royal Legislative Decree 1/2010 of 2 July (the Companies Law), which sets out the rules for all limited liability companies, including a section with specific rules for listed companies. In addition, Law 24/1988 of 28 July, on the securities markets (the Securities Market Law) and related regulation provide additional rules relating to listed companies and specific information requirements relating to corporate governance practices.

Furthermore, listed companies are subject to a corporate governance code (the Unified Code), which contains recommendations that are not compulsory but can be followed voluntarily. The Unified Code was drafted in 2006 by an ad hoc committee appointed by the Spanish government among public officials, businesspeople, and other experts in corporate governance and finally approved by the National Securities Market Commission (CNMV). The Unified Code is a harmonization, review, and update of the recommendations and principles previously stated by consultative committees in 1998 and 2003. Although its recommendations are voluntary, the concepts and definitions of the Unified Code are compulsory (some of them, like those relating to the definitions of the different types of directors, have even been enacted into law), and each listed company must explain its level of compliance with its provisions on a yearly basis. The recommendations range from those relating to general shareholders' meetings to those referring to the board or its directors, including board composition and functions, selection, appointment and removal of directors, remuneration, and internal committees of the board (executive committee, audit committee, and remuneration and appointments committees).

Both the statutory rules on corporate governance and the Unified Code are currently under review. In 2013, an ad hoc experts committee was appointed by the government with a mandate to propose measures to improve effectiveness and increase responsibility and, ultimately, encourage the highest standard of compliance with the international good governance criteria and principles. The committee's first report, issued in October 2013, contains a proposal for an in-depth review of the Companies Law, which will have a substantial impact on matters including: (1) rights, obligations, and liability of directors; (2) directors' remuneration; (3) composition and functioning of the board and its committees; (4) shareholders' rights; and (5) shareholders' meetings. In May 2014, the government produced a draft law that was subsequently submitted to Parliament. The expert committee will further advise the CNMV on updating the Unified Code. Both the statutory reform and the update of the Unified Code are expected to be completed in 2014. Also, in the field of financial institutions, the transposition of Directive 2013/36/EU of 26 June, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, and the enactment of Regulation (EU)575/2013 of 26 June, on prudential requirements for credit institutions and investment firms (known as the CRD IV package to implement Basel III standards on banking capital), will certainly influence corporate governance in banks and other credit institutions. These initiatives are perhaps the highlight issues of corporate governance regulation in Spain in the near future, since they allow us to anticipate substantial changes in the matters referred to above.

Expected changes in executive pay regulations

In particular, it is worth referring to the remuneration of executive directors, which in the past was the subject of discrepancies between the prevailing case law and the practice of Spanish companies. According to prevailing case law, remuneration of executive directors should be provided for in the by-laws of the company (either through the establishment of a maximum amount by the shareholders' meeting or through the granting to directors of a share in the profits of the company). This contrasts with the standard approach taken by many companies that entrust the board of directors (and not the shareholders) with the power to decide on the remuneration of executive directors on the basis that the managerial duties of these directors exceed the ones vested on the board as a whole. This dichotomy, which has sometimes caused the courts to rule on the nullity of contractual arrangements with executives since they were lacking shareholder (and thus by-laws) support, is the core of the discussions about the remuneration of executives and the powers of the shareholders to decide on these matters. Although say-on-pay rules are applicable on a consultative basis in Spain since 2011, the trend toward a growing implication of shareholders in the decisions about remuneration policies for directors (and, especially, executives) is gaining some ground. In this regard, the government drafted a law in May 2014 as a result of the ad hoc experts committee's first report of October 2013. The draft law provides that the general shareholders' meeting of listed companies must approve the remuneration policies for directors every three years and on a decisive basis. It also states that during said period, any changes to said policies must be voted by the shareholders again and that any remuneration of the directors (including executive directors and all kinds of compensation) must be consistent with said remuneration policies, or otherwise approved by the general shareholders' meeting. At the same time, while the annual say-on-pay on the directors' remuneration report is expected to remain of a consultative nature, the failure to obtain such consultative approval from the shareholders will also cause that the remuneration policies for directors for the next year be submitted again to the decisive vote of shareholders, even if the three-year validity term for the remuneration policies already approved by the shareholders has not finished. Therefore, although the draft law also states that the approval of the contractual arrangements with executive directors is a competence of the board, it certainly increases the powers of shareholders for the remuneration to be paid to said executives. Concurrently, the legislation which implements the CRD IV package in Spain also strengthens requirements for executive directors' and top managers' pay by increasing the powers of shareholders.

Conflicts of interest

Another area of expected future reform will be the extension to shareholders attending a general shareholders' meeting of the prohibition to vote in cases of conflicts of interest. Until now, the prohibition to vote in cases of conflicts of interest was limited for S.A. or *sociedades anónimas* (all listed companies are S.A.) to directors in the board meetings or to directors or proxy holders representing others in the general shareholders' meeting, in the absence of precise instructions from the proxy grantor. Although it is common to recommend companies deciding in a general shareholders' meeting about transactions where a controlling shareholder is conflicted to also obtain a majority vote among the shareholders attending the meeting and not conflicted, the fact is that any such conflicted shareholder is not formally prevented to vote. Now, the proposed reform contemplates certain types of resolutions where the relevant shareholder of an S.A. should be prevented from voting, namely: (1) the authorization to transfer shares not freely transferable to the extent the prohibition is provided in the by-laws; (2) the decision to expel a shareholder from a company, to the extent it is provided in the by-laws (not generally available for a listed company, since it requires a unanimous decision of all the shareholders); (3) discharge a shareholder from an obligation or granting a right in his or her favor; (4) provide any kind of financial assistance, including the granting of guarantees in his or her favor; and (5) discharge a shareholder-director from the duty not to compete with the company or engage directly or indirectly in activities that may compete with those of the company. In addition to these cases in which the relevant shareholder would have a prohibition to vote, should any other conflict arise, the relevant shareholder would be allowed to vote, but if said vote cast turns out to be decisive for the resolution to be passed, then in case of a future challenge of said resolution the burden of proof will be reversed and it will be the relevant shareholder who will need to demonstrate that the resolution conforms to the corporate interest. This would not apply to resolutions where the conflict is determined by the position of the shareholder in the company (ie resolutions relating to the appointment or dismissal of directors, among others).

Separation of chair and CEO

The split between the roles of chair and CEO remains among the hottest topics in the corporate governance area, mainly through the influence of proxy advisory firms. The Unified Code has left the decision to companies on how to determine the specific powers of the chair and makes no specific recommendation on the separation of the chair and CEO positions. When the same person assumes the roles of chair and CEO, it is recommended to counterbalance such a concentration of powers by appointing a senior or a lead independent director who would be responsible for requesting the holding of board meetings; including new points on the board agenda; coordinating the relationships with external directors; and supervising the evaluation of the chair by the board. A majority of the Spanish listed companies combine the roles of chair and CEO. While we anticipate that this will probably change during the coming years and that we will see more companies splitting the roles of chair and CEO, we believe that no standard rules can be formulated in this area. It is a matter that depends largely on the culture and needs of the relevant company. While we believe that there cannot be any standard rule for companies on whether to combine the roles of chair and CEO, a decision to split the two roles must be made after a careful analysis of the situation and of the needs of the relevant company, and, in that regard, it seems more reasonable to agree on such matters at the time of the succession of the CEO or at any other time in which change is really required. However, as indicated, new legislation has been recently enacted which implements the CRD IV package in Spain that specifically provides that the chair of the board of a credit institution cannot act as CEO unless the institution justifies the combination of both roles and said combination is expressly authorized by the supervisor—that is, the Bank of Spain. As to the reform of the Companies Law, the bill submitted to Parliament provides that the chair of a listed company may be an executive director, in which case his or her appointment as chair will require a two-thirds majority vote within the board and the appointment of a lead independent director.

Shareholder activism

As to other trends in the field of corporate governance, one that should improve in the coming years, is that of the presence of shareholder activism, which has not blossomed in Spain yet. Contrary to other European countries, Spanish companies have not been as affected in the past by the pressure of activist shareholders, and there are very few examples of activist shareholders engaging in public fights relating to Spanish companies. Proxy fights are normally seen in the context of two groups of significant shareholders trying to take control of a company rather than driven by activist shareholders trying to persuade management to take one or another course of action. This does not mean, however, that activism and shareholder engagement is out of the scope of Spanish firms. There is a growing presence of foreign institutional investors in Spanish listed companies, and this, together with the influence of proxy advisory firms, has noticeably changed the way in which companies approach their corporate governance and remuneration practices and the preparation of shareholders' meetings. While in some cases this policy has facilitated a convergence of the interests of management and shareholders, including, specifically, institutional ones, thus reducing the likelihood of action by corporate raiders, we anticipate that this growing institutional ownership of Spanish companies will allow for an increased frequency of activist shareholders engagement.

United Kingdom

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In the United Kingdom, in common with many other developed markets, there has, since the events of 2008, been a heavy focus on the governance of corporations both as a tool to regulate corporate behavior and as a means of giving confidence that some of the previous mistakes will not easily be repeated. Whether that confidence is well founded is a matter for debate, but investors, politicians, regulators, and media observers have ensured that issues that were once thought dry and technical now sit firmly in the spotlight. Led by the fiery topic of executive remuneration, matters of corporate control, disclosure, and reward are the subject of public debate and scrutiny.

Governance requirements in the United Kingdom are a mixture of the law, of market expectation, and of the non-statutory UK Corporate Governance Code. Perhaps unusually, this Code is one against which listed companies are expected either to comply or to explain non-compliance, but it has no statutory force. The most likely consequences of inadequate compliance or explanation are the withdrawal of institutional support for business at the annual general meeting and public criticism of the board. But it is also around the Code and its scope that much of the debate has been focused, with the Financial Reporting Council, which oversees it, conducting extensive consultation exercises with companies and their investors to seek to reflect changing best practice and areas of corporate risk. There have also been high-profile changes in the law, particularly on remuneration.

The spread of hot topics is quite a broad one. Let me draw out some of the main themes.

The issues

Remuneration

Remuneration of senior executives has taken the brunt of attention over the past year or two. It is of course in many ways an easy target, being portrayed in some circles as the embodiment of corporate excess, displaying a lack of alignment of the individual with the performance of the company and with equity value (the "reward for failure" argument), and as evidence of disproportionality of treatment between the board and the body of employees as a whole. Vince Cable, the business secretary in the UK government, has recently written publicly to chairs of the remuneration committees of the major listed companies urging restraint on bonus awards and telling companies that there is an opportunity "for companies to make peace with the public," a matter that has attracted front page headlines. Alongside this, there has been substantive change. In particular:

Regulation For more than a decade, UK listed companies have had to put a remuneration report to shareholders annually for a vote. That report has been on the remuneration paid to directors, and the vote has been advisory only.

In response to the large amount of publicity over pay levels, and the perceived lack of linkage of pay to performance, there has been a change to the law taking effect for financial years from September 30, 2013. The most significant change was that for the first time shareholders of listed companies have a direct say on directors' pay. As well as the report on remuneration paid, which remains the subject of an advisory vote, listed companies must put a separate report to shareholders, which specifies the policies determining remuneration and which is subject to a binding vote.

This represents a shift in the balance of power between shareholders and directors, although it is too early to say how significant that will be in practice. Unusually to some audiences, shareholders in UK companies have always had the right by simple majority to remove directors from office, and directors of listed companies have had to submit themselves to shareholders for re-election. That has not meant that directors are voted off boards, except very rarely. The cases are not directly comparable, since ousted directors would still have contractual rights to compensation, but the point demonstrates that shareholders are not quick to pull the trigger. What is clear, though, is that they have an additional lever and that corporate engagement will need to take this into account.

Shareholder action The reporting season for the 2012 financial year brought the so-called "Shareholder Spring" during which there were a number of high-profile instances of shareholder discontent at large companies and a small number of high-profile board changes. These were largely, though not exclusively, focused on remuneration and the advisory vote on the report. Though none of these major votes was lost, the opposition affected the likes of Aviva, AstraZeneca, Barclays, BP, Credit Suisse, HSBC, and WPP. Generally, the responses in the following year were more muted, and it seems that this reflected lessons learned in both the structure of remuneration packages, particularly on bonus arrangements, but also more extensive consultation between companies and investors.

So far, the signs on the new policy reports have been mixed. While votes against have not been significant, it is clear that some of the institutional investor bodies have been expressing views in private on the structure of those reports and in particular on the extent of the discretion retained by remuneration committees on some of the variable elements. That has resulted at the date of writing in almost 20 companies putting clarificatory statements on their websites. The statements address a range of different issues, from compensation payable to new recruits, to the extent of incentive awards to general discretion, but each seeks to clarify the extent to which discretion will be used or the normal range of variability. In addition, at least one investor—Fidelity—has stated that it will vote against pay policies that allow vesting and realization of share incentive awards after three rather than five years.

What this demonstrates overall is that shareholders remain concerned about the alignment of executive compensation and corporate performance, and indeed about the level of compensation itself. The combination of this, of the political attention (see above), and of the potential use of the binding policy vote as a new tool all mean that this will continue to be a sensitive issue that corporates will ignore at their peril.

Diversity

Diversity, both at board and senior executive level, is a topic that has again attracted significant attention in the United Kingdom. While the subject is an extremely broad-ranging one, the principal focus in the compliance field has been on gender diversity and on the inadequate representation of women on boards and in senior positions. The UK government commissioned a report on the issue in 2011 from Lord Davies. He fell short of looking to impose quotas, for which there was little general support, but recommended that FTSE 100 companies (the group of the largest listed companies) should aim for a minimum of 25 percent female representation on their boards by 2015. Legislation now requires disclosure by listed companies of the proportion of women on their boards, in senior executive positions, and in the whole workforce. The Corporate Governance Code (see above) requires companies to describe their policy toward diversity, including gender diversity, with any measurable objectives and progress against them. It does not require such a policy to exist. And it is possible that Europe will require further change, including possible targets of 40 percent women non-executive directors by 2020.

At the board level, in the FTSE 100 the proportion of women has increased from 12.5 percent in 2011 to 20.7 percent at the date of writing. The 25 percent target is not therefore out of sight, but this is not the complete picture. Among executive directors, the figure is just under 7 percent, with just over 25 percent of non-executives being women, and within this sample there will be many women with more than one directorship. This is not of itself surprising, given the rapid progress made and the need to address the executive pipeline as a longer-term issue. But with increased focus on the benefits to a corporation of having a diverse board, on the need to address obstacles further down the chain to enable a greater level of diversity at the middle and senior levels that will feed through to the top, and on the need for more attention to longer-term succession planning, the area will remain one where thoughtful and innovative companies will be able to derive benefit.

Audit and audit tendering

Audit and audit tendering is a collective theme deriving from at least two sources. First, the attention given to risk—both its identification and management. Risk, after all, is the one thing that can be said to underpin corporate governance. The taking of equity implies a certain level of risk, and a disclosure regime seeks to ensure that investors understand the level of risk being taken with their money. Failure to identify and manage risk, or failure having done so to explain it clearly, will ensure a mismatch between reasonable investor expectation and what is delivered. Equally, a regime must not seek to eliminate risk—investors who seek no risk should not be operating in the equity markets. Second, the role of the auditor in performing the role of independent scrutineer of the financial accounts that are used as the basis of reporting.

As to the first, auditors are now required to issue an expanded report on the audited accounts. This must set out the scope of the audit; show how this addressed risk and materiality, and, for example, describe the risks that had the greatest effect on the overall audit strategy; and how materiality was applied in planning and performing the audit. Alongside that, the company's audit committee must report on the significant issues that it considered, how it assessed the effectiveness of the external audit process, what approach it is taking to reappoint the auditor, and, where non-audit services are provided, how it is satisfied that auditor independence is preserved.

These requirements are intended both to provide transparency and information. It is still too early to judge how far these intentions are met, but there has been generally positive reaction to the first rounds of reports under the new regime, and it does not seem to be the case that a kitchen sink approach to disclosure has been taken. The visibility provided at one level of greater detail should be helpful to investors, and it will be of interest to see how reports for future periods deal with changing risk issues, and indeed how companies in similar industries or markets assess their individual risk profiles.

On the second, the Corporate Governance Code now requires the top 350 listed companies to put their audit work out to tender at least once every 10 years. There is no obligation to change auditors as a result, but there have been several high-profile changes made as a result of recent tenders, including HSBC, Vodafone, and Unilever. In addition, a recent European directive will make further significant change in the future (more than two years' time). This will include the need for listed companies to have mandatory rotation of auditors after a maximum of 20 years (10 if there is no public tender process) and will severely restrict the ability of audit firms to carry out non-audit work. Positive confirmations of independence will be required, along with further audit report disclosure.

Conclusion

There is not scope to do justice to the entire UK governance world in this short piece. What this section seeks to do is to look at some of the principal themes and put them into a certain context. Underpinning it all is the thought that better governance can operate to improve performance and also to enhance transparency for investors. However one weighs the various factors contributing to the financial crisis of 2008, the ability to identify and manage risk, and the culture within the significant entities (usually financial institutions) that are central to the operation of the system, must be critical ones. If there is a risk that the pendulum swings too far in the direction of regulation and disclosure for its own sake, that is perhaps an inevitable reaction at this stage of the cycle.

ASIA PACIFIC

Australia

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As in other jurisdictions, a combination of challenging business conditions and heightened scrutiny, by both regulators and shareholders, of board decision-making in recent years has sharpened market focus on corporate governance in Australia. Of particular interest to boards of listed companies in Australia are recent regulatory and market developments relating to disclosure of corporate governance compliance, executive remuneration, disclosure of confidential acquisition proposals, and shareholder activism.

Changes to disclosure under ASX's "comply or explain" regime

Unlike the mandatory governance rules applicable to companies listed on the New York Stock Exchange (NYSE), Australian listed companies are subject to a "comply or explain" regime of governance recommendations (the Recommendations) coordinated and published by the Australian Securities Exchange (ASX). Deviations are generally permitted, but the company's basis for non-compliance should be explained in the company's filings or on its website. A newly published third restatement of the Recommendations will take effect for a listed entity's first full financial year commencing on or after July 1, 2014. The rewrite is fairly predictable in light of global governance trends and includes general recommendations regarding board composition and independence, internal risk management, effective disclosure, and board and executive remuneration.

Motivated by concern that disclosure of non-compliance is often overly standardized and difficult for investors to locate in a company's disclosure record, ASX has recently introduced a new Appendix 4G, in the form of a checklist for verifying the location of corporate governance disclosure, to be filed with a company's annual report. ASX has cautioned companies to avoid pro forma governance disclosure—so we expect to see greater detail in responses.

One area in which Australia is an outlier is tenure-based independence criteria. Prior to introduction of the third restatement, proposals were in place to classify board members as non-independent once they had spent nine years on a board. That proposal was dropped during consultation.

Executive remuneration and the "two-strikes" rule

A uniquely Australian invention, the so-called "two-strikes" rule, was controversially implemented in 2011 as one of a number of measures introduced to further regulate executive remuneration in Australian listed companies. The rule piggybacks on an existing "say-on-pay" type provision in Australian corporate law requiring a listed company to put adoption of an executive remuneration report to a nonbinding shareholder vote at each annual general meeting of shareholders. The rule applies where at least 25 percent of the votes cast on the resolution are against adoption of the report at each of two consecutive annual meetings. In that instance, the "two-strikes" rule requires the company immediately to submit a so-called spill resolution to shareholders which, if approved, forces the company to hold a meeting within 90 days at which all of the company's directors (other than the managing director) who were serving at the time of the second "strike" vote must stand for re-election.

Since inception, critics have worried that the "two-strikes" rule's low threshold gives minority shareholders (and specifically shareholder activists) disproportionate powers to hijack annual meetings and that the elevated threat of a board spill distracts directors from corporate performance. Unlike US "say-on-pay" votes, the remuneration report resolution must in all cases be submitted to shareholders at each annual meeting, meaning that minority shareholders could potentially utilize the "two-strikes" mechanism to threaten an incumbent board within a time frame of approximately 15 months.

Despite these concerns, the rule appears to have had only limited practical effect to date. While a total of 42 second strikes were returned by shareholders across the 2012 and 2013 seasons, only six of the resulting spill votes actually led to a spill meeting, and in each of those cases all or most of the board were re-elected.

Disclosure of acquisition proposals and "truth in takeovers"

Similar to NYSE requirements regarding timely disclosure of material new developments, a company listed on ASX generally must make immediate disclosure of any information concerning the company that a reasonable person would expect to have a "material effect" on the price or value of the company's securities. Australian corporate law empowers the Australian Securities and Investments Commission (ASIC), Australia's principal corporate and securities regulator, to enforce this rule by means of both criminal proceedings and civil penalties, including the issuance of infringement notices or acceptance of enforceable undertakings.

Relevant in the context of takeover proposals, the ASX rules provide an exception from the general continuous disclosure obligation for information concerning an "incomplete proposal or negotiation," so long as the information remains confidential and a reasonable person would not expect the information to be disclosed. Despite the availability of the exception, however, Australian market practice regarding disclosure of acquisition proposals has been inconsistent, and it has occasionally been difficult in practice for target boards to determine when a confidential proposal is ripe for disclosure. To assist listed entities with compliance, ASX adopted a revised guidance note in 2013 (ASX Guidance Note 8) on continuous disclosure obligations. The guidance note specifically provides that negotiations between a listed entity and a third party will be deemed complete only when the parties enter into an agreement to implement or give effect to the transaction, thereby adopting an approach similar to US market practice.

Further complicating the issue of when and how to disclose acquisition proposals is ASIC's policy of "truth in takeovers," under which ASIC or another interested party may seek to hold a market participant to definitive public statements made in connection with an acquisition transaction. Where disclosure relating to a proposal is not sufficiently qualified as preliminary and nonbinding (even if the insufficiently qualified statement takes the form of a misquote or inaccurate reporting not promptly corrected), a party may be subject to regulatory action. For example, action may be taken by ASIC for misleading or deceptive conduct, or an application by ASIC or another interested party to the Australian Takeovers Panel (the Panel) for a declaration of unacceptable circumstances and associated relief.

In a 2012 decision, the Panel required a bidder that failed to correct inaccurate reporting of its intentions in the context of a competitive public tender offer to pay compensation to target shareholders who could establish to the satisfaction of an arbitrator that they were aware of the inaccurate press report and, at least in part, relied on it when selling target shares in the market. This and other recent Panel decisions exemplify the seriousness with which Australian regulators take violations of the "truth in takeovers" policy. Both bidders and targets in Australia must be particularly disciplined when making public announcements regarding their intentions in an acquisition context to ensure that their statements are sufficiently qualified and need to be vigilant in monitoring the press to correct inaccurate reporting promptly. The issue becomes a key governance matter from the outset of any public mergers-and-acquisitions transaction, as boards must put in place checks and balances and ensure that directors stay "on message" in discussion with the media.

Shareholder activism on the rise

While Australian activism has traditionally been undertaken by wealthy individual shareholders (as opposed to activist funds), and has often been conducted behind closed doors, the players and attitudes are clearly changing. The number of public activist campaigns is on the rise, with a record number of contested director elections commenced with respect to Australian companies in 2014 and a recent and highly public attempt by Perpetual Limited, a major Australian fund manager and an activist hedge fund, to unravel a long-standing cross-shareholding between prominent Australian companies Washington H. Soul Pattinson and Company Limited and Brickworks Limited, signalling that US-style shareholder activism is gaining acceptance in the market. Activists are assisted by the Australian corporate law regime—one of the most favorable to shareholders among major commercial jurisdictions.

In addition to the "two-strikes" rule described above, activists in Australia have a number of legal tools and advantages that are generally not applicable in attacks on Delaware corporations:

- *Ability to requisition or call a shareholders' meeting:* Directors of Australian companies must call a shareholders' meeting on the request of shareholders representing five percent of the votes to be cast at the meeting (currently, 100 shareholders can also do this, but proposals to change this are well advanced). The requisitioned meeting must be held within two months of the company's receipt of the request. Alternatively, those shareholders can call their own meeting and solicit proxies directly.
- *Ability to submit "spill" resolutions/ staggered boards ineffective:* Although Australian companies are permitted to set specified terms of directors of up to three years and are permitted to classify their boards specifically, shareholders representing five percent of the votes to be cast at the shareholders' meeting (or 100 shareholders currently) may propose a "spill" resolution to replace the board and appoint the shareholders' preferred nominees at any time.
- *Tactical poison pills constrained:* Although shareholder rights plans are not per se impermissible in Australia, an Australian company's ability to implement a tactical poison pill in the face of an unsolicited approach or activist accumulation is

constrained by an ASX requirement to obtain shareholder approval for any non–pro rata issuance of rights exercisable for more than 15 percent of the company's issued capital and by likely Takeovers Panel challenges in the face of defensive measures.

- *Directors' use of corporate funds restricted:* Directors of Australian companies are severely restricted from using corporate funds and resources to campaign against removal or appointment of a hostile slate.

Given the rise of well-funded activist hedge funds, this leaves Australian boards fundamentally exposed.

The emergence of shareholder activism in Australia means it is becoming increasingly important for Australian boards and management to be prepared and to understand how to deal with activist investors appropriately. As in the US, the initial response to an activist campaign is often pivotal to how things will eventually unfold.

Hong Kong

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Corporate governance in Hong Kong is regulated by a well-established legal and regulatory framework comprising common law, statutory laws, nonstatutory rules, and codes of practices.

For nonlisted companies incorporated in Hong Kong, the major sources of corporate governance rules are the Companies Ordinance (Chapter 622 of the Laws of Hong Kong) (the Companies Ordinance), the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32 of the Laws of Hong Kong), and precedent cases under the common law system.

For listed companies in Hong Kong, a much wider range of laws and regulations governing corporate governance issues applies. They include:

- The Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong), which regulates, among other things, disclosure of inside information by listed corporations, insider dealings in relation to listed companies, and disclosure by directors and substantial shareholders of their interests in shares in or debentures of listed companies
- The Rules (the Listing Rules) Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Stock Exchange), which cover various corporate governance issues, including protection of shareholders' rights, directors, and board practices as well as corporate reporting and disclosure. The Listing Rules also contain the Corporate Governance Code setting out the principles and recommendations of good corporate governance on various aspects of board practices that listed companies are required to comply with or explain in a corporate governance report to be contained in their annual reports.
- The Code on Takeovers and Mergers and the Code on Share Buy-backs, which provides a nonstatutory framework regulating takeovers, mergers, and share repurchases with a view to achieving fair treatment for shareholders who are affected by such activities. These codes also apply to nonlisted public companies.

Other than laws and regulations mentioned above, various professional bodies such as the Hong Kong Institute of Directors, the Hong Kong Institute of Certified Public Accountants, and the Hong Kong Monetary Authority publish guidance materials to promote good corporate governance.

Recent development—commencement of the new Companies Ordinance in March 2014

One of the most important recent developments of corporate governance in Hong Kong affecting companies incorporated in Hong Kong is the commencement of the new Companies Ordinance on March 3, 2014.

The Companies Ordinance provides the legal framework in relation to formation and operation of companies. It contains extensive provisions for safeguarding the interests of parties dealing with companies, including shareholders and creditors.

The current Companies Ordinance is the product of a comprehensive exercise started in mid-2006 by the Hong Kong government to rewrite the old Companies Ordinance (Chapter 32 of the Laws of Hong Kong) (the Old Ordinance). Effective from March 3, 2014, the core provisions of the Old Ordinance have been repealed and replaced by the current Companies Ordinance, while the remaining provisions that primarily cover corporate insolvency, winding up, disqualification of directors, receivers, managers, and prospectuses remain intact in Chapter 32 (which has been renamed the Companies [Winding Up and Miscellaneous Provisions] Ordinance) for the time being subject to further reforms in the near future. The Hong Kong government published in May 2014 the conclusions of the public consultation on the corporate insolvency law improvement exercise and the detailed proposals for introducing a statutory corporate rescue procedure and insolvent trading provisions, and an amendment bill is expected to be introduced into the Legislative Council in 2015. The provisions on prospectuses are expected to be moved to the Securities and Futures Ordinance, pending a separate review by the Securities and Futures Commission.

Some of the key changes brought about by the Companies Ordinance for enhancing corporate governance are outlined below:

- restricting the appointment of corporate directors by requiring every private company to have at least one natural person to act as director, to enhance transparency and accountability
- clarifying that a director of a company must exercise the level of care, skill, and diligence that would be exercised by a reasonably diligent person having (1) the general knowledge, skill, and experience that may reasonably be expected of a person carrying out the functions carried out by the director (the objective test), and (2) the general knowledge, skill, and experience that the director has (the subjective test)
- reducing the threshold requirement for members to demand a poll from 10 percent to 5 percent of the total voting rights
- requiring public companies and the larger private companies to prepare a more comprehensive directors' report that includes an analytical and forward-looking business review, while allowing private companies to opt out by special resolution
- widening the ambit of disclosure of material interests of directors in contracts of significance with the company to cover transactions and arrangements and to expand the coverage to include the material interests of entities connected with a director in the case of public companies
- introducing more effective rules to deal with directors' conflicts of interest, including: (1) expanding the requirement for seeking shareholders' approval to cover directors' employment contracts that exceed three years; (2) requiring disinterested shareholders' approval in cases where shareholders' approval is required for transactions of public

companies and their subsidiaries; and (3) requiring the conduct of directors to be ratified by disinterested shareholders' approval
- replacing the "headcount test" (ie the agreement by a majority in number of shareholders) with a not more than 10 percent disinterested voting requirement for privatizations and specified schemes of arrangement
- extending the scope of the unfair prejudice remedy to cover "proposed acts and omissions" so that a member may bring an action for unfair prejudice even if the act or omission that would be prejudicial to the interests of members is not yet effected.

In addition to enhancing corporate governance, the rewrite exercise also resulted in substantive amendments with the major objectives to ensure better regulation, facilitate business, and modernize the law.

The Companies Ordinance is one of the longest and most complex pieces of legislation in Hong Kong. Companies incorporated under the Old Ordinance (or its predecessors) and persons who plan to set up new companies in Hong Kong should seek timely professional advice to assist them in understanding the implications of the provisions under the Companies Ordinance.

Recent development—revised joint policy statement regarding the listing of overseas companies in Hong Kong

For overseas companies seeking a listing on the Stock Exchange, the Listing Rules provide that the Stock Exchange may refuse a listing of an overseas applicant if it is not satisfied that the overseas applicant is established in a jurisdiction where the standards of shareholder protection are at least equivalent to those provided in Hong Kong.

The Stock Exchange and the Securities and Futures Commission of Hong Kong published in September 2013 the revised joint policy statement regarding the listing of overseas companies in Hong Kong, which, among other things, has refined the key shareholder protection standards to ease the burden for overseas applicants. The changes include removing those standards where the relevant protection is already covered under the Listing Rules and broadening some standards to accommodate practices in other jurisdictions, for example, allowing certain matters to be approved by a "super-majority" vote of a two-thirds majority rather than applying Hong Kong's exact threshold requirements.

In December 2013, the Stock Exchange published 20 country guides for each acceptable overseas jurisdiction providing comprehensive and user-friendly guidance on how companies incorporated in these jurisdictions can meet the requirements for equivalent shareholder protection standards under the Listing Rules.

Hot-button issue—controversy over Alibaba's proposed "partnership structure"

One of the hottest topics in the Hong Kong capital market since 2013 is no doubt the listing plan of the China-based e-commerce giant, Alibaba Group Holding Limited (Alibaba).

Throughout 2013, the media reported that Alibaba had been in talks with the Hong Kong regulators on its proposed partnership structure in connection with a proposed listing in Hong Kong, which according to Alibaba was naturally its first choice because of the proximity between Hong Kong and China.

One of the fundamental corporate governance principles in the Hong Kong capital market, as set out in the Listing Rules, is to ensure that all shareholders are treated fairly and equally. Based on this guiding principle, all shares should carry the same voting rights. Specifically, the current Listing Rules do not allow the listing of any shares of which the proposed voting power does not bear a reasonable relationship to the equity interest of such shares.

A dual-class structure that contemplates one class of shares conferring different voting rights from another class of shares therefore, by definition, contradicts the "one-share-one-vote" principle. Back in 2011, Manchester United PLC, the English soccer giant, gave up its original first choice of listing venue, because the Hong Kong regulators refused to grant waiver to accommodate its dual-class structure. The structure purportedly proposed by Alibaba seems to be one that is somewhere in the middle: It proposed that Alibaba's partners, being the key people who manage its businesses, would retain control to nominate a majority of its board of directors despite that their aggregate shareholdings in Alibaba were less than 15 percent. Joe Tsai, a co-founder and executive vice chairman of Alibaba, thought that this partnership structure would "offer an alternative view of good corporate governance" because this would "set the company's strategic course without being influenced by the fluctuating attitudes of the capital markets so as to protect the long-term interests of our customers, company and all shareholders." Since the special right given to the partners does not bear a reasonable relationship to their shareholdings in the company, the proposed partnership structure may be regarded as in violation of the "one-share-one-vote" principle, albeit to a lesser extent than the usual dual-class structure that confers a superior voting power to one class of shares generally.

There have been diverse views in the Hong Kong market as to whether Hong Kong regulators should stand firm in defending the long-established core value of the "one-share-one-vote" principle or whether they should relax the rules for Alibaba or other technology companies in view of the substantial commercial gains their listings would likely bring to the market players in Hong Kong, or even change the rules generally so as to follow the trend of the other stock exchanges, for example, the New York Stock Exchange, to allow dual-class structures.

It would be relevant to briefly explain the overall regulatory approach in the Hong Kong capital market. Unlike the United States, which is in essence a disclosure-based regime that can thus accommodate innovative shareholding structures, Hong Kong regulators traditionally adopt a more parental approach. This is founded against a background that in the 1980s almost all listed companies were family-owned businesses, and even today, there is still a high concentration of ownership of listed companies in Hong Kong as compared to other stock markets around the world. The Hong Kong market also has the feature of a relatively larger population of retail investors in the public, who, compared with experienced institutional investments, may be less ready to fully appreciate the risks of any possible abuses by the controlling shareholders and/or the management even if such risks are fully disclosed in the listing documents. Coupled with the lack of a litigious culture among retail investors, the Hong Kong regulators may therefore see the need to continue the extensively proactive retail investor culture.

Alibaba has finally settled down in pursuing a listing in the United States. Yet, there are continued voices, including the chief executive of the Stock Exchange and the Hong Kong Financial Services Development Council, urging more thorough discussion on whether we should always stand firm on the "one-share-one-vote" principle or give room for some companies with weighted voting right structures (namely, governance structures that give certain persons voting power or other related rights disproportionate to their shareholding) where there are sound commercial or legal reasons. Finally, in August 2014, the Stock Exchange published a concept paper to kick off a public consultation process seeking views on the acceptability of the concept of weighted voting right structures. Depending on the views garnered by end of November 2014, the Stock Exchange may then proceed to launch a second stage formal consultation on the details of the necessary rule changes.

Japan

Hiroki Kodate, Partner, and Keita Tokura, Partner Anderson Mori & Tomotsune

The amended Companies Act, which was enacted on June 27, 2014 and is expected to come into effect in April or May 2015, is the most important and current development in Japanese corporate governance. Concerns about the transparency and effectiveness of the governance of Japanese listed companies have been increasing, particularly following recent "governance failure" incidents such as the Olympus Corporation and Daio Paper Corporation cases. One of the purposes of the Companies Act amendments is to facilitate the reform of Japanese companies' corporate governance structures in order to overcome these concerns.

The two major topics of these reforms are: (1) the introduction of a new governance structure called the "Audit Committee System"; and (2) enhanced disclosure obligations for outside directors.

The Audit Committee System

Background

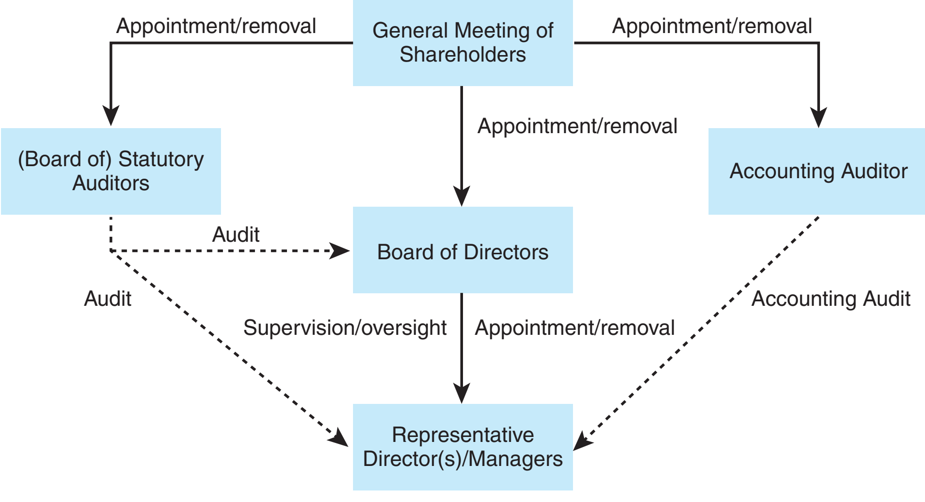
There are two governance structures currently available to listed companies in Japan: the Statutory Auditor System and the Full Committee System. The Statutory Auditor System is the traditional, two-tier board system, while the Full Committee System is a relatively new structure introduced in 2003 as an alternative. According to the Tokyo Stock Exchange (TSE), 97.8 percent of all companies listed on the TSE use the Statutory Auditor System, while only 2.2 percent use the Full Committee System (source: TSE-Listed Companies White Paper on Corporate Governance 2013).

The frameworks of the Statutory Auditor System and Full Committee System as discussed in this white paper relate only to the "statutory minimum" provided by the Companies Act. Many listed companies in Japan voluntarily adopt their own governance structures; for example, utilizing voluntary-based bodies such as management advisory boards.

Statutory Auditor System

The structure of the Statutory Auditor System is shown in Figure 1.

Figure 1 Structure of the Statutory Auditor System



Statutory auditors are distinct from an accounting auditor. An accounting auditor is an independent certified public accountant (CPA) or auditing firm (as a body corporate) appointed by the company to conduct external accounting audits on the company. In contrast, statutory auditors, who are also board members of the company, monitor the directors and managers of the company from both an accounting and operational standpoint. Statutory auditors must be natural persons and, therefore, cannot be a corporate entity, such as an auditing firm.

Although statutory auditors are not directors of the company, they are appointed and may be removed via a resolution of the general meeting of shareholders in the same manner as a director. In order to fulfill their monitoring responsibility, statutory auditors are obliged to attend all meetings of the board of directors and express their opinion to the board when necessary. However, statutory auditors do not have a right to appoint or remove directors or managers of the company and have no voting rights in relation to any matters to be resolved by the board of directors.

Most listed companies in Japan with the Statutory Auditor System are required to have a board of statutory auditors, which is a supervisory body consisting of the company's statutory auditors. The minimum number of statutory auditors for such listed companies (ie those with a board of statutory auditors) is three, at least half of which must be "outside" statutory auditors.

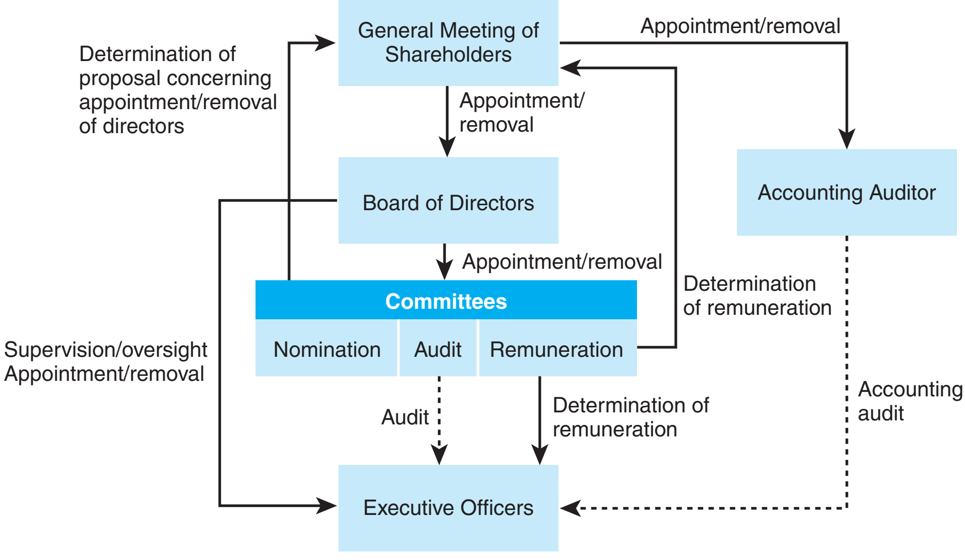
To qualify as an "outside" statutory auditor, a person must not be, and must have never been, a director, executive officer, or employee of the company or its subsidiaries (note that with the Companies Act amendments, the definition of "outside" has been changed to require more independence; for instance, an employee of the parent company of the listed company would disqualify as an "outside" statutory auditor).

In contrast, under the Statutory Auditor System a company is not obligated by law to have any "outside" directors.

Full Committee System

The Full Committee System has some similarities to a US-style governance structure. Under this system, no statutory

Figure 2 Structure of the Full Committee System



auditors are appointed. Rather, a company has three committees: the nomination committee, the remuneration committee, and the audit committee, as shown in Figure 2.

Each committee is composed of at least three directors and a majority of members in each committee must be outside directors. Therefore, unlike the Statutory Auditor System, appointment of outside directors is mandatory. For a director to qualify as an "outside" director they must not be and must never have been an executive director, executive officer, or an employee of the company or its subsidiaries (see the change of the "outside" definition as discussed above).

The supervision/oversight and business execution functions are divided between directors and executive officers. Under the Full Committee System, the directors, whose term of office is one year, are primarily responsible for the oversight of executive officers. Executive officers, who are appointed by the directors, conduct business executions within the scope of the authority delegated to them by the directors.

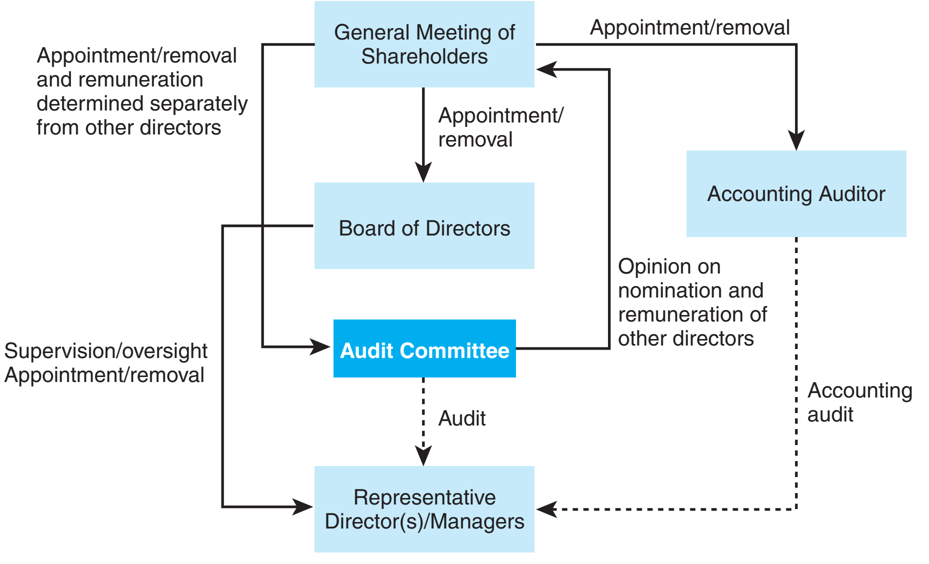
New governance system—Audit Committee System

The Audit Committee System is an alternative governance structure newly introduced by the amendments to the Companies Act. This structure is a hybrid of the Statutory Auditor System and the Full Committee System, as shown in Figure 3.

Under the Audit Committee System, the audit committee is expected to monitor directors and other managers. No statutory auditors may be appointed. A majority of members of the audit committee must be outside directors. Unlike the Full Committee System, the Audit Committee System does not require the establishment of a nomination committee or a remuneration committee. Instead, members of the audit committee are entitled to give their opinion regarding the nomination and remuneration of non-audit-committee-member directors at shareholders' meetings.

The appointment, removal, and remuneration of audit-committee-member directors will be determined at the shareholders' meeting, separately from other directors. The term of office for audit-

Figure 3 Hybrid structure of the Statutory Auditor System and Full Committee System



committee-member directors is two years, while the term of office for other directors is one year.

The Audit Committee System will be introduced on an "opt-in" basis; the same method used to introduce the Full Committee System in 2003. This means that a company wanting to adopt the new system may choose to do so by changing its articles. For listed companies that currently use the Statutory Auditor System, the Audit Committee System may be a more viable alternative than the Full Committee System as it would require less drastic changes to the company structure.

Enhanced disclosure obligations for outside directors

Background

In recent years, an increasing number of Japanese public companies have voluntarily appointed outside directors. In 2014, for instance, it was reported that Canon Inc. and Nippon Steel & Sumitomo Metal Corporation welcomed outside directors on the board for the first time. This trend is thought to be at least partially in response to the ever-increasing demand of investors for transparent and effective corporate governance in Japanese listed companies. This is evidenced by some proxy adviser firms opposing the renewal of chief executives' terms at companies with no independent directors. However, as discussed above, an overwhelming majority of listed companies, which adopt the Statutory Auditor System, are not currently required by law to have any outside directors on the board.

New "comply or explain" approach

Over the years there has been contentious discussion among business communities, academics, investors, regulators, and other market participants in Japan regarding whether a listed company should be required by law to have a certain number of outside directors. However, these discussions did not ultimately lead to the inclusion of such an obligation in the amendments. Instead, the amended Companies Act contains a new "comply or explain" rule, under which reporting issuers (notably, listed companies) that do not have any outside directors on the board must disclose in their annual business reports "why the company believes that having outside directors is not appropriate." This rule may, in effect, encourage or even force listed companies to appoint outside directors.

The new "comply or explain" approach, together with a newly-introduced restriction on the definition of "outside" director, are indicative of the fact that the amendments aim to utilize outside directors to bring enhanced transparency to the corporate governance of Japanese public companies.

"Independent" requirement under the stock exchange rules

The stock exchange rules also regulate the corporate governance of listed companies. Since 2009, the TSE has required listed companies to appoint at least one "independent" director or "independent" statutory auditor and notify the TSE of this appointment. An "independent" director or statutory auditor is defined under the TSE regulations as an "outside" director or statutory auditor who is unlikely to have conflicts of interest with general shareholders of the company. Accordingly, not every "outside" director or statutory auditor can qualify as an "independent" director or statutory auditor. Consequently, even under the TSE regulations, listed companies are not required to have any "outside" directors on their board.

However, on February 10, 2014, the TSE amended its regulations to oblige companies to "make efforts" to have at least one "independent" director (not statutory auditor) on the board. This amendment has further encouraged more listed companies to appoint more "independent" (hence, "outside") directors at annual general meetings of shareholders in 2014. According to the TSE's announcement on June 17, 2014, 74.2 percent of companies with shares listed in the first section of the TSE now have at least one "outside" director and 61.0 percent of companies in the same category have at least one "independent" director.

Supplemental note: On June 27, 2014, the Prime Minister, Shinzo Abe, announced the revised "Japan Revitalization Strategy - 10 Key Reforms". One of the key reforms is to enhance corporate governance. It was also announced that the government will assist the TSE in drafting the corporate governance code, which outlines the principles of corporate governance for listed companies. The details of the draft code have not yet been disclosed, but it is likely to further progress governance reforms in Japan.

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Ms. Parrish's client experience is varied having worked across industries spanning retail, consumer, education, real estate, media, and financial services while now largely focusing her time on capital markets communication programs for retail and consumer companies. She has led ongoing programs for a variety of retailers such as Office Depot/Max, Aeropostale, Lumber Liquidators, Guitar Center, Talbots, Dollar General, and consumer companies such as International Flavors & Fragrances, Hanesbrands, Movado Group, and Jarden.

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Paul Schulman joined MacKenzie Partners in October 2010 and has over 20 years of experience in the proxy solicitation industry. He is primarily responsible for representing clients in friendly and contested mergers and acquisitions, going-private transactions, proxy contests for board seats, and a broad range of shareholder approval issues. He also counsels clients on governance and compensation issues and advises companies on responses to shareholder proposals. Mr. Schulman has extensive experience as the lead on over 100 contested solicitation assignments, representing corporate issuers, shareholder groups, activist institutions, and hedge funds.

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Tom Campbell is the leader of Pillsbury Winthrop Shaw Pittman's Crisis Management team. Mr. Campbell counsels US and multinational corporations facing financial and reputational loss associated with a crisis. Typically, these matters require a multidisciplinary response involving public relations, government relations, and litigation.

Mr. Campbell's significant representation includes acting as team leader for the crisis management group that advised a 10 percent leaseholder of the *Macondo* well on a billion dollar settlement related to the 2010 *Deepwater Horizon* accident and oil spill in the Gulf of Mexico. Mr. Campbell also recently oversaw a foreign conglomerate's internal investigation and integrated response to sensitive military, legal, and political issues that jeopardized a multi-billion dollar financing.

Mr. Campbell's global perspective and emphasis on strategic planning and policy are reflective of his experience in Washington, D.C. as the former General Counsel of the National Oceanic and Atmospheric Administration (NOAA). At NOAA he led the federal assessment of the natural resource damage claim for the *Exxon Valdez* oil spill and played a pivotal role in the associated $1 billion natural resource damage settlement.

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Nicholas Krohn is a member of Pillsbury Winthrop Shaw Pittman's Crisis Management team. His practice focuses on crisis liability management and emergency response.

Mr. Krohn works closely with Tom Campbell and has made significant contributions to the representative matters described above. He is familiar with all facets of a multidisciplinary response—including, public relations, government relations, litigation, and internal investigations. This experience allows him to act as a "crisis coordinator," the attorney responsible for coordinating a multidisciplinary crisis management team. He also regularly counsels the large companies who are looking to proactively strengthen their crisis management capabilities.

Prior to his legal career, Mr. Krohn proudly served as a light infantry soldier in the US Army's 101st Airborne Division (Air Assault).

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Fusae Nara is a partner in the law firm's Litigation practice and a lead in the Crisis Management focus team. She has significant experience in complex commercial litigations, including class actions, with a strong record of securing favorable out-of-court settlements on behalf of her clients. Ms. Nara has extensive experience in both court-sponsored and private mediations. Her extensive litigation experience is an asset to the Crisis Management team as crises typically require this type of knowledge.

Ms. Nara brings an understanding of the business ramifications of legal disputes to each matter and works with her clients to develop common sense business solutions. Her previous work in the legal department of a major Japanese corporation provided her with an understanding of the dynamics of multinational corporations and the delicate relationship with their respective government authorities. Ms. Nara also represents clients in a wide variety of issues associated with importation of goods into the US by providing most cost-effective solutions. Her clients appreciate her talent, experience, and passion in resolving difficult problems and express how much they enjoy working with her.

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Stella Pulman is a senior associate in Pillsbury Winthrop Shaw Pittman's Environment, Land Use, & Natural Resources practice and is a member of the Crisis Management team. Her practice is focused on environmental compliance, emergency response and crisis management, internal investigations, EHS management systems reviews, and management of complex environmental liabilities. She regularly advises clients on matters involving crisis events, including refinery and pipeline explosions, oil spills, and other major industrial accidents. In addition, she frequently works with clients to address environmental remediation issues, natural resource damage liabilities and restoration, hazardous waste management, and regulatory compliance under state and federal environmental laws. Ms. Pulman also regularly provides clients with comprehensive reviews of their environmental, health, and safety management programs and systems, including evaluation of compliance assurance, performance, process safety, and management oversight of EHS.

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Ms. Hamberg writes, edits, and publishes *The SVC Digital Scoop*, a monthly newsletter about hot topics in social media. She speaks regularly on social media issues before internal forums.

Prior to joining Sard Verbinnen, Ms. Hamberg interned at Cohn & Wolfe, a public relations firm (2010). Ms. Hamberg has published articles about social media issues in *Directors and Boards* (March 2013) and *O'Dwyer's* (April 2012). She holds a BFA degree from Cornell University (2010).

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Mr. Ogden draws from direct board experience for client work, currently serving on the board of the American Business Conference, an organization that includes the CEOs of emerging growth companies. He is also secretary and a director of Project HOPE, a leading health-care foundation based in Washington, D.C.

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