Governance Challenges: 2015

A Publication of the
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Foreword

On behalf of the National Association of Corporate Directors (NACD), I am pleased to share *Governance Challenges: 2015*.

Now in its fourth year, *Governance Challenges* is a unique publication series for NACD. We ask our strategic content partners—Heidrick & Struggles, KPMG's Audit Committee Institute, Marsh & McLennan Companies, Pearl Meyer & Partners, and Sidley Austin—to provide their respective guidance on the areas they believe will present challenges for directors and boards in the coming year.

This year's submissions discuss imperatives for board leadership in a complex, changing environment. Common themes include the importance of early engagement in discussions of strategy, risks, and succession planning in the boardroom, as well as the need for proactive communication and engagement with shareholders and other key stakeholders.

It is well known that the expectations for, and obligations of, directors have continued to expand in the years since the financial crisis. Today, exemplary board leadership requires directors to keep a steady eye on long-term corporate and boardroom objectives while remaining aware of the many risks and opportunities that may lie just around the corner. This publication will help directors to maintain those critical lines of sight.

Kenneth Daly
April 2015

Early Engagement: Going Beyond Traditional Board Succession Planning

By Heidrick & Struggles

AN UNHAPPY SURPRISE. The news of the activist investor's arrival came with a copy of the Schedule 13D filing, provided by the Securities and Exchange Commission (SEC). The investor had waited the full 10 days—the maximum time allowable—to disclose that he had passed the 5 percent ownership threshold. The 13D was followed quickly by an open letter harshly indicting the company's strategy and questioning its ability to right itself. Soon after, the activist proposed replacing three of the company's directors with candidates of his choosing.

The board and management were caught flat-footed, having thought that the company was not on any activists' radar screens. Now, not only did they believe the investor's proposed strategy was flawed, but they didn't know his director candidates and had no viable alternatives to propose (i.e., candidates who would both satisfy the activist and make desirable colleagues). Under threat of a proxy fight that would distract attention from running the business, the board conceded the three seats.

STATES OF EMERGENCY. An activist investor's sudden appearance isn't the only circumstance that can expose the consequences of insufficient board succession planning. So, too, can the unexpected departure of directors, multiple retirements, underperformance by one or more directors, or strategic evolution that spotlights the need for new skills on the board.

The board of a leading financial services company, for example, waited until it was only two years away from four nearly simultaneous retirements to begin addressing succession. Two of the departing directors were committee chairs, further complicating matters. In such circumstances boards often act hastily, settling for candidates who may be ill-suited to the board's culture and do little to enhance its composition. Moreover, time spent in firefighting mode is time lost from other strategic priorities.

PLAY CHESS, NOT CHECKERS. Leading boards increasingly take an approach to board succession that goes beyond traditional placement and even planning. At its most advanced, this approach includes establishing relationships with potential candidates even when foreseeable board vacancies lie far in the future. At a minimum, it involves identifying robust candidates across the various sets of competencies the board might need down the road, and then keeping tabs on them, looking for opportunities to get to know these individuals, and learning how they might one day fit into the company's future.

By contrast, many boards simply replace a departing director with someone who possesses similar skills or experience—an industry expert with an industry expert, a CFO with a CFO, and so on. Other boards, insisting that they engage in succession planning (and not merely placement), attempt to look ahead to the talent implications of the company's strategic priorities. They understand that simply replacing "like with like" freezes the composition of the board, rendering certain skills less relevant as the industry and company strategy change. For example, if management foresees the need to swing decisively away from organic growth to growth through acquisition, the board would seek someone with extensive M&A experience. While that's smart, the approach can still occasionally result in shortsighted searches for particular kinds of candidates at particular times. When taken to extremes, it can even result in counterproductive herd behavior, as was the case in the late 1990s when some companies sought to bulk up on boards' IT skills in anticipation of Y2K problems that failed to arrive. While such skills are, of course, useful for boards to have, the risk is that companies wind up with long-term solutions to what are ultimately short-term problems.

The approach employed by the boards of leading companies goes several steps further. These boards

- **Manage foreseeable vacancies and skill sets as a portfolio.** Through detailed assessment, boards can identify critical gaps in their committees or expertise, and zero in on the skills they will need. They can then develop a competency index that enables them to manage succession planning holistically, not as a series of one-offs. For example, if several vacancies are to occur within a few years of one another, the board could conduct searches simultaneously. As with traditional succession planning, the board projects the mix of skills it will need. But instead of looking single-mindedly for a candidate with a particular skill in successive searches, the board begins the search for all pending vacancies at the same time. Or they might find a prospective board member who brings a combination of the necessary skills, thus freeing the board to close still other gaps in later appointments. Taking a portfolio view often leads to pleasant surprises, as it did for a global company that found a single board member with both CEO experience and Silicon Valley know-how—skills the company might previously have sought from two people at different times.
- **Continually identify a broader range of potential candidates to address expected (and unexpected) vacancies.** The board of a leading consumer products company, for example, maintains what they call an "evergreen book" of 40–50 potential candidates they keep their eye on from year to year. Similarly, the board of a leading financial services company, facing four vacancies in the next five years, conducts periodic "lit searches" and at any one time is aware of a dozen or so potential candidates.
- **Engage potential candidates before they are needed.** Activist investors, for example, are well aware of annual meeting cycles, and they use this time pressure to push through their proposed director candidates. Boards must, therefore, either be able to conduct rapid searches for world-class alternative candidates or face the prospect of a proxy fight. Boards that have already engaged with candidates and gotten to know them will not only understand who would best fit the bill but also who has the stomach to enter the fray. Moreover, these candidates will better know the company. We find that this knowledge not only gives the company an edge in convincing sought-after executives to join the board but also helps to ensure a faster, more productive start when they do.
- **Anticipate cultural fit.** As directors know, the culture and dynamics of a board can make all the difference between an effective board and a dysfunctional one. Through proactive engagement, board members can get a sense of how potential candidates might improve upon (or poison) the atmosphere of candor and collegiality that effective boards require. To be sure, boards will, and frankly should, have their differences. Nonetheless, in high-performing boardrooms this normal blend of personalities and viewpoints is a productive force—not a destructive one.
- **Understand how board culture and company culture support strategy.** Boards are not teams in the typical sense; they are collections of individuals from different operating environments who meet for a few days several times a year. By contrast, the companies they oversee tend to comprise more closely knit teams and individuals who work together daily to create and reinforce a distinctive and deep company culture, whatever it may be. While a board's culture is real, it is far more tenuous than the culture of the company it oversees. How board culture intersects with company culture can be critical, both for the success of the company and in shaping the culture of the board itself. For example, we have observed how a company culture that thrives on learning and "failing fast" may baffle and frustrate a new board member from a performance culture, where target-setting and table-pounding are the norm.

  The challenge, however, is to create not a board culture that mimics the company's culture but a board culture that is *appropriate* for the company's culture. For example, a high-growth, innovation-focused company in a fast-paced industry might be best served by a board with a more informal, highly transparent culture that surfaces issues quickly and with little bureaucracy. Similarly, a new CEO looking to change a company's culture might look to the board as a place to model the necessary behaviors. Boards that engage with potential candidates over time and continually reflect on board and company culture come to better understand both cultures at a deeper, more meaningful level.

WHERE TO LOOK. A board's pool of potential directors should include "ready now" candidates, such as sitting or retired CEOs and other leaders with industry or general management experience. The pool should also include outstanding leaders who are not available now but could become so later: sitting CEOs or CFOs with restrictions on board service, government officials, directors who are now fully "boarded up" but might not remain so, and industry "rock stars" with CEO potential.

Most CEO candidates will be highly visible and, in many cases, already known to boards. In identifying additional potential candidates—the next generation of directors—the board may need to look to large, U.S.–based global companies known for best practices in talent development, to non-U.S. global companies, and to private companies in which private equity firms have installed short-term CEOs to stabilize the business until a liquidity event.

In any case, the pool should be managed against the board's competency index. So, for example, the list might include outstanding CIOs if customer privacy and cybersecurity are essential to the business, CMOs if a customer-centric perspective is gaining importance, or general counsels with deep M&A experience if the company's ambitions point to inorganic growth.

A LIGHT TOUCH. Boards will differ in how they engage with potential candidates, but the process is usually jointly owned by the CEO and an independent director. In some cases, the CEO takes the initial meeting with potential candidates. In others, the lead director or a member of the nominating committee makes initial contact. In all cases, the encounters should be informal, get-acquainted sessions, not formal interviews. If the company's CEO and a potential candidate happen to both be at a meeting of, say, the Business Roundtable or at Davos, then dinner or drinks might be arranged. Some meetings, however, may inevitably take place in an office setting, where special pains should be taken to maintain a light touch.

Such meetings should be approached informally. The point is to get to know the person, their interests, their style, and potential fit. The subject of board membership should be brought up only as a casual point of conversation, with no commitment to timing and no assurance that discussion will move forward. Nonetheless, when handled well, these conversations can help a company to gauge the potential board member's personal style and particular competency-based strengths, as well as how he or she thinks, makes decisions, and leads.

AVOID THE PITFALLS. Taking a more advanced approach to succession planning is not without its challenges. Chief among them is managing the expectations of potential candidates. You should make it clear to them at the outset that meetings with them are not formal interviews or the beginning of a search. Why, then, should they agree to meet? Because the worst that can happen is that they have made contact with the CEO and board of a prominent company and established relationships that could lead in any number of directions—in short, networking at the highest levels. The prospect of having a substantive conversation with their peers can be a powerful motivator, and many are happy to join such discussions for the learning opportunities they provide.

Some independent directors, too, might have reservations about the process, seeing it as ceding too much power to the CEO in what is ultimately a board responsibility. Here again, some expectation-setting may be in order: engagement is not the same as looking to fill a position, and the board should retain its full prerogatives in appointing directors.

Perhaps the biggest challenge for the board is to maintain the discipline and focus to persevere in what might appear to be a task with a hazy, distant goal. And time has become an even scarcer commodity as the responsibilities of directors continue to increase in number, intensity, and scope. Nonetheless, by spending time inside and outside of board meetings identifying and engaging with potential colleagues, boards can reap big dividends, enabling them to

- respond faster, more flexibly, and more effectively to unforeseen events;
- refuse to settle for less-than-ideal candidates;
- evolve the board in step with the company's long-term strategy; and
- strengthen the board's culture, both through thoughtful appointments and the board's better understanding of that culture.

As we have found, once the process begins to pay off—in a faster search in an emergency, the successful recruitment of an accomplished leader, a rapid and smooth onboarding of a new director, or the fine-tuning of the board's culture or mix of skills—board members get firmly behind it. This is particularly true when a board encourages a highflier to join, as was the case for the board of a U.S. consumer-goods company that first engaged with a future director two years in advance of the eventual opening.

CONCLUSIONS: The bar for board performance will continue to rise, and the board's oversight role will continue to grow. In response, boards should adopt holistic, long-term approaches to succession planning that include the early engagement of potential colleagues. Boards that do so will give themselves a perpetual head start on one of their most important responsibilities.

Are You Ready?

Boards can start by asking themselves three questions:

1. How would we describe our board's culture to a potential board member, and how does it differ from our ideal?
2. What's our five-year plan for filling director vacancies? (Do we look ahead or replace "like with like"?)
3. Is our board's competency index a subject of regular updates and conversation, or is it gathering dust? The nominating committees of high-performing boards revisit the topic quarterly.

On the 2015 Audit Committee Agenda

By KPMG's Audit Committee Institute

Prioritizing a heavy audit committee workload is never easy, and 2015 will continue to be challenging given developments in the global risk, regulatory, and political environments. Drawing on insights from our latest survey work and interactions with audit committees and business leaders over the past 12 months, we've flagged 10 things that audit committees should keep in mind as they consider and carry out their 2015 agendas.

MAINTAIN (OR REGAIN) CONTROL OF THE COMMITTEE'S AGENDA. Half of the 1,500 audit committee members we surveyed recently said it's increasingly difficult to oversee the major risks on the audit committee's agenda in addition to its core responsibilities (financial reporting and related internal controls, and oversight of internal and external auditors). Take time to reassess whether the committee has the time and expertise to oversee other major risks—such as cybersecurity and IT risks, supply chain and other operational risks, and legal and regulatory compliance. Does cyber risk require more attention at the full board level? Given the challenges posed by global economic conditions and geopolitical risks as well as new competitors and technologies, the risk of mission creep will be high in 2015. Keeping the audit committee's agenda focused—and its eye on the ball—requires discipline and vigilance.

QUALITY FINANCIAL REPORTING STARTS WITH THE CFO AND FINANCE ORGANIZATION; MAINTAIN A SHARP FOCUS ON LEADERSHIP AND BENCH STRENGTH. Nearly 60 percent of the directors we surveyed globally said their company does not have a formal succession plan for the CFO. Not good. Given the critical role the CFO plays in maintaining financial reporting quality—and the high rate of CFO turnover—the company should have a succession plan in place for the CFO (and other key finance executives, e.g., the controller, chief accountant, chief audit executive, treasurer, and perhaps the chief compliance and chief risk officers). How does the audit committee assess the finance organization's talent pipeline? Do they have the training and resources they need to succeed? How are they incented to stay focused on the company's long-term performance? What are the internal and external auditors' views?

MONITOR FAIR VALUE ESTIMATES, IMPAIRMENTS, AND JUDGMENTS OF THE KEY ASSUMPTIONS THAT UNDERLIE CRITICAL ACCOUNTING ESTIMATES. A company's greatest financial reporting risks are often in those areas where there is a range of possible outcomes and management must make difficult judgments and estimates. The Public Company Accounting Oversight Board (PCAOB) has expressed concern about adverse inspection findings pertaining to critical accounting estimates, and the U.S. Securities and Exchange Commission's (SEC's) use of data analytics to look for outliers in MD&As points to heightened scrutiny in this area.[1] The message: quality financial reporting requires a disciplined, robust, and unbiased process to develop accounting judgments and estimates. To that end, understand management's framework, make sure that management has appropriate controls in place, and ask for the external auditor's views.

UNDERSTAND THE IMPLICATIONS OF FASB'S NEW REVENUE RECOGNITION STANDARD AND OTHER ACCOUNTING CHANGES ON THE HORIZON. In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) finalized a converged, principles-based standard on revenue recognition that will change the way many U.S. companies recognize revenue from customer contracts. The standard isn't effective until Jan. 1, 2017, for calendar-year-end companies (and the FASB is assessing whether to delay the implementation date), but it will have a significant impact across the company—from systems, data, and accounting processes to controls and business contracting processes. Companies should already be developing transition plans and identifying areas that require close attention. Also, stay apprised of other FASB projects, such as leases, financial instruments, and insurance, which have significant implications not only for the company's financial reporting and accounting but also for staffing, resources, and IT systems.

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[1] SEC's Division of Enforcement, Financial Reporting and Audit Task Force.

UNDERSTAND THE COMPANY'S DOMESTIC AND INTERNATIONAL TAX POSITIONS AND THE (VERY REAL) IMPLICATIONS FOR THE BRAND. Pay particular attention to the global "tax transparency and morality" debate being driven by notions of "fairness" and "morality," and consider the impact of tax risk on the company's reputation. Tax is no longer simply an expense to be managed; it now involves fundamental changes in attitudes and approaches to tax globally. Ensure that tax decisions take into account reputational risks and not simply whether the company has technically complied with tax laws. Monitor efforts by the Organisation for Economic Co-operation and Development (OECD) and governmental efforts globally to address perceived transfer pricing abuses (e.g., in October, 38 countries reached agreement on automatic sharing of tax information). Stay apprised of the federal tax-reform debate in Washington, and consider the impact of likely tax legislative scenarios (particularly with a Republican-controlled Congress). Help shape the company's tax risk appetite, and establish a clear communications protocol for the chief tax officer to update the audit committee regularly. Help ensure the adequacy of the company's tax resources and expertise globally.

CONSIDER WHETHER THE FINANCIAL STATEMENTS AND OTHER DISCLOSURES TELL THE COMPANY'S—AND THE AUDIT COMMITTEE'S—STORY. Investors want to understand the company's story. Consider how the company's disclosures—and the audit committee's—can be improved to better tell that story. Think about going beyond what's required to provide a clear picture not only of the company's recent performance but also of where it's headed and the key risks it faces. In addition to traditional financial metrics, can the company provide investors with greater insight into the drivers of long-term growth, such as customer satisfaction, talent, and innovation? Get a briefing on the SEC and FASB projects to reassess the rules that underpin their disclosure regimes, and consider the recommendations of the Audit Committee Collaboration Group (which includes the National Association of Corporate Directors [NACD] and the Center for Audit Quality [CAQ]) on ways to enhance the audit committee's reporting and communication to shareholders. (See *Enhancing the Audit Committee Report: A Call to Action*, footnoted below.) Given the audit committee's critical oversight role, "it is important for investors and others with a stake in the financial markets to understand and have confidence in the committee's work."[2]

STAY APPRISED OF PCAOB PROPOSALS—AND GLOBAL AUDIT REFORM INITIATIVES—POTENTIALLY IMPACTING THE EXTERNAL AUDITOR'S ROLE AND RELATIONSHIP WITH MANAGEMENT AND THE COMPANY. The PCAOB has a number of initiatives focused on enhancing auditor independence, objectivity, and professional skepticism. In particular, PCAOB projects on the inspection process and proposed changes to the auditor's reporting model may have a significant impact on the audit process and the auditor/management relationship. From expanding the auditor's report (to include discussion of critical audit matters and the auditor's responsibilities related to fraud) to evaluating information outside of the financial statements, your external auditor's report may change dramatically. That could impact your company because the report will be included in your company's financial statements. Regulators in the European Union and around the world have undertaken similar initiatives (on auditor reporting, auditor tenure/mandatory rotation, and restrictions on non-audit services), which may create inconsistencies across jurisdictions that could affect certain subsidiaries of U.S. multinationals. Stay apprised of these projects, and take the lead on ensuring audit quality. Set the tone and clear expectations for the external auditor, and actively monitor auditor performance through frequent, quality communications, both formal and informal.

MAKE SURE THE COMPANY'S ETHICS AND COMPLIANCE PROGRAMS ARE KEEPING UP WITH NEW VULNERABILITIES TO FRAUD AND MISCONDUCT. Globalization, information technology, and fast-changing business models have, in many ways, created a Wild West. Moving quickly to capitalize on opportunities in new markets, leveraging new technologies and data, and engaging with more vendors and third parties across longer and increasingly complex supply

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[2] Audit Committee Collaboration Group, *Enhancing the Audit Committee Report: A Call to Action* (Washington, DC: NACD, 2012), 3, www.nacdonline.org/Resources/Article.cfm?ItemNumber=12967.

chains heighten the risk of fraud and corruption. Coupled with the complex global regulatory environment—the Foreign Corrupt Practices Act (FCPA) and the U.K. Bribery Act, the SEC's whistleblower program, and the sheer volume and scope of new regulations—these vulnerabilities will require vigilance. Help to ensure that the company's regulatory compliance and monitoring programs cover all vendors in the global supply chain and clearly communicate the company's expectations for high ethical standards. The SEC's shift from a "neither admit nor deny" settlement policy to requiring admission of wrongdoing in certain cases has heightened the reputational risk of ethics and compliance lapses. Recognize that the radical transparency enabled by Twitter, YouTube, Facebook, and other social media has effectively put every company in a fishbowl: the company's culture and values, commitment to integrity and legal compliance, and its brand reputation are on display as never before.

POSITION INTERNAL AUDIT TO BE AN INDISPENSABLE RESOURCE. At a time when audit committees are wrestling with heavy agendas and when issues like cybersecurity and global compliance are putting risk management to the test, internal audit should be a crucial voice on risk and control matters. (One out of every two audit committee members we surveyed said internal audit should be delivering greater value to the organization.) That means focusing not just on financial reporting and compliance risks but also on critical risks to the business—key operational and technology risks and related controls. Does internal audit have the stature—and a direct line to the audit committee—to ensure that its voice is heard and valued? Leverage internal audit as a barometer of the company's financial and operational health, helping the audit committee understand the quality of financial and operational controls, processes, and people. "High-performing departments stand apart in their mind-set and how they approach their work," says the Institute of Internal Auditors' (IIA's) CEO Richard Chambers. "They grasp the importance of delivering value, and they are seen by stakeholders as an indispensable resource."

MAKE THE MOST OF THE AUDIT COMMITTEE'S TIME TOGETHER: *EFFECTIVENESS REQUIRES EFFICIENCY.* As we noted in the first item on this list, keeping the audit committee's agenda focused on financial reporting and related internal control risk is essential to the committee's effectiveness; but meeting the workload challenge requires efficiency as well. Streamline committee meetings by insisting on quality pre-meeting materials (and expect pre-read materials to have been read), making use of consent agendas, and reaching a level of comfort with management and auditors so that financial reporting and compliance activities can be addressed efficiently, thus freeing up time for more substantive issues facing the business. Do we leverage the array of resources and perspectives necessary to support the committee's work? Do we spread the workload among audit committee members, rather than relying on the audit committee chair to shoulder most of the work? Do we spend time with management and the auditors outside of the boardroom to get a fuller picture of the issues? Take a hard, honest look at the committee's composition, independence, and leadership. Is there a need for a fresh set of eyes? Is it time for a rotation?

On the 2015 Board Agenda

The challenges for companies and their boards in 2015 will be intense, with a volatile economic and geopolitical landscape, the accelerating speed of technology change, and competitive disruption topping the list. The spotlight on corporate directors continues to intensify as regulators and investors (including activists) scrutinize the board's contribution to strategy, risk, and compliance. Drawing on insights from our interactions with directors and business leaders over the past 12 months, we've distilled eight recommendations that boards should keep in mind as they consider and carry out their 2015 agendas.

MAKE TIME TO READ THE NEW *REPORT OF THE NACD BLUE RIBBON COMMISSION ON STRATEGY DEVELOPMENT.* The complex, volatile, and uncertain business environment today has made the "annual review and concur" model of the board's oversight of strategy obsolete. Globalization, new technologies, upstart competitors, and all the what-ifs looming on the horizon require a frank reassessment of the board's role in strategy. The NACD Blue

Ribbon Commission report released in October 2014 proposes a framework for deeper board engagement in strategy—from formulation, monitoring execution, and testing the continuing validity of assumptions to recalibrating strategy throughout the year—and advocates for changing the board's "strategic rhythm."[3] Use the report to benchmark your board's role in strategy and assess the need for greater engagement. It's a quick read, with recommendations you can put into practice.

FOCUS ON THE COMPANY'S PLANS TO GROW AND INNOVATE. The "new normal" of low growth will continue to challenge companies in 2015, particularly with European economies struggling to avoid deep recession, slowing growth in Asia, and a long list of geopolitical hotspots and uncertainties. The growth conundrum is a particular challenge for this generation of business leaders who, having gone through the financial crisis, are inclined to be more risk averse. In this environment, boards have a critical role to play in helping the company not only to avoid missteps but also to take smart risks to grow, innovate, and stay competitive. What kinds of discussions is the board having about growth opportunities? How do we ensure that the company's culture and processes create the right environment for growth through innovation? How do we measure and reward innovation success? Are we tapping into emerging markets? The economic momentum in emerging markets has slowed, but the growth story isn't over, and each country presents its own set of risks and opportunities with different growth prospects and business climates. Do we have, in the words of Eurasia Group's Ian Bremmer, a "worldview of the world," and how might that impact the company's strategy and growth plans?

CONSIDER WHETHER THE BOARD NEEDS TO RECALIBRATE HOW ITS COMMITTEES COMMUNICATE AND COORDINATE ON RISK OVERSIGHT. According to the 2014 *Spencer Stuart Board Index*, 71 percent of S&P 500 boards have more than three standing committees; S&P boards have an average of 4.3 committees; and 14 percent have six or more. Despite the clear benefits of committees (including increased focus on key risks), a complex committee structure poses its own risk of fragmented or balkanized board oversight. Do we have the right committee structure to oversee the major risks facing the business? Are risk responsibilities clear? Does the audit committee have too much on its plate? How do we communicate and coordinate the oversight activities of standing committees? Consider overlapping committee memberships, particularly when inter-committee coordination is of strategic importance. Are committee chairs communicating regularly to make sure they understand what's going on in the other committees? Are committee reports to the board robust or perfunctory?

REASSESS THE COMPANY'S VULNERABILITY TO BUSINESS INTERRUPTION AND ITS CRISIS READINESS. As illustrated by recent geopolitical turmoil, financial crises, natural disasters, and pandemics, the global interconnectedness of businesses, markets, and risk poses challenges for virtually every company. Ensure that management is weighing a broad spectrum of what-if scenarios, from supply-chain links and the financial health of vendors to geopolitical risks and cyber threats. Is the company's crisis response plan robust and ready to go? Is the plan actively war-gamed and updated as needed? Does it take into account the potential failure of critical infrastructure, e.g., telecommunications networks, financial systems, transportation, and energy supplies?

PROMOTE ENGAGEMENT WITH SHAREHOLDERS, AND PREPARE FOR ACTIVISTS. In our recent survey, some 60 percent of respondents said that their company has increased its level of engagement with shareholders as a result of the activist environment—but 40 percent have not. Shareholder activism continues to be on the rise, as is the pressure on boards and management teams to engage with these investors. In a speech made in December of 2013, SEC Chair Mary Jo White said the "landscape has unquestionably changed," and that "there is widespread acceptance of many of the policy changes that so-called 'activists' are seeking to effect."[4] She emphasized the importance of proactive outreach to shareholders—"honest communications about how and why decisions

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[3] National Association of Corporate Directors (NACD), *Report of the NACD Blue Ribbon Commission on Strategy Development* (Washington, DC: NACD, 2014), 7, http://www.nacdonline.org/strategy.

[4] Mary Jo White, "Remarks at the 10th Annual Transatlantic Corporate Governance Dialogue," Dec. 3, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1370540434901.

are being made"—and said that "the board of directors is—or ought to be—a central player in shareholder engagement." Do we understand the activists' agenda? Have we conducted a vulnerability assessment? Do we know and engage with our largest shareholders and understand their priorities? Executive compensation, management performance, strategy, separating unrelated businesses, capital allocation, and board composition are likely on their radar.

SHARPEN THE BOARD'S FOCUS ON CYBER RISK AND SECURITY. Increasing threats to corporate information systems and intellectual property—as well as compliance risks, the potential for lawsuits, reputational damage, and loss of customers—have elevated cybersecurity to the board level and as a critical business priority (where it should be). The SEC, Federal Trade Commission, and other regulators (federal, state, global) have sharpened their scrutiny of companies' data-security efforts, as well as disclosures and communications about cybersecurity risks and breaches. As SEC Commissioner Luis A. Aguilar recently noted, "ensuring the adequacy of a company's cybersecurity measures needs to be a critical part of a board of director's risk oversight responsibilities." Is cybersecurity risk given regular and adequate time on the board's agenda? What are our biggest vulnerabilities and our most critical data sets? What are the results of our most recent penetration tests and external assessments of our cyber defenses? Do we have a cybersecurity scorecard and a cyber-incident response plan? Help elevate the company's cyber-risk mind-set to an enterprise level, encompassing key business leaders (CEO, CIO, CFO, general counsel, CRO, HR) and business decisions, from new product development to acquisitions and expansion into new geographies.

DO WE HAVE THE RIGHT PEOPLE ON THE BOARD? Is the board asking itself whether it has the right mix of skills, backgrounds, experiences, and diversity? Shareholders are. Activists are questioning whether long-tenured boards are keeping pace with the broad array of challenges facing their businesses. Governance experts are also weighing-in: as Ann C. Mulé and Charles Elson note, "What boards need are *industry-expert* independent directors."[5] In its studies on diversity gaps, Egon Zehnder observes that "companies with global aspirations require boards with global capability," and that "the real purpose of increasing gender diversity is not simply to increase the number of women on the board, but to find exceptional directors who can help take the organization to the highest level of performance."[6] In short, lack of diversity can hamper the board's performance—and the company's. Have we squarely addressed the composition of our board, including gaps and obvious shortcomings in director performance, to ensure that we have the right mix to provide strategic direction and effective oversight of the company?

SET THE TONE AND CLOSELY MONITOR LEADERSHIP'S COMMITMENT TO THAT TONE, AS WELL AS THE CULTURE THROUGHOUT THE ORGANIZATION. The year ahead will be one of tremendous pressure and change—and a good measure of complexity and uncertainty. In this environment it is more important than ever to be acutely sensitive to the tone from (and the example set by) leadership and to reinforce the culture of the organization, i.e., what the company does, how it does it, and the culture of compliance. Is the board hearing views from those below senior management and outside the company? Are there dissenting views? Recognize when asymmetric risk—the over-reliance on senior management's information and perspective—is too high. Make time to visit company facilities and attend employee functions. The tone and culture throughout the company's global operations and the extended organization are critical. How confident is the board that it has a good sense of the culture in the company's global operations—far away from headquarters? Do the company's compensation policies and practices send the right message about accountability and long-term performance?

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5 Ann C. Mulé and Charles Elson, *"A New Kind of Captured Board," Directors & Boards,* First Quarter (2014): 27–29, esp. 27.

6 Egon Zehnder, *2014 Global Board Index™*; Claudia Pici-Morris and German Herrera, *Gender Diversity on Boards: Breaking the Impasse* (New York: Egon Zehnder International, 2012).

Responding to Global Risks: Enhancing Capacity to Assess the Impact of External Threats on Strategic Investments

By Marsh & McLennan Companies

The 2014 *Report of the NACD Blue Ribbon Commission on Strategy Development* argues that corporate boards must be more active in developing strategy and recognizes that "successful corporate strategy must continually adapt to ever-accelerating change in an increasingly uncertain operating environment that is being reshaped by new competitors, emerging technologies, globalization, regulation, demographic trends, and economic and geopolitical volatility."[1]

The uncertain operating environment—with its unprecedented range of geopolitical, technological, and societal risks—is discussed in the *Global Risks 2015* report prepared by the World Economic Forum in collaboration with Marsh & McLennan Companies and other partners. This year's publication demonstrates the most dramatic shift in global risk rankings in the 10-year history of the report. In the face of accelerating risks, it is critical that boards be strategically engaged; that they ensure that management has consistent, effective analytical processes in place to assess how risks may impact investments; and that the development of risk-management approaches be aligned with the organization's risk appetite.

Global Risks 2015 highlights a new type of fragility and instability in the world (outlined in the following section). Economic measures aimed at combating fiscal crises and unemployment and improving competitiveness are some of the drivers of this fragility. Equally significant are societal demands regarding structural unemployment, rising middle-class ambitions in many emerging economies, fundamentalism, and dissatisfaction with elites. Increased geopolitical friction, including the threat of interstate conflict and the ineffectiveness of international organizations and governance mechanisms, is adding to political instability. Against this backdrop, geopolitical risks stand out, as evidenced by the events in Ukraine in 2014, which have led to a deterioration in the relationship between Russia and the West and have had a spillover impact on international trade, economic growth, and energy investments. Growing instability will likely influence the trajectory of global risks and their outcome in the years ahead. Technological risks have also risen to prominence, as highly publicized cyberattacks on companies and governments underscore the potential for economic damage as well as the need for new risk mitigation approaches.

Top-Ranked Global Risks by Impact and Likelihood

Looking forward, *Global Risks* highlights 13 underlying trends that will continue to accelerate and shape the business environment, especially in their impact on organizations' supply chains and customers. These trends cut across and link together multiple risk categories. Demographic and social trends include an aging population, the increase of chronic diseases, rising geographic mobility, and rapid urbanization. For example, in 1950, one-third of the world's population lived in cities; today, the number has already reached more than one-half. By 2050, city dwellers are expected to account for almost two-thirds of the world's population. Most of the increase in urbanization will occur in Asia, India, and Africa.

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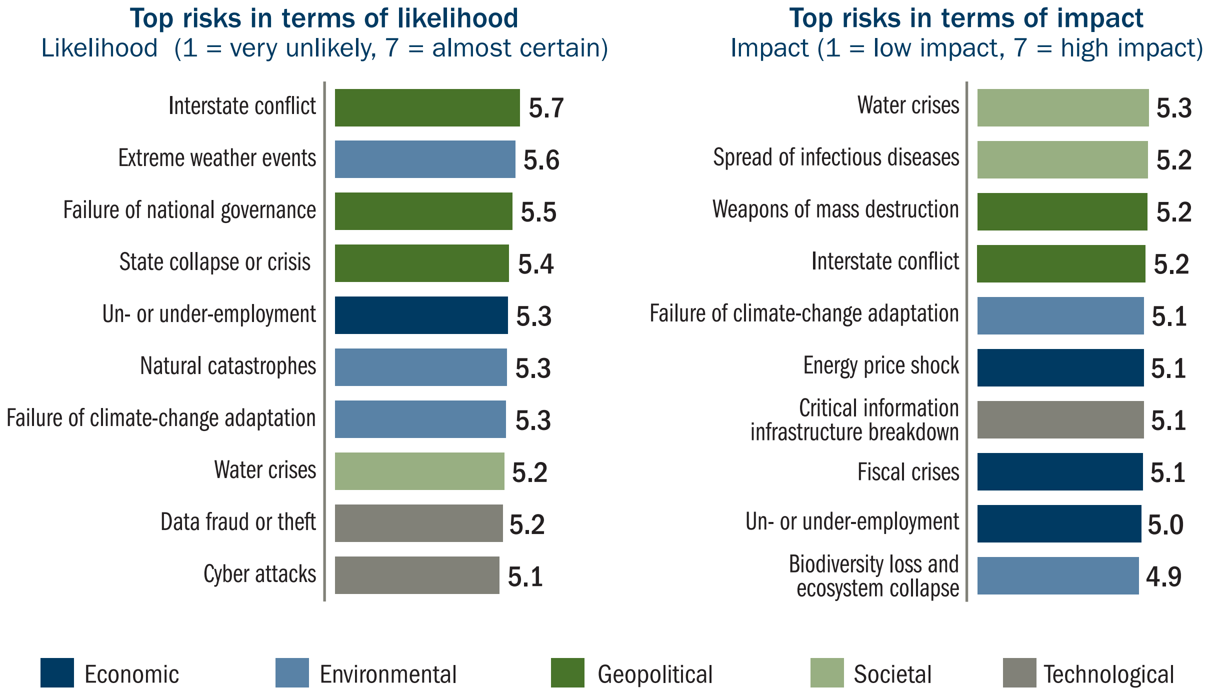
[1] National Association of Corporate Directors (NACD), *Report of the NACD Blue Ribbon Commission on Strategy Development* (Washington, DC: NACD, 2014), 3, hereafter cited as *BRC Report on Strategy Development*; http://www.nacdonline.org/strategy.



Environmental trends include climate change and environmental degradation. These trends interact with social trends, as environmental stress can be one factor driving the rural-to-urban migration in many regions. Water stress is also a growing concern in many regions. It is estimated that the percentage of the population in China, Brazil, and India (three of the United States' largest trading partners) and Russia living under medium-to-severe water stress will increase from 63 percent currently to 80 percent in 2030 if no new water management measures are introduced. The economic impacts are significant; for example, increasing water stress may lead to a shortfall of up to 30 percent in the production of cereals in the next 15 to 20 years, while in the United States the 2014 droughts will cost California approximately $2.2 billion in lost agricultural revenues in addition to the loss of more than 17,000 jobs. The failure to manage water effectively is therefore not merely an environmental issue but one that has the potential to create high levels of economic uncertainty, social unrest, and geopolitical friction.

A number of socioeconomic and political trends underpin rising geopolitical risks, including the growing middle class in emerging economies, rising income disparity, the growth of nationalism, increased polarization of societies, shifts in power, and weakening of international governance. The trend of increased hyperconnectivity is another force driving global risks, including political risks such as social activism and technological risks such as cyberattacks.

Alongside traditional business risks, the uncertainties and potential disruptions identified in the *Global Risks 2015* report must be factored into corporate decision-making. Individual companies cannot control trends and events of this magnitude; however, it is critical for business leaders to understand such risks, since the global risk environment has implications for businesses and their strategic goals. Global risks have a significant impact on the earnings potential of existing business activities and may change the lens through which new investment opportunities are evaluated. Heightened awareness of the trends underlying global risks can help companies to prepare for adverse scenarios and take action to mitigate their impact. The evolution of some global risks may also create growth opportunities. Thus, success in this rapidly shifting risk landscape is dependent on business leaders assessing the impact of global risks on their current businesses and future strategies and investments.

The 2014 *NACD Blue Ribbon Commission Report* sets forth a number of recommendations for boards when approaching strategy in this complex environment, including the following:

- Expect change and understand how it may affect the company's strategic course, potentially undermining the fundamental assumptions on which the strategy rests.
- Engage with management on strategy issues on an ongoing basis, including early involvement to improve strategy development, adjustment, and monitoring.
- Evaluate strategy options and underlying assumptions in good times as well as in times of change or crisis.[2]

While few would disagree with the importance and value of adopting these recommendations, the difficulty lies in effectively analyzing and interpreting the potential impact of emerging risks and trends on an organization's strategic plans. Put differently, companies struggle to answer the question: "what does this really mean for us?" Surveys reveal that capturing, assessing, and understanding the implications of emerging risks remains a constant challenge, with directors often expressing frustration that risk information is not linked to drivers of earnings volatility. Management teams often find it difficult to funnel huge amounts of information into consistent and meaningful analysis that supports a robust dialogue between board and management on potential threats and opportunities.[3]

To enable an enhanced approach to strategy review and revision, boards must support management initiatives to develop consistent processes for conducting risk analysis and assessing the impact on current and planned investments. One approach that some companies have adopted is a robust and holistic portfolio analysis that enables the organization to model potential risk impact across different businesses units.

A corporate portfolio-management approach differs fundamentally from standard investment opportunity assessment tools, delving beyond intuition and relying instead on robust, holistic analysis to evaluate risk and make investment decisions. The goal is to address investment "blind spots" that are typically present in traditional investment opportunity assessments, including failure to account for non-financial risk, failure to consider the impact across organizational "silos," and failure to contemplate unconventional scenarios and risks while constructing portfolios.

A consistent and robust analysis in assessing risks to strategic investments is critical to communication between the board and management. It ensures a dialogue that moves beyond superficial discussions of a "top 10 risk register" to an analysis that quantifies how risk impacts strategies and expected returns. It allows management and the board to understand risk in terms of metrics that are more meaningful to the organization (such as earnings, revenue, etc.).

A portfolio-management approach addresses these shortcomings in four steps:

- **Define a target strategic portfolio** by developing an investment policy statement to guide investment and rebalancing decisions. The policy statement should have multiple dimensions, taking into account legal, regulatory, and social considerations, as well as factors such as expected returns, risk appetite, and portfolio constraints.

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2 *BRC Report on Strategy Development*, 4.

3 See Lucy Nottingham, Robyn Bew, and Craig Martin, "Risk Communication: Aligning the Board and C-Suite" (New York: Oliver Wyman, 2014), http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/insights/risk-management/2014/feb/Risk%20Communication%20Feb%202014.pdf.

- **Establish an analytical risk-return framework** to profile individual assets. This analytical approach enables data-driven decision-making when building a portfolio.
- **Measure individual asset performance** in order to create a results-based culture. This measurement should capture an asset's returns across distinct parts of the organization. Furthermore, in evaluating asset performance, risk adjustments should include not just historical fluctuations but also plausible extreme scenarios.
- **Develop tools and modeling capabilities.** Given the persistent challenge of risk forecasting, organizations should focus on developing tools to simulate portfolio options under a variety of conditions, including commonly accepted scenarios and more extreme "stress" scenarios. Modeling adverse scenarios to understand potential downsides and building the information into the planning and investment process is a key component of effective exposure management. Similar tools can be used throughout the organization to evaluate customers, suppliers, and products, and to provide insights on prioritizing and optimizing resources.

This approach enables business leaders to maximize returns in an environment of constantly evolving risks. A portfolio view helps to account for non-financial risk, allocates capital on the basis of the complete range of businesses, and facilitates forward-looking evaluations across a full gamut of market and strategic scenarios. The increased transparency and insights unlocked by rigorous portfolio analysis are of crucial assistance to companies facing an uncertain risk environment.

With the information captured through such risk analysis, boards and management teams are better positioned to determine the risks affecting strategies and returns, and to develop risk-management responses aligned with the organization's risk appetite. For example, organizations seeking to hedge geopolitical and geo-economic uncertainty could diversify investments across countries. The organization can also increase resilience by being prepared in the event of a crisis and maintaining business agility.

Given the wide range of global risks and the unprecedented shifts in the risk landscape, business leaders must enhance their organizations' abilities to assess and respond to uncertainties and challenges. Companies that take these steps are likely to be the ones that will thrive in the current environment of heightened and enduring uncertainty.

Compensation's Role in Strategy: Elevating the Discussion and Expanding the View

By Pearl Meyer & Partners

Many positive trends have emerged in executive compensation since the financial crisis. Tangible actions are being taken by boards to improve the structure of pay programs in ways that advance business strategy and improve stakeholder engagement.

Overall, compensation committees are moving the needle in a positive direction. They are beginning to develop an agenda outside the traditional purview and elevate their discussion beyond compliance. At the same time, they are broadening their scope and looking at a wider variety of organizational issues that are influenced or affected by compensation design, beyond the core decisions about salaries and incentive plans. Below we identify some specific areas where compensation committees can add considerable value, either through initial or increased focus.

Directional Opportunities

SAY-ON-PAY IS JUST THE STARTING POINT. In 2014, only 60 companies in the Russell 3000 failed their say-on-pay vote—a fairly consistent pass/fail rate compared with the prior three years. Some might interpret these results as a sign that say-on-pay has not had much impact on executive compensation and related governance practices. Not so. Over the past four years, say-on-pay has provided the impetus for improved communications between companies and shareholders. In the best instances, outreach that might begin as an explanation of pay levels and results has led to more fulsome discussions of the company's business strategy and how pay programs support those priorities. Further, many companies have found that engaging in direct communication with their shareholders allows them to part ways with market-prevalent practice and still retain strong shareholder support.

SAY-ON-PAY GOES BEYOND CHECKING THE BOXES. Say-on-pay provides an example of an influencing element that consumes significant mindshare yet has little direct link to business priorities. It can be all too easy for boards to rush to execute checklists in service of regulations and best practices, when in fact these efforts rarely advance the company's strategic direction. Most public companies have long since addressed "red flag" issues, such as tax gross-ups and post-retirement perquisites. However, we note that many of the practices now viewed as "egregious" were at one time commonly accepted. The standards of "reasonableness" evolve over time, and companies need to stay abreast of market expectations. Conformity is insufficient as a compensation strategy; nor is it always necessary. But companies do need to understand market practices and perceptions, and make conscious, informed decisions regarding which to follow and which to eschew. Ultimately, focusing on a specific business strategy above rote compliance allows companies to chart their own course.

USE COMPENSATION TO DRIVE OUTCOMES. Proper compensation design—with clear alignment between the program and business goals—can become an effective tool to drive company performance. Committees have increasingly robust data and analytics available to help develop targeted compensation plans that incent the right behaviors and drive positive business outcomes.

- **Select performance metrics that truly drive value creation.** There are a number of analytic tools (value trees, regression analyses, etc.) that can provide quantitative validity to management/board insights. Incentive measures should balance several perspectives and considerations:
  - *Short-term versus long-term results*. Both the measures themselves and the goal-setting process should take into account the inevitable trade-offs between maximizing short-term performance relative to investing in long-term growth opportunities.

- *Leading versus lagging indicators*. Many of the most common incentive measures are tied to financial statement results. These measures are largely lagging indicators, i.e., the results of actions and decisions. While sometimes more challenging to define and track, appropriate leading indicators in the incentive plan can focus an organization on activities that will improve the quality and sustainability of the ultimate financial results.
- *Organization-wide versus line-of-sight*. While shareholders may prefer incentives that are tied to overall organizational results, committees and management teams need to consider the motivational aspects of the measures selected. Incentive plans are most effective as management tools when they are tied to actions, decisions, and results that are within the control of participants.

- **Calibrate chosen metrics to meet long-term goals.** The default most companies adopt is to set target incentive opportunities equal to budget. That budget then becomes the center of the incentive opportunity range, with threshold and maximum points set equidistant from the budget. Once established, the incentive range and payout leverage often remain static over several years. This approach likely serves many companies reasonably well. It certainly simplifies annual goal-setting and communications. However, we think companies need to periodically review the goal-setting process and the resulting payout curves to ensure that they accurately reflect the long-term expectations of stakeholders. Again, there are quantitative analyses that can add depth to a discussion of the degree of difficulty embedded in the current goal-setting process; they can also assess the extent to which internal budgets are aligned with market expectations for future growth.
- **Test results annually.** A year-end review of actual incentive plan results can help to refine future incentive-plan design. Plans are structured at the beginning of the year on the basis of the company's best estimation of the right measures and the degree of performance required to create shareholder value. These estimations take into consideration not only the company's historical performance but also the performance of industry peers and the market as a whole. It is important to look at actual results to assess the degree to which those estimations were borne out and to determine what adjustments, if any, should be made in the future to continue to refine the pay-for-performance alignment.

Contextual Opportunities

THE ROLE OF LEADERSHIP STRATEGY AND CULTURE. As the renowned Peter Drucker once noted, "Culture eats strategy for breakfast." Business history is littered with examples of seemingly valuable business strategies (from mergers and acquisitions to external CEO hires) that fell short of their potential due to the impact of leadership and/or culture. Yet boards have historically been loath to delve into the realm of organizational culture, viewing issues of people management to be the purview of the leadership team.

As companies and their boards come under increasing pressure to deliver results, we see those old lines of demarcation blurring. In fact, some compensation committees have formally signaled the expansion of their purview by changing their names and charters to include succession, talent development, performance management, etc. Without stepping on executives' toes over day-to-day people management issues, the compensation committee can, and should, play an oversight role defining the interplay between leadership and culture, business strategy, and compensation design. Key questions committees should consider include the following:

- What characteristics define our organization? For example, are we an R&D company, or are we entrepreneurial? Are those characteristics consistent with our business strategy?
- Does our management team reflect our business and leadership strategies? Are our criteria for hiring, recognition, and promotion linked to the drivers of success?

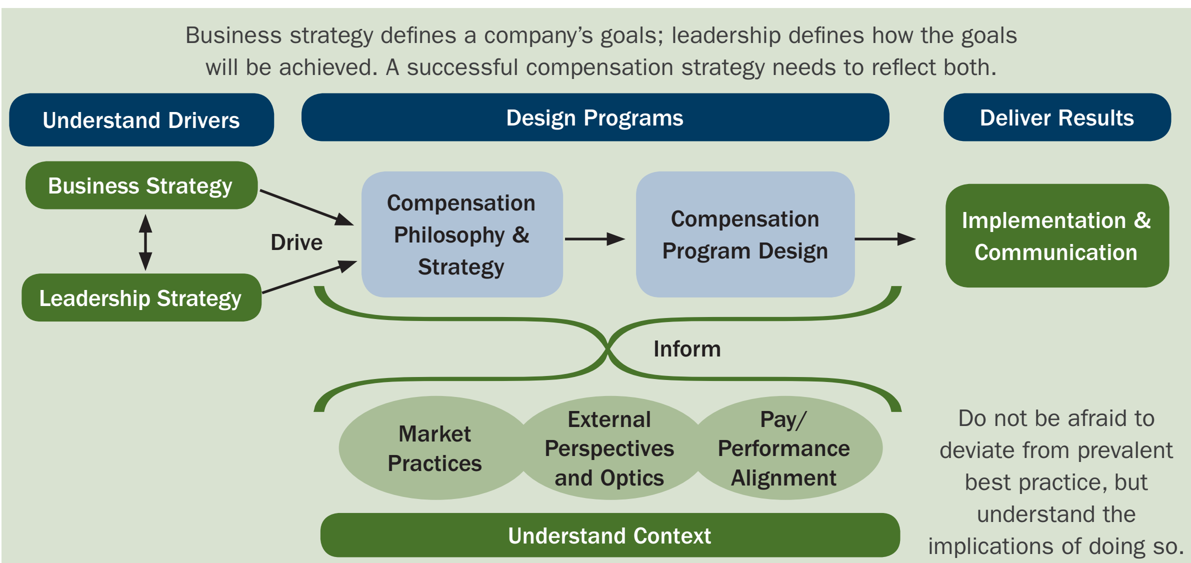
- Are our compensation plans consistent with our leadership style? For example, is the leverage in our pay opportunity consistent with our views on risk-taking? Is the weighting between company and individual metrics consistent with our decision-making?

THE COMMUNICATION IMPERATIVE. A key objective of an incentive plan is to signal to participants the priorities of the company. The effectiveness of that objective depends on the clarity and consistency of the communications message. In fact, willingness to share performance results with participants should be one of the considerations in measure selection.

For public companies, plan design must be disclosed to shareholders as well. As committees have begun to put more time and attention into increased and improved shareholder communication, it is important to coordinate the messages between the two constituencies. Furthermore, public companies need to consider other consumers of the public disclosure (e.g., competitors, customers, media, regulators, etc.). Careful consideration of what is communicated, and to whom, is a growing element of overall compensation design, and one that can have a major impact on the success of a pay program and the broader business strategy it serves.

Putting the Pieces Together

Business strategy defines the company goals, while leadership strategy shapes how those goals will be achieved. A successful compensation strategy must consider both. External factors, such as market prevalence and accepted standards of best practices, can provide important context for strategy-based design but shouldn't drive compensation decisions.



Most executives and board members can articulate the unique attributes of their company's business strategy and culture. That differentiation is the key to creating long-term value. In the same way, a company's compensation strategy should reflect and support those unique aspects of the company's strategy and culture. Too many companies design their compensation plans based on the safety of competitive practice. But following the pack seldom results in competitive advantage. Committees are realizing that a differentiated compensation strategy, linked to the company's distinct business and leadership strategies, can become a driving force that will benefit shareholders through both superior value creation and corporate sustainability over the long term.

Current Tensions in Corporate Governance*

By Sidley Austin

The balance of power between shareholders and boards of directors is central to the U.S. public corporation's success as an engine of economic growth, job creation, and innovation. Yet that balance is under significant and increasing strain. In 2015 we expect to see continued growth in shareholder activism and engagement, as well as in the influence of shareholder initiatives, including advisory proposals and votes. Time will tell whether, over the long term, tipping the balance to greater shareholder influence will prove beneficial for corporations, their shareholders, and our economy at large. In the near term, there is reason to question whether increased shareholder influence on matters that the law has traditionally apportioned to the board is at the expense of other values that are key to the sustainability of healthy corporations. These concerns underlie the issues that will define the state of governance in 2015 and likely beyond:

- Impact of federal regulation on governance roles that have traditionally been defined by state law
- Tensions between achieving short-term returns versus making long-term investments
- The impact of shareholder activism on board decisions and on wealth creation
- Litigation and reactive protectionism by boards through bylaw provisions
- Proxy advisor power and influence
- Rebuilding society's trust in the corporation

Governance Roles and Responsibilities

Over the past 15 years, two distinct theories have been advanced to explain corporate governance failures: too little active and objective board involvement, and too little accountability to shareholders. The former finds expression in the Sarbanes-Oxley Act's emphasis on improving board attention to financial reporting and compliance, and in related U.S. Securities and Exchange Commission (SEC) and listing rules on independent audit committees and director and committee independence and function generally. The latter is expressed in the Dodd-Frank Act's focus on providing greater influence to shareholders through advisory say-on-pay votes and access to the company's proxy machinery for nomination by shareholders of director candidates.

The emerging questions are whether federal law and regulations (and related influences) are altering the balance that state law provides between the role of shareholders and the role of the board, and, if so, whether that alteration is beneficial or harmful. State law places the management and direction of the corporation firmly in the hands of the board of directors. This legal empowerment of the board—and implicit rejection of governance by shareholder referendum—goes hand in hand with the limited liability that shareholders enjoy. Under state law, directors may not delegate or defer to shareholders as to matters reserved by law for the board, even where a majority of shareholders express a clear preference for a specific outcome. Concern about appropriate balance in shareholder and board roles is implicated by the increasingly coercive nature—given the influence and policies of proxy advisory firms—of federally mandated advisory say-on-pay proposals and advisory shareholder proposals submitted under Securities Exchange Act Rule 14a-8 on other matters that do not fall within shareholder decision rights. The extent of proxy advisory firm influence is linked, at least in part, to the manner in which the SEC regulates registered investment advisors.

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* This article is a condensed version of "The State of Corporate Governance in 2015," available at www.sidley.com/en/news/01-13-15-corporate-governance-update.

Short-Term Returns vs. Long-Term Investment

Management has long reported significant pressures to focus on short-term results at the expense of the long-term investment needed to position the corporation for the future. Observers point to short-term financial market pressures, which have increased with the rise of institutional investors whose investment managers have incentives to focus on quarterly performance in relation to benchmark and competing funds.

Boards that should be positioned to help management take the long-term view and balance competing interests are also under constant pressure from financial- and governance-focused shareholder activism. Both forms of activism are supported by proxy advisors who favor some degree of change in board composition and who tend to have fairly defined—some would say rigid—views of governance practices. While it is prudent for boards to understand and consider the range of shareholder concerns and views represented in the shareholder constituency, shareholder engagement has its limits: the board must make its own independent judgment and may not simply defer to the wishes of shareholders. While activist shareholders often bring valuable perspectives, they may press for changes to suit particular special interests or short-term goals that may not be in the company's long-term interests.

Shareholder Activism and Its Value

FINANCIAL ACTIVISM. Over the past three years, the number and intensity of financial activism initiatives have increased. The ongoing debate on the wealth effects of hedge-fund activism is worth following. Although financial activism may return immediate wealth to some shareholders through the sale of assets, payment of special dividends, or share buybacks, evidence is mounting that this may be at the expense of longer-term corporate and societal interests. Indeed, a growing number of commentators, including senior representatives of some institutional investors, have expressed concern about the impact of hedge-fund activism—and associated increased debt and cuts in capital spending—on long-term corporate health, innovation, job creation, and GDP growth.

GOVERNANCE ACTIVISM. Shareholder pressure for greater rights and influence through advisory shareholder proposals are expected to continue in the 2015 proxy season. A study of trends from the 2014 proxy season in Fortune 250 companies by James R. Copland and Margaret M. O'Keefe, *Proxy Monitor 2014: A Report on Corporate Governance and Shareholder Activism* (available at www.proxymonitor.org), suggests that the focus of most shareholder proposal activity does not relate to concerns that are broadly held by the majority of shareholders:

- Shareholder support for shareholder proposals is down, with only 4 percent garnering majority support, down from 7 percent in 2013.
- A small group of shareholders dominates the shareholder-proposal process. One-third of all shareholder proposals are sponsored by three persons and members of their families, and another 28 percent of proposals are sponsored by investors with an avowed social, religious, or public-policy focus.
- Forty-eight percent of proposals at Fortune 250 companies in 2014 were related to social or political concerns. However, only one out of these 136 proposals received majority support, and that solitary passing proposal was one that the board had supported.
- Institutional Shareholders Services Inc. (ISS) is far more likely to recommend in favor of shareholder proposals than the average investor is to support them.

Nonetheless, the universe of shareholder proposals included in corporate proxy statements pursuant to Rule 14a-8 has grown significantly over the years. In addition, the coercive power of advisory shareholder proposals has expanded as a result of the policy of proxy advisors to recommend that their clients vote against the re-election of directors who fail to implement advisory shareholder proposals that receive a majority of votes cast. Directors should carefully assess the reasons underlying shareholder efforts to use advisory proposals to influence the company's strategic direction or otherwise change the board's approach to matters such as CEO compensation and succession, risk management, governance structures, and environmental and social issues. Shareholder viewpoints provide an important data set but must be understood in the context of the corporation's best interest rather than through the single lens of one particular constituency.

HOT TOPICS FOR 2015 SHAREHOLDER PROPOSALS. Early indications are that in 2015 the most frequent shareholder proposals will relate to

- shareholders' ability to impact board composition, through proxy access and—at mid-tier companies—replacement of plurality voting in uncontested director elections with majority voting;
- board leadership in the form of an independent board chair; and
- enhanced disclosure regarding corporate efforts on social and environmental issues or sustainability reporting.

Proxy access proposals are particularly prominent in the 2015 proxy season. The New York City Comptroller has targeted 75 companies with non-binding proxy access shareholder proposals to bring pressure to bear with respect to other issues. The proposal seeks access to the proxy for up to a quarter of board seats for shareholders who have held 3 percent of company shares for three years, tracking the SEC's vacated proxy access rule. Such proposals have a fair likelihood of receiving a majority of votes cast. Of the proxy access proposals that went to a vote in 2014, fewer than half received a majority of the votes cast in favor, with average support of approximately 37 percent. Support was highest for proposals that relied on a 3-percent/three-year holding requirement; all proposals that received a majority of votes cast were based on this requirement.

Note that the SEC Division of Corporation Finance recently announced that for the 2015 proxy season it will not express any views on whether a company may exclude a shareholder proposal from its proxy statement on the grounds [provided by Exchange Act Rule 14a-8(i)(9)] that management is putting forth a proposal that "directly conflicts" with the shareholder proposal. Numerous companies had requested to exclude proxy access proposals on these grounds after the Division granted such relief to Whole Foods Markets in light of its announced intent to submit a bylaw amendment to a shareholder vote that would permit proxy access for holders of 9 percent holding for five years. (Whole Foods subsequently included a management proposal at 5 percent for five years in its proxy statement.) However, on Jan. 16, 2015, SEC Chair Mary Jo White announced that she had called for a review of this rule and its application. In response, the Division announced that it would express no views on Rule 14a-8(i)(9) during the 2015 proxy season. This leaves companies on their own if they determine to exclude a shareholder proposal from their proxy statements on the basis that it directly conflicts with management's proposal.

Litigation and Protectionism

Corporations today are routinely subject to shareholder litigation for which corporations—and, by extension, their shareholders—foot the bill. An oft-cited January 2014 article by Matthew D. Cain and Steven Davidoff Solomon, "Takeover Litigation in 2013" (available at http://papers.ssrn.com), reported that 97.5 percent of 2013 takeover transactions valued at over $100 million resulted in shareholder litigation—up from 39 percent in

2005. Board decisions and proxy disclosures related to executive compensation are also leading to an increase in shareholder litigation, albeit on a smaller scale.

Since even weak shareholder claims generate uncertainty, significant costs, and settlement pressures, corporate interest in how to reduce nuisance suits has grown. For example, the Delaware courts have upheld, at least as a general matter, the validity of board-adopted bylaws that seek to limit the forum for intra-corporate litigation. A forum selection provision is not designed to prevent stockholders from bringing claims; it addresses only where the claims may be litigated. Delaware courts, particularly the Court of Chancery, are thought to afford several benefits to corporations, including a well-established body of corporate case law, a judiciary knowledgeable in business disputes, and relatively expedited litigation schedules. In addition, the Delaware Supreme Court has upheld—in the context of a non-stock corporation—the validity of bylaws that allocate all or a portion of the cost of intra-corporate litigation to the losing party.

Although these court decisions have spurred significant interest in board-adopted bylaws aimed at reducing incentives for the plaintiffs' bar to file claims, caution is advised. Despite strong arguments that support deterring nuisance suits that are costly to companies and their shareholders, some shareholders, shareholder rights advocates, and proxy advisory firms have expressed concern about board-adopted bylaws that may deter shareholder litigation.

On Nov. 6, 2014, ISS issued its final 2015 proxy-voting guideline updates, effective for annual shareholder meetings held on or after Feb. 1. Notably, the policy changes suggest a negative bias toward director elections where boards have unilaterally adopted bylaws (or, in certain circumstances, charter amendments) that ISS views as limiting stockholder rights. ISS will now recommend against the election of directors when the board unilaterally adopts bylaws or charter amendments that, in ISS's view, "materially diminish shareholders' rights or … could adversely impact shareholders."

Concerns About Proxy Advisors

Over the past decade the growing influence of proxy advisory firms on shareholder voting, executive compensation, and corporate governance practices has caused no small degree of consternation and concern among public companies, given the perceived power of the highly concentrated proxy advisory industry to effectively coordinate shareholder voting. Criticisms have also been voiced about the opacity and lack of nuanced analysis underlying vote recommendations; potential conflicts that arise when proxy advisors also provide consulting services to public companies; and inherent pressures in the proxy advisors' business model that motivate these firms to continually "push the envelope" on corporate governance and disclosure reform. Federal legislation and the SEC rules and guidance are also thought to have played a role in the growth of proxy advisor influence.

On June 30, 2014, the staffs of the SEC's Division of Corporation Finance and Division of Investment Management issued long-awaited guidance related to both proxy advisory firms and their investment advisor clients. The guidance, published in *Staff Legal Bulletin* No. 20 (available at www.sec.gov/interps/legal/cfslb20.htm), addressed investment advisor responsibilities for the voting of proxies and diligence considerations regarding the retention and oversight of proxy advisory firms. The *Bulletin* also addressed two exemptions to the proxy solicitation rules on which proxy advisory firms often rely. Although the SEC staff's guidance could cause investment advisors to more carefully scrutinize the quality of proxy advisors' services—and even to reduce reliance on these services—the guidance does not directly address many concerns that have been raised to date.

Restoring Trust

Corporations create wealth for shareholders. The ability of a corporation to return long-term shareholder value is a key metric for assessing whether the corporation is effective and efficient in its activities. However, corporate contributions to our economic and societal well-being extend far beyond shareholder return. By spreading investment risk, corporations facilitate the funding of large-scale entrepreneurial activities that enhance the qualities of our lives. They deploy assets and support innovation to produce needed goods and services; they provide employment and associated insurance and retirement benefits, pay taxes, and support various social and charitable programs.

Shareholders, boards, and management have a common long-term interest in promoting both shareholder value and the societal trust in corporations that is essential to ensuring that regulation does not stifle innovation and robust entrepreneurial activity. They also have a common interest in maintaining the governance balance that is essential to corporate success.

Appendix: NACD's Strategic Content Partners

Heidrick & Struggles

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2001 Pennsylvania Ave. NW
Suite 500
Washington DC 20006
Phone: 202-775-0509
Fax: 202-775-4857
www.NACDonline.org

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