# <u>Some Thoughts for Boards of Directors in 2011</u>

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## I. INTRODUCTION

In the coming year, boards of directors face a two-fold challenge: they must implement the various new legislative, regulatory and "best practice" mandates relating to corporate governance, while at the same time tailoring them to the needs of each corporation and implementing them in ways that will promote the board's core mission of securing long-term value for shareholders. This challenge is complicated by the fact that many of the corporate governance provisions of the Dodd-Frank Act, new SEC regulations and other reforms require or put pressure on the board to adopt a one-size-fits-all approach to corporate governance. Thus, while the financial crisis and ensuing global recession have prompted boards to critically review their oversight role and consider ways in which they might function more effectively, their individualized action plans and "lessons learned" have to some extent been preempted by blunt regulatory mandates and best practices. Moreover, as boards work to craft strategies for sustainable economic recovery, they are increasingly vulnerable to shareholder activist demands for quick turnaround measures and short-term gains, particularly as hedge funds and other special interest shareholders seek to execute their own agendas for liquidity and financial recoupment.

The governance mandates in the recent legislative and regulatory reforms have been percolating for a number of years and are consistent with the steady pressure exerted by shareholder activists over the past decade. Newly enacted and pending rules regarding proxy access, say-on-pay, enhanced SEC disclosure requirements, compensation clawbacks, board structure and other reforms largely represent a culmination of persistent trends rather than a new directional shift in corporate governance. Indeed, over the past several years, boards have increasingly engaged with shareholder activists in the corporate governance debate and have accommodated many of their demands. For example, approximately 70% of S&P 500 companies have adopted majority voting provisions, and only 153 of S&P 500 companies had a poison pill in effect at the end of 2009.

This latest round of reforms is remarkable not because it has ushered in bold new ideas for improving governance, but rather because of the extent to which it has one-sidedly embraced the shareholder rights agenda and further expanded the ability of shareholders to direct corporate decision-making. As a result of the Dodd-Frank Act and other reforms, boards will increasingly need to solicit shareholder views and support for a range of decisions—including executive compensation and director nominations—that have traditionally been a core responsibility of boards.

The growth and consolidation of shareholder power, as well as the widespread deference of investors to the governance benchmarks dictated by a few leading proxy advisory firms, is beyond dispute. Although the notion of "shareholder democracy" has been an effective campaign slogan, the reality today is that large, sophisticated hedge funds, institutional shareholders and union and public pension funds wield considerable clout. Moreover, companies are disciplined and held accountable not only by means of annual director elections, but also on a quarterly if not daily basis by the votes of confidence or disapproval that are reflected in their stock price performance. In this environment, we have reached a point of serious debate—not only among companies targeted by activists but also bipartisan public interest groups, the SEC and other regulators—as to whether the scales have tipped too far in empowering shareholders and preventing boards and management from managing for the long term.

In that regard, there have been some promising signs of a new focus on the responsibilities of shareholders and proxy advisory firms, and the regulatory loopholes they currently enjoy. This past July, the SEC voted unanimously to issue a concept release seeking public comments on the U.S. proxy system, including whether new regulations are warranted to address a lack of accountability and transparency in how proxy advisory firms formulate their voting recommendations and conflicts of interest they may have, as well as the use by shareholders of derivatives and other instruments to acquire voting power which does not correspond to their economic investment in a company. The recent report of the NYSE Commission on Corporate Governance noted the "significantly increased ability of shareholders to influence corporate conduct" and emphasized as a core principle the responsibility of shareholders to vote their shares in a thoughtful manner. In the U.K., the Stewardship Code issued earlier this year by the Financial Reporting Council sets out a series of principles aimed at enhancing the quality of engagement between institutional investors to help improve long-term returns, including principles aimed at enhancing their disclosures about their voting policies and their use of proxy advisory services. In addition, a report issued earlier this year by the OECD Steering Group on Corporate Governance concluded in its key findings that "as the importance of institutional shareholders increases, greater attention needs to be given to proxy advisors and to the potential for conflicts of interests," and it underscored the need to ensure a competitive market for proxy advisory services.

In the meantime, as boards of directors seek to implement the Dodd-Frank Act and other corporate governance reforms and engage with shareholders, the key is to strike the right balance and bear in mind that good corporate governance is a means to an end rather than an end in itself. The ultimate responsibility and objective of boards is not to ensure perfect compliance with the latest best practices and governance checklists, but rather to thoughtfully exercise their oversight role, promote a culture of excellence and integrity within the corporation and work with management to develop strategies for long-term value. The importance of striking this balance is underscored by the pressing need for corporations to rebound economically and succeed in a global market that features, among other things, the challenge of competing with state-sponsored firms who are insulated from short-termist demands and the distraction of form-over-substance governance proposals.

A few of the more notable corporate governance issues that boards will face in the new year are highlighted below.

## II. PROXY ACCESS

One of the most sweeping new reforms on the horizon is the proxy access rules adopted by the SEC last summer. Although the effectiveness of these rules has been stayed by the SEC pending resolution of a legal challenge seeking their invalidation, an SEC spokesperson has said the SEC expects the legal issues to be resolved by late spring of 2011. While the timing of the effectiveness and the final form of the rules remains uncertain, if the court upholds the validity of the rules, some version of proxy access will be available to shareholders in the near future. And even if the new rules are struck down, it is likely that activists will pursue shareholder proposals and bylaw amendments to impose proxy access on a company-by-company basis. Proxy access is expected to significantly impact the dynamics of shareholder engagement and, in some cases, the composition of boards, and each company should begin to determine the best way to implement proxy access given the particular features of its corporate governance regime. We issued a memo-

randum earlier this year setting out some of the major actions companies should consider in adopting a moderate, middle-of-the-road approach that avoids the more aggressive tactics some commentators have advocated (see the following link: Shareholder Proxy Access: Time to Get Ready).

The SEC rules currently on hold would provide that shareholders and shareholder groups who have collectively held investment and voting power of at least 3% continuously for at least three years will have the right to have director nominees included on the company's ballot and described in the company's proxy statement. Companies and their shareholders would not have the ability to opt out or to adopt more limited arrangements. Shareholders would be entitled to nominate up to a maximum of 25% of the entire board, rounding down (with a minimum of one director), even if the company has a classified board with only one-third of the board up for election at the meeting (but shareholder nominees serving a three-year term would count against the 25% cap for the following two annual meetings). Shareholders intending to make use of proxy access would be required to communicate their intent by filing a new Schedule 14N with specified disclosures no earlier than 150 days, and no later than 120 days, prior to the anniversary of the mailing date of the prior year's proxy materials.

The extent to which the access rules may lead to a higher incidence of proxy contests or "shadow" proxy contests, where nominations are threatened in the context of seeking to change corporate policy or board composition, remains to be seen. It is clear, however, that proxy access would effectuate a significant ratcheting-up of the already heightened ability of shareholders to exert pressure on boards, particularly when considered in the context of the elimination of broker discretionary voting in director elections and majority voting standards. Companies will need to engage constructively and proactively with shareholders and, in the cases where directors nominated by shareholders are successfully elected, boards will need to work to minimize the potential for adverse effects on board stability, collegiality and effectiveness.

## III. EXECUTIVE COMPENSATION

Executive compensation continues to be a major area of regulatory focus and public debate, and the Dodd-Frank Act and related SEC rules include several notable developments that boards and compensation committees will need to take into account. In the upcoming proxy season, companies that hold their annual meeting on or after January 21, 2011 will be required to include a non-binding say-on-pay resolution seeking shareholder approval of named executive officer compensation, as well as a separate vote by shareholders on how often the say-on-pay vote will be held (*i.e.*, every one, two or three years). Although a triennial rather than annual say-on-pay vote more closely aligns say-on-pay with the goal of avoiding short-termism in corporate governance and executive pay arrangements, ISS and other proxy advisory firms are, not surprisingly, advocating that the say-on-pay vote be held on an annual basis. In addition, the new rules require companies to include disclosure of certain "golden parachute" arrangements in merger proxy statements and tender offer materials, and to solicit an advisory shareholder vote on such arrangements in connection with mergers and similar transactions subject to shareholder approval.

In addition to requiring shareholder advisory votes on compensation, the Dodd-Frank Act and related rulemaking call for disclosure in annual proxy statements regarding the relationship between executive compensation and the company's financial performance, and the company's policies regarding the ability of employees and directors to engage in hedging transactions on

company stock. The SEC is also slated to issue new rules requiring disclosure of the ratio of the median annual total compensation of the company's employees (excluding its CEO) to the annual total compensation of its CEO. Depending on how the SEC formulates some of the specific details of this disclosure requirement, it could require companies to collect large amounts of compensation data and entail substantial administrative costs.

The Dodd-Frank Act has also expanded the compensation clawback requirements of the Sarbanes-Oxley Act to require recoupment of compensation paid to current or former executive officers who received incentive-based compensation during the three-year period preceding the date on which the company is required to prepare an accounting restatement due to material noncompliance with the securities laws, if the compensation is determined to have been based on erroneous data. In addition, companies will need to disclose their policies on certain incentive-based compensation based on financial information.

In this environment, boards and compensation committees should review compensation policies with great care, being mindful of pay-for-performance principles while also seeking to avoid policies that will encourage excessive risk-taking. Directors should also bear in mind the heightened sensitivity to pay packages that could be deemed "excessive" given the new post-crisis emphasis on financial restraint. At the same time, the board and compensation committee should not lose sight of the underlying goal of executive compensation—namely to attract and retain qualified individuals. A compensation committee that follows normal procedures and has the advice of legal counsel and an independent consultant should not fear being second-guessed by the courts, which continue to respect compensation decisions so long as the directors act on an informed basis, in good faith and not in their personal self-interest. In the final analysis, the ability to recruit and retain world-class executives is essential to the long-term success of the company.

## IV. RISK MANAGEMENT

This past year, the heightened focus on risk management that was precipitated by the financial crisis was further underscored by the tragic events in the Gulf of Mexico and major product recalls by Toyota. Many of the lessons learned by financial institutions and other market participants from the financial crisis have proven to be all too relevant across a broader range of industries and operational areas—including environmental, health and safety, products liability, natural disasters, antitrust, employment practices and overseas business practices. Moreover, the repercussions of the subprime meltdown, as well as the experiences of companies facing more recent high-profile failures, have made boards acutely aware of the value at stake (both economic and reputational) in determining acceptable levels of risk and managing risks within those parameters.

The regulatory response to risk management issues has continued to evolve. The Dodd-Frank Act has created new federally mandated risk management procedures principally for financial institutions, and requires bank holding companies with total assets of $10 billion or more, as well as certain other non-bank financial companies, to have a separate risk committee which includes at least one risk management expert with experience managing risk at large companies. This requirement may be extended to bank holding companies with less than $10 billion in assets by the Federal Reserve Board. Additionally, the SEC has added new proxy statement requirements for both financial and non-financial public companies that call for discussion of a com-

pany's board leadership structure and role in risk oversight. Companies are required to disclose in their annual reports the extent of the board's role in risk oversight, such as how the board administers its oversight function, the effect that risk oversight has on the board's process and whether and how the board or board committee monitors risk.

The interplay between executive compensation policies and risk management has been a particular area of focus in the regulatory response. Federal bank regulators have cited incentive compensation policies in the financial industry as one of the many factors that contributed to the financial crisis, and issued guidance designed to ensure that incentive compensation policies do not undermine the safety and soundness of banking organizations by encouraging employees to take undue risks. In addition, SEC proxy rules now require a company to discuss the extent that risks arising from a company's compensation policies are reasonably likely to have a "material adverse effect" on the company. Companies must also discuss how their compensation policies and practices, including those pertaining to non-executive officers, relate to risk management and risk-taking incentives.

The optimal risk management structures and policies for each company vary widely; this is an area where a tailored approach in implementing governance objectives is particularly critical. Not surprisingly, a recent survey conducted by the Conference Board concluded that while most boards have been taking steps to upgrade their risk oversight capabilities, there is significant diversity across companies in their approach to this task.

As a basic principle, however, the board cannot and should not be involved in actual day-to-day risk management. Directors should instead, through their risk oversight role, satisfy themselves that the risk management policies and procedures designed and implemented by the company's senior executives and risk managers are consistent with the company's corporate strategy and risk appetite, that these policies and procedures are functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision-making throughout the organization. The board should establish that the CEO and the senior executives are fully engaged in risk management. Through its oversight role, the board can send a message to the company's management and employees that comprehensive risk management is neither an impediment to the conduct of business nor a mere supplement to a firm's overall compliance program, but is instead an integral component of the firm's corporate strategy, culture and business operations.

In addressing executive compensation risks, the compensation committee should directly approve the incentive arrangements for senior executives and, in fulfilling its risk oversight function, should satisfy itself that management has designed risk management processes for all covered employees that do not jeopardize the company's safety and soundness. Compensation committees should be engaged as management develops the compliance framework and should coordinate with risk and audit committee members in fulfilling its function.

Earlier this month, we issued a memorandum that contains a more detailed discussion of risk management issues facing companies and their boards today. A copy of that memorandum may be accessed at this link: Risk Management and the Board of Directors.

## V. BOARD COMPOSITION AND DIRECTOR QUALIFICATIONS

Despite the litany of procedural, structural and disclosure-based corporate governance requirements that have been prescribed over the years, the single most important factor in determining the effectiveness of boards is the people who serve as directors and the expertise, business sense, judgment, integrity, diverse perspectives, commitment, energy and objectivity that they bring to the boardroom. The task of recruiting a well-rounded board has been complicated by a variety of factors, including the heavy-handed focus on director independence at the expense of other skills and qualifications. This focus on independence has been advocated by proxy advisory services and activist shareholders for several years and, at this point, is a well-entrenched feature of the corporate governance landscape. According to the 2010 Spencer Stuart Board Index, the CEO is the only non-independent director on nearly 53% of S&P 500 boards, and this number has risen sharply from 22% in 2000.

Furthermore, regulators and proxy advisory firms have adopted stringent independence standards that have been applied to disqualify outstanding director candidates on the grounds of relatively insignificant business or personal relationships. Earlier this year, the New York Stock Exchange issued guidance to Black & Decker Corp. that suggests the scope of relationships that should be taken into account in making director independence determinations under the NYSE rules may be broader than companies have previously assumed. The NYSE indicated that relationships not only between the company and its directors, but also between a director and a member of senior management, may be relevant.

However, one of the "lessons learned" from the financial crisis is that the tremendous complexity of the businesses and risks facing financial institutions warranted more industry expertise and insider knowledge in their boardrooms. While independence and expertise are not always mutually exclusive, independence thresholds do preclude the candidacy of insiders with extensive, day-to-day knowledge of the company, and tend to also preclude individuals who, in conjunction with their development of industry expertise, have naturally developed relationships and affiliations in the sector. Last year, a joint statement issued by the Department of Treasury, Federal Reserve, FDIC and Comptroller instructed banks to review their existing board membership "to assure that the leadership of the firm has sufficient expertise and ability" to manage risk and maintain sufficient balance sheet capacity.

This focus on director qualifications was expanded beyond the financial sector by proxy disclosure rules adopted by the SEC last year that require companies to discuss the specific experience, qualifications and skills relevant to service as a director at the company. More recently, a report issued by the NYSE's Commission on Corporate Governance noted that "a minority of directors who possess in-depth knowledge of the company and its industry could be helpful for the board as it assesses the company's strategy, risk profile, competition and alternative courses of action," and reminded companies that "a properly functioning board can include more than one non-independent director." As we discussed in a memorandum issued last month (available at this link: The Future of Corporate Governance and the Board of Directors), we believe that, given the importance of expertise, there should be no complaint about adding additional inside directors to a board so long as a majority of the board consists of "independent" directors.