Director Notes

Some Thoughts for Boards of Directors in 2011

by Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain

As boards of directors seek to implement the Dodd-Frank Act and other corporate governance reforms and to engage with shareholders, the key is to strike the right balance and bear in mind that good 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 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. This report highlights a few of the more notable corporate governance issues that boards will face in 2011.

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 such mandates 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.

Most important, as a result of the Dodd-Frank Act[1] 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 corporate directors.

On the responsibility of shareholders and proxy advisors There have been some promising signs of a new focus on the responsibilities of shareholders and proxy advisory firms. This past July, the U.S. Securities and Exchange Commission (SEC) voted unanimously to issue a concept release seeking public comments on the U.S. proxy system,[2] 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 that does not correspond to their economic investment in a company.

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The recent report of the New York Stock Exchange (NYSE) Commission on Corporate Governance[3] 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 United Kingdom, the Stewardship Code[4] 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 and companies to help improve long-term returns, including standards on voting policy disclosures and use of proxy advisory services. In addition, a report issued earlier this year by the Organization for Economic Cooperation and Development (OECD) Steering Group on Corporate Governance[5] 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.

Corporate governance as a means 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 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 that are insulated from short-termist demands and the distraction of form-over-substance governance proposals.

This report highlights a few of the more notable corporate governance issues that boards will face in the New Year.

Proxy Access

One of the most sweeping new reforms on the horizon is the proxy access rules adopted by the SEC last summer.[6] Although the effectiveness of these rules has been stayed by the SEC pending resolution of a legal challenge seeking their invalidation,[7] an SEC spokesperson has said the SEC expects the legal issues to be resolved by late spring 2011. While the effectiveness and the final form of the rules remain 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; therefore, each company should begin to determine the best way to implement proxy access, given the particular features of its corporate governance regime.[8]

The SEC rules currently on hold provide that shareholders and shareholder groups that have collectively held investment and voting power of at least 3 percent continuously for at least three years 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 do not have the ability to opt out or to adopt more limited arrangements. Shareholders are entitled to nominate up to a maximum of 25 percent 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 percent cap for the following two annual meetings). Shareholders intending to make use of proxy access are 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. However, proxy access is expected to strengthen the 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. As a result, companies will need to engage constructively and proactively with shareholders; in cases when directors nominated by shareholders are successfully elected, boards may need to work to minimize the potential for adverse effects on board stability, collegiality, and effectiveness.

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.[9] 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 (e.g., every one, two, or three years). A triennial rather than annual say-on-pay vote could align more closely say-on-pay with the goal of avoiding short-termism in corporate governance and executive pay arrangements; however, ISS and other proxy advisory firms advocate 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, as well as 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, companies may need to assume the administrative costs of collecting extensive amounts of compensation data.

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.

Risk Management

This past year, the heightened focus on risk management precipitated by the financial crisis was further underscored by the tragic oil rig explosion and spill 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, accompanied by 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[10] principally for financial institutions, and requires bank holding companies with total assets of $10 billion or more, as well as certain other nonbank financial companies, to have a separate risk committee including 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 company'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 nonexecutive 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 surprising, 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.[11]

However, as a basic principle, the board cannot and should not be involved in actual day-to-day risk management. Instead, through their risk oversight role, directors should 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;
- these policies and procedures are functioning as directed; and
- 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 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. The compensation committee should be engaged as management develops the compliance framework and should coordinate with risk and audit committee members in fulfilling its function.[12]

Board Composition and Director Qualifications

The most important factors in determining the effectiveness of boards are 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 percent of S&P 500 boards, and this number has risen sharply from 22 percent in 2000.[13] The Conference Board reported similar data even for smaller companies.[14]

Earlier this year, the NYSE 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.[15]

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 U.S. 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.[16]

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.[17] 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."[18] For these reasons, 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.[19]

Endnotes

1 The Wall Street Reform and Consumer Protection Act of 2010 (also known as the "Dodd-Frank Act," available at www.opencongress.org/bill/111-h4173/text/).

2 SEC Release No. 34-62495 ("Concept Release on the U.S. Proxy System,") July 14, 2010, available at www.sec.gov/rules/concept/2010/34-62495.pdf.

3 *Report of the NYSE Commission on Corporate Governance,* New York Stock Exchange, September 23, 2010, available at www.nyse.com/pdfs/CCGReport.pdf.

4 The UK Stewardship Code, Financial Reporting Council, July 2010, available at www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf.

5 *Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles,* OECD Steering Group on Corporate Governance, February 24, 2010, available at www.oecd.org/dataoecd/53/62/44679170.pdf.

6 See SEC Release 33-9136 ("Facilitating Shareholder Director Nominations") August 25, 2010, available at http://sec.gov/rules/final/2010/33-9136.pdf.

7 For the SEC order granting the stay, see http://sec.gov/rules/other/2010/33-9149.pdf.

8 See "Shareholder Proxy Access: Time To Get Ready," client memorandum, Wachtell, Lipton, Rosen & Katz, September 2, 2010, available at www.wlrk.com/webdocs/wlrknew/wlrkmemos/WLRK/WLRK.17886.10.pdf.

9 See Section 951 et ss. of the Dodd-Frank Act.

10 Section 805 of the Dodd-Frank Act.

11 Matteo Tonello and Judit Torok, *The 2010 U.S. Directors' Compensation and Board Practices Report,* The Conference Board, Research Report 1467, 2010, p. 59.

12 For a more detailed discussion of risk management issues facing companies and their boards today, see "Risk Management and the Board of Directors," client memorandum, Wachtell, Lipton, Rosen & Katz, December 3, 2010, available at www.wlrk.com/webdocs/wlrknew/wlrkmemos/WLRK/WLRK.18121.10.pdf.

13 *U.S. Board Index 2010,* Spencer Stuart, October 2010, available at www.spencerstuart.com/research/articles/1454/.

14 See Tonello and Torok, p. 34.

15 For a discussion, see Oliver C. Brahmst, et al., "Relationships between Directors and Senior Management under Stock Exchange Independence Standards," in The Harvard Law School Forum on Corporate Governance and Financial Regulation, April 4, 2010. Available at http://blogs.law.harvard.edu/corpgov/2010/04/04/director-management-relationships-under-stock-exchange-independence-standards/#more-8289.

16 "Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Blair, and Comptroller of the Currency John C. Dugan," U.S. Department of the Treasury, May 6, 2009, available at www.financialstability.gov/latest/tg91.html.

17 Regulation S-K, Item 401(e) and Item 407(c)(vi). Also see SEC Release No. 33-9089; 34-61175 ("Proxy Disclosure Enhancements"), December 16, 2009, available at www.sec.gov/rules/final/2009/33-9089.pdf. On this topic, see Louis L. Goldberg and Janice Brunner, *Enhanced Disclosure in the Dow 30 and Select Financial Companies: Board Diversity and Director Qualifications,* Director Notes 12, The Conference Board, August 2010.

18 *Report of the NYSE Commission on Corporate Governance*, p. 5.

19 Also see "The Future of Corporate Governance and the Board of Directors," client memorandum, Wachtell, Lipton, Rosen & Katz, November 17, 2010, available at www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.18080.10.pdf.

About the Author

Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz, specializes in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy and has written and lectured extensively on these subjects. Lipton is chairman of the board of trustees of New York University, a trustee of the New York University School of Law (chairman 1988-98), a member of the Council of the American Law Institute, and a director of the Institute of Judicial Administration. He also is a member of The American Academy of Arts & Sciences, a trustee of The Economic Club of New York, a member of the International Advisory Council of Guanghua School of Management of Peking University, and a Chevalier de la Légion d'Honneur. Lipton has a B.S. in Economics from the Wharton School of the University of Pennsylvania and an L.L.B. from the New York University School of Law.

Steven A. Rosenblum has been a partner at Wachtell, Lipton, Rosen & Katz since 1989 and serves as co-chair of the firm's corporate group. He focuses on mergers and acquisitions, buyouts, takeover defense, shareholder and hedge fund activism, proxy fights, joint ventures, restructurings, corporate governance, and securities law. He is a member of the American Law Institute, the ABA Committee on Corporate Laws, and the board of advisors of the Yale Law School Center for the Study of Corporate Law. He has been recognized by Chambers Global as one of the world's leading transactional lawyers. Rosenblum received his J.D. from Yale Law School in 1982 and his B.A. from Harvard College *magna cum laude* and Phi Beta Kappa in 1978.

Karessa L. Cain is an associate in the corporate department at Wachtell, Lipton, Rosen & Katz, where she has worked on matters ranging from domestic and cross-border mergers and acquisitions, private equity transactions, corporate governance matters, proxy contests and joint ventures. Cain graduated *cum laude* from Yale College in 2000. She received her J.D. from Columbia Law School in 2004, where she was a James Kent Scholar and a Harlan Fiske Stone Scholar. Following graduation from law school, Cain served as a law clerk to the Honorable J. Clifford Wallace of the U.S. Court of Appeals for the Ninth Circuit.

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About the Series Director

Matteo Tonello is director of corporate governance research at The Conference Board in New York. In his role, Tonello advises members of The Conference Board on matters of corporate governance, regulatory compliance, and risk management. He regularly conducts analyses and research in these areas in collaboration with leading corporations, institutional investors, and professional firms. Also, he participates as a speaker and moderator in educational programs on governance best practices. Recently, Tonello served as the co-chair of The Conference Board's Expert Committee on Shareholder Activism and as a member of the Technical Advisory Group to The Conference Board Task Force on Executive Compensation. Before joining The Conference Board, he practiced corporate law at Davis Polk & Wardwell. Tonello is a graduate of Harvard Law School and the University of Bologna.

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For more information on this report, please contact:
Matteo Tonello, LL.M., S.J.D., director, corporate governance, at 212 339 0335 or matteo.tonello@conferenceboard.org.

The Conference Board www.conferenceboard.org

The Americas 845 Third Avenue, New York, NY 10022-6600, United States / Tel +1 212 759 0900 / Fax +1 212 980 7014

Asia **CHINA** Beijing Representative Office, 7-2-72 Qijiayuan, 9 Jianwai Street, Beijing 100600 P.R. China / Tel +86 10 8532 4688 / Fax +86 10 8532 5332 / www.conferenceboard.cn

HONG KONG Suite No. 2-3, 18/F, Queen's Place, 74 Queen's Road Central, Hong Kong SAR / Tel +852 2804 1000 / Fax +852 2869 1403

INDIA A-701 Mahalaxmi Heights, Keshavrao Khadye Marg, Mahalaxmi (East), Mumbai 400 011 India / Tel +91 22 23051402

SINGAPORE 8 Eu Tong Sen Street #22-81, The Central, Singapore 059818 / Tel +65 6325 3121 / Fax +65 6222 4637

Europe Chaussée de La Hulpe 130, box 11, B-1000 Brussels, Belgium / Tel +32 2 675 54 05 / Fax +32 2 675 03 95

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