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CORPORATE FINANCE REVIEW (ISSN 1089-327X) is published bimonthly by Warren, Gorham & Lamont, Division of Thomson Reuters, 195 Broadway, New York, NY 10007. Subscriptions: $285.00 a year. For subscription information, call 1 (800) 950-1216; for customer service call 1 (800)431-9025. Foreign callers (who cannot use our toll-free numbers) should call (914) 749-5000 or fax (914) 749-5300. We encourage readers to offer comments or suggestions to improve the usefulness of future issues. Contact Scott Gates, Editor, Thomson Reuters, 195 Broadway, New York, NY 10007; (212) 337-4129.

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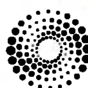
Postmaster: Send address changes to CORPORATE FINANCE REVIEW, Thomson Reuters, 117 East Stevens Avenue, Valhalla, NY 10595.



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WHAT BOARDS NEED TO DO TO PRESERVE THEIR RELEVANCE AND PROVIDE VALUE IN THE WORLD OF THE NEW NORMAL

The authors investigate the causes of board dysfunction and illustrate ways for corporate boards to reclaim their reputation.

FRED G. STEINGRABER AND KAREN KANE

Congress, taxpayers, activist shareholders—and now a blockbuster book written by Wall Street insiders—blame the financial crisis on a systemic collapse of corporate democracy caused by the utter failure of corporate boards to do their jobs. Though corporate CEOs such as Angelo Mozilo of Countrywide, Jimmy Cayne of Bear Stearns, and Richard Fuld of Lehman Brothers may be top contenders to the Corporate Greed Hall of Shame, the reputations of individual directors that sat on those company boards are also damaged beyond repair. In the last three years, directors have presided over corporate governance failures that cost shareholders trillions of dollars.

How did we get here? Directors relinquished governance authority gradually, almost imperceptibly, over the past decade. Since the early 2000s, the center of gravity for corporate responsibility and board oversight quietly shifted from the CEO, to the board of directors, to shareholder activists, and now increasingly to government. Ten years ago, it was easy for boards to ignore shareholder concerns and petitions as aberrations. In reaction to this nonchalance, shareholder activists agitated for greater regulations to enforce their rights, and in doing so, launched a worldwide movement that has resulted in gradual power shift and a more shareholder-centric world.

The impetus for this power shift was born in the accounting and auditing scandals of Enron and WorldCom in the late 1990s, followed by a litany of other bad behavior including insider trading, backdating options, and earnings restatements—all

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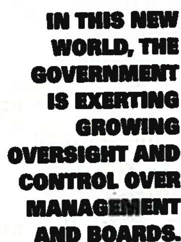


IN THIS NEW WORLD, THE GOVERNMENT IS EXERTING GROWING OVERSIGHT AND CONTROL OVER MANAGEMENT AND BOARDS.

of which made boards appear to be complicit in management's sins. In the recent global economic crisis, the reputation of corporate boards hit an all-time low. How is it possible—asked the public—that directors lacked the competence to understand and rein in risk posed by complex financial instruments? Failed to understand the risks of dual CEO-chairperson roles? Approved unprecedented and reckless degrees of leverage within their institutions? The fallout from governance incompetence devalued the pension assets of 57 million Americans who invest in public companies and brought about the still-shocking bailout of iconic companies such as General Motors and AIG. Suddenly, the public at large has a stake in corporate governance.

Today, most boards have experienced the removal of poison pills, the end of supermajority, the elimination of staggered boards, and majority voting replacing plurality voting. The ban on broker voting, the SEC's requirements for greater disclosure regarding the structure of the board and the competencies of its directors will all be up for debate. In the meantime, Congress has advanced legislation to mandate such advisory votes on executive compensation at all public companies. For the past three years, the number of shareholder resolutions has remained steady at just under 1,200 per year, double what it was in 2002.

Current bestsellers document how closely the world economy came to failure in 2008: *On the Brink, Too Big to Fail, The Quants, Money for Nothing,* etc. Politicians unwilling to waste a crisis have exploited public outrage over corporate malfeasance to fuel their own populist agenda. In this new world, the government—including Treasury, the Federal Reserve, the SEC, Congress, and the president—is exerting growing oversight and control over management and boards.

Understanding the root causes of board dysfunction

For years, boards of directors worked behind the scenes and their activities were largely invisible to the public. In recent years, the inaction and ineffectiveness of some boards have shaped the public's perception of all boards. Cynicism is the natural reaction to director silence and the trillions of dollars of losses. Not surprisingly, trust in corporate governance was a victim of the economic collapse. And because boards are so unaccustomed to maintaining a public profile, they have been largely absent from the public dialogue on governance. This silence has only reinforced the belief that boards have no real long-term orientation and no substantive personal investment or alignment with shareholders.

Too often, the facts bear this out. As Sarbanes-Oxley (SOX) brought stricter requirements, many boards began providing oversight by checklist, with greater focus on compliance and short-term performance. Worse, CEOs of failed enterprises departed with rich compensation packages approved by the board. Documentation of executive pay practices showed that boards had relied too heavily on compensation surveys and inappropriate peer data as opposed to substantive and longer-term business performance. Even detractors don't dispute that SOX had a significant impact on improving audit and accounting trails and reducing earnings restatements. Yet the impact of SOX was largely limited to accounting and audit.

At the same time, it appeared that boards were not paying enough attention to productivity, quality, growth, and risk management—mechanisms by which companies renew their businesses, pursue sustainable growth, and mitigate risk. CEO tenure declined and turnover reached new highs, demonstrating that leadership development and succession planning had been largely ignored by boards. Much of the pressure to separate the role of the chairperson and CEO focuses on the issue of succession planning: How can a CEO properly identify and develop his or her own replacement? The public was shocked when embattled Bank of America CEO Ken Lewis announced his resignation and it was immediately clear that the board had no succession plan in place. Although the public was shocked, many board direc-

tors in other companies realized that their own boards would not have fared any better.

The consequence of director inaction or inefficacy has been confident shareholder and government action. Emboldened by wins on say-on-pay and proxy access, shareholders are morphing into a stronger force in corporate governance. More distressing, the government has intervened in private enterprise in ways that were once unimaginable: influencing decisions on executive and director appointments, compensation, financing, investment, mergers and acquisitions, and sale of assets.

In spite of the colossal governance failures, however, the loudest critics of corporate boards do not advocate their elimination. Rather, the AFSCME, the Council of Institutional Investors, CalPERS, CalSTRS, the Corporate Library, and others want boards to provide greater oversight by asserting their independence. To the say-on-pay advocates, an advisory vote on compensation reinforces the accountability of boards to shareholders but does not usurp board power. In fact, except in rare activist cases, shareholders do not want to take on the work of the board. They just want the boards to do the job for which they have been hired. Who then would they hold accountable if shareholders were empowered to approve executive compensation? It is ultimately boards rather than shareholders that must approve executive compensation decisions that bear some relationship to longer-term business performance, are aligned with shareholder interests, and are fully transparent.

The current corporate structure presumes the board's relevance while imposing responsibilities. Boards should consider the recent governance actions as a signal that regulators and shareholders want boards to show greater leadership, independence and accountability. Recent regulatory action has endorsed the shareholder legitimacy for holding boards accountable. At the same time, shareholders have obligations to be informed and to act in a responsible way aligned with the company's objective of long-term value creation.

Toward repairing the reputation of the corporate board

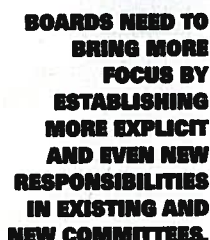
To regain the trust of shareholders and regulators, boards will have to reestablish their governance authority. Boards require a culture change, including an acknowledgement of the role of shareholders in the governance process and a recommitment to excellence. Directors will be required to reexamine and even revise board committees and committee work. This will require new skills and qualifications as well as more time and effort to understand the companies they serve, to provide effective oversight in representing the interests of shareholders, and to hold management accountable.

It will take substantive changes for boards to regain the trust needed to recapture oversight control and to be perceived as fulfilling their stewardship duties. It begins with board organization, and includes the competencies of the board members as well as processes and committee roles. Boards need to transform themselves into strong, highly functioning work groups whose members trust and challenge one another. Directors also need to recognize the role shareholders play: They are the owners of the company and board-shareholder engagement is an important element in keeping them invested. Most importantly, boards need to demonstrate leadership, which has been lacking, with a transparent, results-orientation in the conduct of their work.

Public boards must face the reality that they will soon be operating in a world where majority voting, say-on-pay, shareholder access to director nomination, and a separation of CEO and chairperson roles are the norm. Some of these changes will happen this year, others in the not-so-distant future. Already, the SEC has banned broker voting and increased the disclosure requirements for compensation, director experience, and succession planning. Some form of proxy access is in final consideration by the SEC and various shareholder bills of rights under consideration will separate the role of the chairperson and the CEO.

BOARDS SHOULD CONSIDER THE RECENT GOVERNANCE ACTIONS AS A SIGNAL THAT REGULATORS AND SHAREHOLDERS WANT BOARDS TO SHOW GREATER LEADERSHIP, INDEPENDENCE, AND ACCOUNTABILITY.

How smart boards are seeking meaningful change



BOARDS NEED TO BRING MORE FOCUS BY ESTABLISHING MORE EXPLICIT AND EVEN NEW RESPONSIBILITIES IN EXISTING AND NEW COMMITTEES.

Some boards are stepping up. RiskMetrics Group reported in early March that 56 US public companies have adopted some form of say-on-pay, which does not include the 311 companies that held advisory votes in 2009 as a result of their participation in the Troubled Asset Relief Program. Many boards have already separated the chairperson and CEO roles (approximately 40% of the S&P 500). Other companies are voluntarily increasing the responsibility and authority of the independent lead director as a path to separating the chairperson and CEO role in the future. Those boards that still feature a combined chairperson-CEO must document the board's structure and how it best serves the organization. Directors are expected to engage from time to time with the owners of the company—the shareholders who elect them—particularly on matters of executive compensation. The boards that have been leaders in the arena of board-shareholder communication were generally prompted by management or a board issue that required shareholder buy-in, a crisis, or a merger. Boards that have engaged in dialogue with shareholders report that the input has been helpful and has made them more effective directors.

Greater scrutiny and a wider cast of stakeholders have changed the role of the board forever. Directors are expected to bring their relevant business experience and judgment to help companies execute winning strategies. At the same time, directors put their reputations on the line. The best directors engage directly with leadership to challenge and improve management strategies to protect companies against threats of rapid decline and sudden demise. Strong directors can serve as player coaches helping management to seize the opportunities that can elude management in the daily fray of running the business. The best boards turn governance into a competitive advantage.

Going forward, directors will possess additional and different skills, take on greater responsibility, and spend more time in order to understand fully the companies they serve, their core businesses, their strategies, the drivers of success, and the accompanying risks. They will do this *not* to manage the company, but because it's what it takes to provide effective oversight and enterprise risk management. Understanding is a critical element of risk assessment. Being a director is still less than a full-time executive position, but it is also far more serious than a part-time job. Gone are the days when former CEOs routinely served on seven or eight boards. There may even be a trend for "professional" directors, who retire as executives early and redirect their careers to governance. Boards are not lifetime achievement awards for distinguished CEOs or ceremonial roles. In this new phase, directorships will become professional positions with relevant and requisite qualifications required to serve, including the contribution of more time.

Directors need to demonstrate their dedication to reform and renew their commitment to integrity, good judgment, and sufficient due diligence. They need to rethink and reconfigure their committee structure and committee work for greater effectiveness—which will likely involve a combination of some new responsibilities in existing committees as well as the creation of new committees. This will mean implementing new best practices that will require the same comprehensive, intense effort that was needed to implement the financial and audit guidelines of Sarbanes-Oxley. The good news is that this will be a more public transformation, which is what is required.

Most boards currently have audit, compensation, and governance and nominating committees. Though these committees are essential, boards in the future must also include committee work on leadership development and succession planning, operations, growth, risk management, and shareholder communication if they hope to provide meaningful and credible oversight for the companies they represent. Boards need to bring more focus by establishing more explicit and even new responsibilities in existing and new committees.

As in all blueprints for change, the devil is in the details. Here is an outline of the responsibilities, roles, and skills

that need to be addressed more effectively in new or existing committees:

Leadership development/succession planning committee. The purpose of this committee is to oversee the scope and quality of leadership development programs/processes, the succession planning processes and progress, the assessments of talent bench-strength, and talent risk management, among other things. Boards need to spend far more time in this area, including overseeing the alignment human resources with business strategy. Leadership development and succession planning is without a doubt one of the areas of highest risk if not pursued in a proactive mode by the board of directors.

Operations. The purpose of operations is to oversee the establishment of performance targets by implementing best practices in productivity, quality, and service. In addition, it should audit the application of technology, shared services, and outsourcing to achieve performance improvement. This will require different skills than those found on many boards today and is a vital forward-looking area of key indicators impacting risk and financial performance.

Corporate growth and resource. The purpose of this group is to review organic growth targets and trends. This would include products and services, markets and channels, geography, and relevant resource requirements. This committee should oversee the due diligence related to acquisitions as well as postmerger audits. It would also be responsible for understanding and overseeing the targeted and actual growth in revenues from new products in the last three to five years.

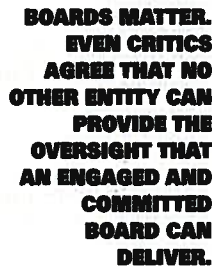
Risk management committee. The group should be configured in a far more holistic way than is typically done currently to include a range of issues that can impact the business, including macroeconomic conditions, regulatory trends, demographic changes, technology, competition, environment, consumer behavior, energy, leadership depth and breadth, financial resources, and balancing change and continuity. In addition, this Committee should review the strength, weakness, opportunity and threat analysis periodically.

Boards need to address shareholder communications and ensure that the company provides transparency and effective shareholder communications across multiple audiences—including investors, brokers, and owner research groups—as well as through traditional outlets such as proxies, annual reports, and on investor website portals.

Compensation committee. This committee should continue to perform many of the current functions, but also adopt a clear statement of compensation philosophy that provides a transparent understanding of the factors that drive compensation decisions. Incentive compensation awards for executives should be tied to the business performance and not share price. Although these goals may include both short- and long-term targets, longer-term performance and goals should be weighted more heavily. Perhaps of greatest importance is the need to move to a principles-based system of compensation determination and reporting. Examples of key principles could include accountability, alignment, fairness, transparency, and objectivity as briefly defined below:

- Accountability: Demonstrate that incentive pay is tied to business performance targets/metrics established *prior* to the commencement of the evaluation period with approval of awards based on audited financial results. There should be no incentives for failed or material nonperformance and claw-backs for earnings restatements and fraudulent results.
- Alignment: Establish an alignment of CEO incentive compensation in relation to shareholder rewards and incentives for other top-level executives (including direct reports and supervisors). Establish a balance, with the majority of incentives being tied to longer-term business performance. Incentive compensation and stock awards should provide for a deferred component objective over time (vesting) with a material component of shares being

PERHAPS OF GREATEST IMPORTANCE IS THE NEED TO MOVE TO A PRINCIPLES-BASED SYSTEM OF COMPENSATION DETERMINATION AND REPORTING.



BOARDS MATTER. EVEN CRITICS AGREE THAT NO OTHER ENTITY CAN PROVIDE THE OVERSIGHT THAT AN ENGAGED AND COMMITTED BOARD CAN DELIVER.

held through departure or retirement.

- Fairness: Establish an order of priority for the allocation of discretionary awards during good and bad economic times; require senior executives to hold a targeted level of share investment in relationship to their compensation. Avoid paying tax gross-ups on executive compensation and perquisites and only pay change-of-control awards when both a change of control and termination occurs.
- Objectivity: Verify the independence of all compensation committee members and ensure compensation consultants selected are independent of management and board connections. Verify appropriateness of peer company comparisons. In addition to compensation, peer comparisons should include relevant business performance metrics.
- Transparency: Communicate internally and externally the company compensation principles (and the application of these in reporting); provide a complete compensation tally sheet in proxies and annual reports (in the CD&A section), including all compensation, deferred payments, pensions, tax planning, stock options, severance, change of control, benefits, etc. paid to top executives as well as how the company has observed each of the principles outlined and, if not, why not.

Finally, boards should be expected to adopt a policy to comply or explain with respect to reporting in proxies and annual reports the demonstrable application of the above compensation principles.

The governance and nominating committee. This committee will need to adjust its charter and approach to take into account the skills and qualifications required for the new committees and their additional responsibilities.

The reinvigorated committee will need to look beyond just sitting CEOs to directors with expertise in succession management and leadership development, perhaps C-level Human Resource experts, individuals with expertise in productivity, quality and service best practices, growth strategies and risk management. These will not necessarily be only sitting CEOs. The list may include former CEOs, academicians, research leaders, management consultants, think tank experts and technology gurus. It also makes sense to look at individuals with backgrounds in economics, technology, competitive assessment, finance and shareholder communications.

Conclusion

These ideas represent a fundamental shift in the breadth and focus of board work, which will bring about other needed changes. As boards get back to the proper oversight of management and engage in corporate strategy, corporate performance, and risk management, the enterprise itself will be strengthened. Shareholders, too, must change and exercise responsibility by educating themselves. Though lawmakers and regulators have focused on shareholder losses, the financial crisis also took its toll on the company's other stakeholders: customers, employees, suppliers, and creditors. It raises the issue of the corporation's longer-term mission. Some innovative boards have begun to focus on a stakeholder mission to include shareholders as well as other key constituencies such as employees, customers, vendors, and even communities in pursuing sustainable long-term value enhancement.

In this new world, boards will also have a chance to engage with a broader group of stakeholders, convincing them of the board's execution of their duty of loyalty and duty of care in overseeing the enterprise. Directors could find themselves serving an important role as private enterprise statesmen.

Boards matter. Even critics agree that no other entity can provide the oversight that an engaged and committed board can deliver. Directors serve a critical purpose in our economic system and we all have an enormous stake in reforming them for the benefit of the shareholders, the customers, the employees, the suppliers, and the community. ■