AGENDA

THE WEEK'S NEWS FROM OTHER BOARDROOMS

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HIGHLIGHTS...

AUDIT & RISK MANAGEMENT

2 **Corporate Taxes and Dodd-Frank's Derivatives Rules**
Boards need to query their treasuries about new rules

3 **COSO Risk Oversight Surveys Reveal Need for Improvement**
Report outlines ways to improve

LEGAL AND REGULATORY

4 **Debate Over Say-on-Pay Fine Print Continues**
Companies and investors plead cases to SEC

OPINION & ANALYSIS

5 **Forget Dodd-Frank; SOX Still Top Nuisance for Boards**
SOX was a bad idea from the beginning, opines Stephen Bainbridge

COMPENSATION

6 **GM CEO Calls for Looser Pay Restrictions**
New chief fears talent will leave the company

7 **Compensation Committees: Key Stats**
More meetings, more pay and more retired chairmen

NOMINATING & GOVERNANCE

9 **Fewer Board Seats After Lawsuits**
Study reveals how directors lose their attractiveness

Rethinking the Value of Independent Boards

New studies reveal risk and performance issues

by Josh Martin

Corporate boards dominated by independent directors have not effectively linked compensation to reduced risk taking or performance, according to a series of recent studies. Such boards, the studies suggest, may lack the expertise or the clout with management to put forward necessary long-term pay policies.

These studies, conducted by scholars at **Princeton University**, the **University of Michigan**, the **University of Southern California** and other institutions, come as some lawmakers, governance experts and regulators are clamoring for more independence on boards to strengthen their oversight of management.

The effectiveness of board independence is most explicitly challenged in a major study conducted by USC's Leventhal School of Accounting, which examined the performance of boards at 296 banks, brokerages and insurance companies up through the 2007-2009 financial crisis.

The report finds that firms with more independent boards and higher institutional ownership experienced

Independent Boards continued on page 8

SEC: No Need to Disclose Future Pay Targets

Targets required only for completed performance periods

by Katie Wagner

The **SEC** has taken the official stance that companies do not need to disclose performance targets for ongoing pay programs in their Compensation Discussion & Analysis (CD&A) sections.

There has been some inconsistent treatment on this in staff comments, said **Meredith Cross**, the SEC's director of the Division of Corporate Finance, during the **Practising Law Institute**'s annual securities regulation conference last month.

"[The] official stance is no, you don't have to disclose future targets that you're in the process of trying to meet," Cross said.

This announcement came just about a year after **Shelley Parratt**, who was the SEC's deputy director of the Division of Corporate Finance at the time, gave a speech that focused on what the SEC requires companies to disclose in their CD&As regarding their incentive pay targets. That

CD&As continued on page 7

Corporate Taxes and Dodd-Frank's Derivatives Rules

A last minute addition could have large effect on tax treatment

by Katie Wagner

The Dodd-Frank Act could have surprising and unfavorable tax consequences for many corporations. The new law provides for entirely new treatment of over-the-counter derivatives, in that it requires most of them to be cleared and traded on exchanges like **Nymex** and **CME**.

Corporations that used over-the-counter derivatives in the past received ordinary tax treatment on the income flows from those agreements, meaning that gains were considered to be income and losses were deducted from income for tax purposes.

Boards may need to make sure that their treasury and tax departments are aware of which derivatives will be required to be traded on exchanges that previously were not and how any new tax treatment for those derivatives will impact their companies.

Now that most over-the-counter derivatives are required to be traded on exchanges, the expectation is that almost all such derivatives will be subject to the same tax treatment as other exchange-traded derivatives. Generally, the tax treatment for exchange-traded derivatives has been less favorable for corporations than the tax treatment of over-the-counter derivatives. Corporate America is still waiting for the **IRS** to issue guidance on the act.

"Even without Dodd-Frank, one of my clients lost hundreds of millions of dollars in capital losses because its management wasn't aware of the tax implications of its derivatives activities," says **Viva Hammer**, a partner at **KPMG** in Washington and formerly associate tax legislative counsel in the Office of Tax Policy at the **Treasury Department**.

"Shifting over-the-counter derivatives to being cleared and traded on public exchanges would generally be a bad thing for corporations, for two reasons," says Hammer. "First, because exchange-traded derivatives must be marked to market at year-end for tax purposes. This means that there will be lots of losses and gains and the losses may outweigh the gains by a large amount because derivatives are highly volatile.

"Additionally, when derivatives are traded on exchanges, they receive capital treatment. Corporations do not like capital treatment in general because capital losses cannot be offset against ordinary income."

Another challenge that corporations will face as a result of Dodd-Frank is to determine which of their derivatives will be subject to the IRS's Section 1256 rules.

Thanks to some ambiguous terms included in the last page of Dodd-Frank, this will not be an easy task. That is because on that page Dodd-Frank exempted a list of swaps and other contracts from the mark-to-market rules provided in Section 1256. But the act does not define the individual kinds of exchange-traded derivatives that will be exempt (please see sidebar).

Some of these terms, which were pulled from IRS tax regulations, also are defined in another part of Dodd-Frank. But **Steven Rosenthal**, a partner with **Ropes & Gray**, says this may be a coincidence, because the last page of Dodd-Frank was put together just hours before the bill was passed by Congress.

Fortunately, the IRS just added "guidance on the application of [Section] 1256 to certain derivative contracts" to its annual business plan for the 2010-2011 period. Additionally, the "Treasury Department is supposed to be writing rules explaining what the last page of Dodd-Frank means, and they're waiting for people to write comments to them on this," says Hammer. ■

Derivatives Dodd-Frank Exempts From 1256 Mark-to-Market Tax Treatment

The Problem: The Act Fails to Define These Terms

List of Exempt Derivatives:

- any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract; or
- any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

Source: Dodd-Frank Act

Katie Wagner (212-542-1243 or kwagner@AgendaWeek.com) covers executive compensation and audit committees.

COSO Risk Oversight Surveys Reveal Need for Improvement

Directors are split on their views; corporate risk officers are pessimistic

by Marc Hogan

Many companies have room for improvement when it comes to identifying and addressing risks. That's the key takeaway from a pair of recent surveys commissioned by **COSO**, formally known as the Committee of Sponsoring Organizations of the Treadway Commission.

One survey, conducted jointly with consulting firm **Protiviti**, finds that directors are split on the current state of their boards' risk oversight practices. The other shows that management-level risk leaders hold a more pessimistic view of their companies' underlying risk management processes.

Of more than 200 board members who responded to Protiviti's online questionnaire in the third quarter of 2010, 53% identified the board's risk oversight process as either "effective" or "highly effective." But 71% of respondents noted that their boards are not formally executing "mature and robust" risk oversight processes.

More than half of the director survey's respondents served on boards of public rather than private companies. The results among public company directors were slightly more positive, especially among those from larger organizations. For instance, 59% of public company respondents indicated that their risk oversight processes are either "effective" or "highly effective," and 65% of respondents from public companies with annual revenue greater than $1 billion did so.

Among public company respondents, as with respondents overall, 71% said their boards are not formally executing "mature and robust" risk oversight processes. Directors from the financial services industry expressed a higher level of confidence, with only 50% of public company respondents saying their boards are failing to formally execute "mature and robust" risk oversight processes. Among nonfinancial organizations, 78% of public company respondents said their boards are failing to do so.

6 Ways for Boards to Improve Risk Oversight

1. Establish a more formal procedure for monitoring key risks.
2. Look for chances to make the risk reporting process more efficient.
3. Raise the frequency of reporting based on company's risk profile
4. Check at least once a year if changes to business environment have altered the assumptions and risks underlying strategy.
5. Establish a more structured procedure surrounding board-management dialogue on the company's risk appetite.
6. Incorporate questions relating to risk oversight into boards' own performance evaluations.

Source: Protiviti

The gap between the many directors who consider their board risk oversight process "effective" and the few who consider the same processes "mature and robust" could boil down to confusion over what "mature and robust" means, Protiviti acknowledges in a report on its findings. "What is a more robust and mature process?" the firm writes. "Generally it is one that is repeatable over time, well-defined, supported by rigorous methodology and analytical frameworks and applied periodically over time as opposed to on an 'as needed' basis."

For the second recent COSO survey, **North Carolina State University**'s Enterprise Risk Management Initiative this summer polled executives who were either leading or knowledgeable about their companies' ERM processes. Of 460 respondents, 37% identified themselves as internal audit heads and 23% as CFOs, followed by chief risk officer (12%), controller (10%) and board member (6%). Forty-one percent of respondents were from public companies. NCSU's ERM Initiative says the results for public companies are "mostly similar" to the results of the full sample.

Those results indicate companies' risk management processes may be less thorough than board members would hope. Nearly 60% of NCSU's respondents said their risk tracking is mostly informal or only conducted within individual silos rather than enterprise-wide. Just 28% of respondents identified their present phase of ERM implementation as "systematic, robust and repeatable" with regular reporting to the board. Meanwhile, 35% said they are either "not at all satisfied" or "minimally" satisfied with how they report key risk indicators to senior executives. ■

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Debate Over Say-on-Pay Fine Print Continues

Companies want fewer requirements, investors want more

by Marc Hogan

Comments on the **SEC**'s proposed say-on-pay rules indicate little controversy, in contrast with the fight over proxy access, but investors and corporate advocates differ on certain key details.

SEC officials have said they want to see final rules approved before 2011, *ISS Governance Weekly* reports.

The rules implement the Dodd-Frank Act's mandates on shareholder advisory votes on executive compensation, say-on-pay vote frequency and golden parachutes.

Based on a sampling published by *ISS Governance Weekly*, the more than 60 comments received by the SEC on its say-on-pay rules fall along familiar lines, with corporate representatives generally arguing for fewer formal requirements and investors typically seeking expanded requirements.

For one example, British investors **Railpen Investments** and the **Universities Superannuation Scheme** recommend that the SEC force companies to take pay-related questions in a conference call or online forum prior to their proxy voting deadlines.

A big area of difference between investors and issuers concerns whether companies should be allowed to omit shareholder proposals that seek a different frequency for future pay votes. The proposed rules would allow companies to do just that — if they approve the pay-vote frequency preferred by a plurality of shareholders.

Dodd-Frank forces companies to hold votes on pay-vote frequency every six years.

Afscme, **Walden Asset Management** and the **Social Investment Forum** urge the SEC to allow shareholders to voice their opinions on frequency more often than every six years if warranted.

"Significant changes can occur in a company's compensation practices during a six-year period, and such changes could affect shareholders' views regarding the desirable frequency of [say on pay] votes," Afscme writes.

Corporate advocates oppose such votes, which the NACD calls "disruptive." Eaton finds "no compelling justification" for an additional vote where a company already conforms to the wishes of a plurality of shareholders.

Boeing cautions that permitting shareholder proposals on frequency after a "material" change in pay policies would require the SEC to wade through heaps of no-action letters to determine which changes are material.

Boeing also says the SEC should allow companies to be flexible in interpreting frequency-vote results. "For example, if shareholders' preference is split 34% for an annual vote and 33% each for a biennial and triennial vote, an issuer may determine that a biennial vote best reflects overall shareholder preference," the company writes.

Other areas where corporate representatives and investors take opposing views include whether companies should be allowed to omit similar shareholder proposals and whether companies should have to address whether they considered previous shareholder votes on compensation.

According to *ISS Governance Weekly*, comments show broad agreement that the SEC should not mandate specific language for advisory vote proposals. ■

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Forget Dodd-Frank; SOX Still Top Nuisance for Boards

Dodd-Frank corporate governance provisions are comparatively moderate

by Stephen Bainbridge

Stephen Bainbridge *is the William D. Warren Professor of Law at* **UCLA**, *where he holds a seminar on corporate governance.*

U.S. capital markets are becoming less competitive globally. Foreign companies long present in the U.S. are delisting from U.S. stock markets.

It's generally agreed that the growing maturity and liquidity of overseas market fuels this trend. But I believe the critical factor is the disproportionate growth of U.S. regulatory compliance costs and liability risks relative to other markets. The main culprit behind this development is not the Dodd-Frank Act; it goes by the familiar acronym of SOX. Why is this?

First, even though the Dodd-Frank Act is a much larger act than the Sarbanes-Oxley Act, it ended up having a relatively modest number of corporate governance provisions.

Second, we don't know yet what the costs of Dodd-Frank's provisions will be, because most of them haven't kicked in yet. In contrast, we know a lot about SOX's costs and the adverse impact of those costs.

SOX Section 404 is the poster child for excess regulatory compliance costs. And, unfortunately, the evidence is clear that many 404 costs turned out to be not one-time start-up costs, but reoccurring annual expenses.

There's also very little doubt that the costs outweigh the benefits. SOX discouraged privately held corporations from going public. Start-up companies opted for financing from private-equity firms, rather than using an IPO to raise money from the capital markets. Consider how the post-SOX period saw the declining share of U.S. markets in such transactions as global IPOs, and the trend for both foreign and U.S. firms to exit the public U.S. capital markets.

> **"[N]o cure in sight for the corporate governance aspects of the American Illness."**

Worse yet, 404 costs proved curiously resistant to scaling and can adversely impact small companies. Just take the extra cost small companies have had to pay directors, due to their increased responsibilities. Director compensation at small firms increased from $5.91 paid to non-employee directors on every $1,000 in sales in the pre-SOX period to $9.76 on every $1,000 in sales in the post-SOX period. In contrast, large firms incurred 13 cents in director cash compensation per $1,000 in sales in the pre-SOX period, which increased only to 15 cents in the post-SOX period.

Likewise, companies with annual sales of less than $250 million incurred $1.56 million in external resource costs to comply with Section 404. In contrast, firms with annual sales of $1 billion to $2 billion incurred an average of $2.4 million in such costs.

And while Section 404 gets 99% of the attention, the certification requirements in Sections 302 and 906 significantly increase the regulatory burden on the CEO and CFO. In turn, because best practice requires the assistance of other corporate executives, much of the top management team's time is devoted to preparing these certifications instead of conducting business. In addition, the heightened liability exposure created by these sections increases the risks to which these executives are subject, for which they will demand compensation.

This is an example of what academic **Larry Ribstein** called a bubble law. This concept touches on the three recurring problems with federal responses to the bursting of a stock market bubble. First, federal bubble laws tend to be enacted in a climate of political pressure that does not facilitate a careful costs and benefits analysis. Second, federal bubble laws tend to be driven by populist anti-corporate emotions. Finally, they are often derived from prepackaged proposals advocated by policy entrepreneurs skeptical of corporations.

Federal bubble laws tend to make corporate governance less effective and more costly. Some relief can come when lawmakers begin to see the unintended consequences of their policies. This was seen when Congress used the Dodd-Frank Act to provide Section 404 relief for small reporting companies. But the overall trend in the past century has been for each crisis to result in government expansion. The unfortunate conclusion thus seems to be that there is no cure in sight for the corporate governance aspects of the American Illness. ■

Comp Intelligence

GM CEO Calls for Looser Pay Restrictions

General Motors CEO **Dan Akerson** said earlier this month he would like the Obama administration to ease executive pay restrictions on the company following an initial public offering that slashed the government's GM holdings. So the *Detroit Free Press* reports.

In remarks at the Economic Club of Washington, Akerson expressed concerns about losing quality executives to rivals. He declined to name potential departures or specify what action he wants from the **Treasury Department**, according to the *Free Press*.

GM and other companies that accepted bailout money under the Troubled Asset Relief Program are subject to stringent pay requirements. While $50 billion in bailout money went to GM, the government's position in the company fell by roughly $23 billion thanks to November's IPO, the *Free Press* notes.

Treasury spokesman **Mark Paustenbach** tells the *Free Press* that it's common for the department's acting special master for executive compensation, **Pat Geoghegan**, to receive these kinds of requests.

In other compensation matters, Akerson said 2011 will bring no increases in base salaries for GM salaried employees, according to the *Free Press*.

Akerson stepped into GM's top role in August. His government-approved compensation package awarded him $9 million. **David Rubenstein**, who worked with Akerson when both were managing directors at the **Carlyle Group**, introduced his former colleague at the event and said Akerson could have earned a lot more, according to the *Free Press*.

— Marc Hogan

Morgan Stanley Readies Pay Cuts: Sources

Plan comes as court dismisses suit claiming firm overpaid

by Marc Hogan

Morgan Stanley is preparing to lower the compensation of many top executives in an attempt to shrink the company's overall payout, *The New York Times* reports, citing "people with knowledge of the plan."

In February, Morgan Stanley CEO **James Gorman** responded to shareholder criticisms about lofty pay at the company by pledging to lower its compensation totals. Now the bank is looking to cut executive pay rather than cut jobs, the *Times'* sources say.

Speaking on condition of anonymity, the sources tell the *Times* that Gorman has been saying internally that reducing pay for some now will help the company later. According to the sources, Gorman has called 2010 "the year of differentiation": Employees in divisions that performed strongly, such as equities, will get solid bonuses, while employees in divisions that performed less well, such as fixed-income, might receive lower payouts.

A Morgan Stanley spokeswoman tells the *Times*, "Our long-term success depends on retaining the best people, and we are committed to paying competitively."

Michael S. Levine, a portfolio manager at **OppenheimerFunds**, tells the *Times* that Morgan Stanley has been confronting challenges. Levine's firm owns 1.5 million shares in Morgan Stanley.

"The stock performance between Morgan Stanley and **Goldman Sachs** started to diverge in September and has yet to reverse, showing that the market remains impatient with Morgan on a number of issues, including compensation," he said.

The **New York State Supreme Court** last week dismissed a shareholder lawsuit that claimed that Morgan Stanley had overcompensated its employees in the past few years, Bloomberg reports. Filed by the **Security Police and Fire Professionals of America Fund**, among other shareholders, the complaint called employee payouts for 2006, 2007 and 2009 "unconscionable" in light of the company's financial results, among them its use of government bailout funds.

In a Dec. 10 ruling, New York State Supreme Court Justice **Shirley Werner Kornreich** points to the requirement that shareholders must issue a demand to the board before suing or else prove that such a demand would be futile. The "complaint fails to show" that a demand on Morgan Stanley directors "would be futile," Kornreich ruled, adding, "There is no reasonable doubt that the respective board approvals were not a valid exercise of business judgment." ■

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Happy Holidays!

Agenda will not publish an issue next week due to the holidays.
Our next issue will come out on Jan. 3.

CD&As continued from page 1

speech did not specifically address whether boards needed to be revealing current and future performance targets.

There has been some confusion about whether Regulation S-K, which is the SEC's general list of disclosure items, requires disclosure of targets for ongoing performance periods, according to some compensation attorneys.

"[Regulation S-K] says you have to disclose targets unless they are competitively harmful, and people were saying it's competitively harmful to tell the Street what your targets are that you are in the process of trying to meet," says **Laura Thatcher**, the leader of **Alston & Bird**'s executive compensation practice.

At the same time, the SEC was more lenient about requiring companies to disclose targets for current or future periods than for past performance periods, Thatcher says.

Cross' announcement provided needed clarity for boards in determining what to include in their CD&As, several compensation attorneys say.

The disclosure of future-year performance targets under multi-year incentive programs was the most perplexing aspect of disclosing incentive pay targets for attorneys preparing CD&As.

"The issue is… if you have a three-year performance plan, so [that] in one year's proxy you are reporting that the arrangement has been established. Are you going to disclose the targets that year, or not until after the three years are up?" writes **Ronald Mueller**, a partner at **Gibson, Dunn & Crutcher**, in an e-mail.

Thatcher says her clients have approached disclosures of performance pay targets in a variety of ways.

"Some companies in CD&As say, 'Here's what the performance goals were and how we performed last year,' and if they changed their metrics for the current year they might explain what the new metrics are and the reason for the change. They may or may not say, 'Here are the current targets under the new metrics,'" she adds.

Randolph Ferlic, a director at **Apache**, welcomes the clarification. "What I hate to do is have anything revealed about our true proprietary goals," he says. "It hurts your negotiating stance if you telegraph too much with regards to mergers, acquisitions or dispositions."

While several compensation consultants found Cross's statements surprising, at least one compensation expert said he has always understood Regulation S-K to exclude requiring disclosure of targets for current and future performance periods.

"This has been the SEC staff's general view when it comes to incentive compensation plans that are in progress at the time that disclosure is made," **Mark Borges**, a principal at **Compensia**, writes in an e-mail. ■

Katie Wagner (212-542-1243 or kwagner@AgendaWeek.com) covers executive compensation and audit committees. **Kristin Gribben**, *Agenda*'s associate editor, also contributed to this report.

Compensation Committees: Key Stats

Boards appear to be adjusting to the increasing demands on compensation committees, according to data from the 2010 Spencer Stuart Board Index. Key trends include more meetings, more pay and more chairmen who are retired executives.

Getting Together

More boards have been holding more compensation committee meetings. Thirty-one percent of boards held eight or more meetings last year, according to data from 2010 proxy statements, compared to 27% the year prior.

Pay for Service

Retainers for comp committee members continue to rise along with the demands of the job. The average retainer for committee chairs last year was $16,547, up from $12,304 five years before, according to Spencer Stuart. For all other committee members, the average retainer was $10,445 last year, up from $7,654 five years before.

Boards are also increasingly offering retainers. Thirty-four percent now pay a retainer to their comp committee chairs compared to 17% five years ago and 23% of S&P 500 companies offer a retainer to all committee members, up from 10%, five years prior.

Who's in Charge

Experience as a CEO, chairman or president is more highly valued by boards for their comp committee chairmen than for other committees. There has been a shift, however, toward more retired executives. Last year's data showed 36% of comp committee chairmen were retired CEOs, chairmen or presidents. This year that increased to 40%. ■

— *Eduardo Llull*

Independent Boards continued from page 1

worse stock returns during the crisis period.

Moreover, the report suggests that firms with higher institutional ownership "took more risk prior to the crisis, which resulted in larger shareholder losses during the crisis period," and that firms with more independent boards "raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debtholders."

In this process, the report's authors — **David Erkens**, **Mingyi Hung** and **Pedro Matos** — charge that independent directors did not effectively monitor risk, with the result that major banks ended up dangerously overexposed.

"We found that independent directors didn't have an impact on risk taking before the crisis," says Erkens. "During the crisis, the steps they took often didn't help."

A number of groups, including the **American Accounting Association**, at which the USC report was presented this year, say boards need to add more directors with executive experience and expertise in the sectors in which the companies they lead operate.

Ing-Haw Cheng, a co-author of a separate study by Princeton and the University of Michigan, agrees: "Independence may be overrated compared to other aspects such as having a risk committee or having directors with relevant skills."

This raises the question: What is independence? While the USC study uses **ISS**/RiskMetrics independence standards, the Princeton/Michigan study defines a director as independent if he or she is a non-executive, non-full-time employee of the company. But both definitions hint at the problem many boards face: Even as governance experts bemoan the shortage of director candidates with top management skills, the push for independence might preclude boards from drawing on a key body of experienced managers: insiders who have held or currently hold top executive positions in the company.

Experience Deficits on Boards

The result should not be surprising, says **Ira Kay**, managing partner at **Pay Governance**. "Boards are more independent, with fewer insiders and executives serving," he notes. "The trade-off is that in the process you lose experience on the board."

Board Lessons Learned From Harsh Critique

- Effectively link pay to performance
- Determine pay metrics allowing appropriate risk levels
- Bring expertise to the board
- Be proactive to spot pay-performance disconnects

Critics say drawing on lawyers, academic experts or former government officials because they are "independent" is a poor substitute for an insider's managerial experience, which might allow such directors to better control excessive risk taking. The Princeton/Michigan study underscored the importance of linking the two, citing the "persistently high residual compensation" that prevailed at firms noted for pliant boards and high risk exposures, including **Bear Stearns**, **Lehman Brothers**, **Citicorp**, **Countrywide** and **American International Group**.

While these recent studies focus on the financial services sector, one conclusion they make is that all boards need to be much stricter in curbing excessive CEO pay.

The authors of the Princeton/Michigan study urge corporations to reconsider board structures and appointments. They note that even a principled independent board could be offset "in both firm culture and investor preferences for short-termism and risk-taking."

The USC team's conclusion goes further, directly questioning whether board independence offers any guarantee of better governance: "Our findings cast doubt on whether regulatory changes that increase shareholder activism and monitoring by outside directors will be effective in reducing the consequences of future economic crises," they wrote.

Challenging Conventional Wisdom

Advocates of independent boards say that these conclusions are misleading, in part because the reports consider only particular industry groups, using definitions of independence that might not comply with current standards set by the **SEC** or the **New York Stock Exchange** listing requirements.

But the data presented, covering 3- to 8-year time periods up through 2009, shows independent boards challenged to provide informed oversight of the executive compensation process, allowing management to engage in risky practices in order to push for higher pay. The USC study adds that this occurred despite U.S. financial firms having a high percentage of independent directors (85%) relative to those in other industries, such as manufacturing. A recent study prepared for the **Council of Institutional Inves-**

tors by **Paul Hodgson**, senior research associate at **The Corporate Library**, found that regardless of the degree of board independence, little or no Wall Street compensation was linked to long-term future performance measures, in contrast with policies at many non-financial companies, where incentive pay was awarded for hitting long-term performance targets.

While Hodgson questions the "narrow" definition of independence employed in the USC study, he warns that the record from Wall Street suggests "there is more to an effective board than independence."

Some independence advocates grudgingly agree. **Stephen Brown**, director of corporate governance at **TIAA-Cref**, says that while independent boards may "have [TIAA-Cref's] own long-term interests at heart," such independence isn't a guarantee of good governance. "We look at the issue of board governance on a case-by-case basis," he says. "We look at each director's track record. Beyond independence, we look at the quality of the director and their expertise."

Can independent boards get back on track? The consensus answer is a resounding "yes, but."

"Being independent doesn't necessarily mean that they will act independently," warns Hodgson, noting that such boards will fully link executive compensation to performance and risk factors only if shareholders apply pressure. He believes recent reforms may provide a major tool to do so: "The say-on-pay vote will, I believe, especially in the very worst instances, have a… dramatic [corrective] effect." ■

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Fewer Board Seats After Lawsuits

Study suggests boards are protecting their reputations

by Amanda Gerut

A class action lawsuit may cause independent directors to lose sleep, but it could also result in the loss of other directorships, a recent report concludes.

There is "strong descriptive evidence" that the number of board seats held by independent directors drops three years after misconduct related to misrepresentation of financial information is alleged by investors and a shareholder lawsuit has been filed, finds **Jason Schloetzer**, an assistant professor of accounting at **Georgetown University**'s **McDonough School of Business.**

Schloetzer is the author of a recent **Conference Board** research note on the subject in which he reports that 95.7% of directors who hold at least one other board seat lose at least one directorship, while 96.3% of directors who hold one other board seat lose the directorship.

A director's involvement in a shareholder lawsuit at one company could create concerns that the negative attention will spill over onto the other boards on which he or she serves. Activists and research firms have publicized board interlocks and in the past have referred to the directors as "problem directors." In addition, nominating and governance committees looking for new, qualified directors to serve on their boards may have to decide if it's worth recruiting a director involved in a past or ongoing lawsuit, or if a director currently serving on the board can effectively carry out his or her duties.

Schloetzer looked at research covering 113 companies involved in a shareholder class action lawsuit between 1998 and 2000 that used information in proxy statements to track director turnover. He says it's difficult to distinguish the actual drivers of the decline in directorships among hypotheses researchers have made.

"There is a meaningful risk to directors of losing other directorship opportunities when their board tenure coincides with the initiation of shareholder litigation pertaining to the firm's misrepresentation of financial information to investors," writes Schloetzer in an e-mail response to questions. "The results suggest that directors will almost always confront the question of losing other directorships if such litigation is initiated against the firm."

What's less clear from existing research, says Schloetzer, is whether other boards are less interested in serving with the director, or if the director has less interest in board work or less capacity to serve on other boards.

Some boards have begun reexamining policies for the nominating and governance committee or full board to consider governing when directors offer their resignations. Oftentimes such policies ask for a resignation after a material change in employment. But some boards have begun to question whether these policies should be broader in order to protect a board, a company and its shareholders from negative attention spreading from one company to another. The negative attention could be the result of a lawsuit

Misconduct continued on page 10

Misconduct continued from page 9

or even smaller matters that gain attention in the media.

Beverly Behan, founder of consulting firm **Board Advisor**, says even shareholders that aren't traditionally activist in nature will often take the position that they don't want a so-called problem director representing their interests, she says. Shareholders may indicate that they will withhold votes for the director at the next annual meeting.

"This puts pressure on the Nominating Committees of the other board the director serves on not to re-nominate him/her, otherwise [they] risk controversy with shareholders and the embarrassment of the candidate not being re-elected at the Annual Meeting," Behan says in an e-mail response to questions.

Some have offered resignations because they have felt that it's unfair to tar one board because of problems at another company. And directors haven't wanted to face a battle with shareholders who have said they will withhold votes from the director if they're renominated, writes Behan.

Alternatively, nominating committees have opted not to renominate a director after discussing whether the director will have the time and attention to devote to the board during litigation and then bringing the matter before the full board. Because directors are elected by shareholders, forcing a director to resign is difficult, she says. Not renominating a director is often a board's only recourse if they feel the director should step down.

In some cases, committees have determined that the director has been a valuable part of the board and an effective director and have left it to shareholders to reelect the director.

Keith Bailey, a director on the boards of **Apco Oil & Gas International**, **Integrys Energy Group** and **MarkWest Energy Partners** and the retired chairman, president and CEO of **Williams Companies**, says each instance must be evaluated according to its own facts and circumstances. In addition, the existence of a lawsuit, particularly in these litigious times, doesn't mean a company doesn't have a strong culture that discourages misconduct simply because it was beset by a rogue trader, for example.

Disappearing Board Seats

The frequency with which independent directors lose board seats after misrepresentation of financial information is alleged and a shareholder lawsuit is filed:

- **95.7%** of directors who hold at least one other board seat (that is, in addition to the seat on the sued firm's board) lose at least one directorship.
- **96.3%** of directors who hold one other board position lose this directorship.
- **79.2%** of directors who hold two other board positions lose both of these directorships.
- **48.6%** of directors who hold three or more other board positions lose all three directorships.

Source: "Corporate Misconduct and the Market for Directorships"

If the lawsuit plays out, however, and there's ultimately a judgment, the board would look closely at that judgment to see whether it concluded that the company, management or the board was culpable in some way, he says.

"Those are the kinds of facts you look at before you make any kind of judgment as to the appropriateness of a director's continuing involvement with your company," says Bailey.

Bailey also notes that he disagrees with the report's linking of shareholder litigation with directors' holding fewer board seats three years later.

In terms of recruitment, Bailey says his experience has been that the director involved in litigation typically raises the issue with the board recruiting him or her, and says the recruiting board would want to be aware of whatever is going on with the director in terms of litigation.

Behan says litigation is "absolutely" a red flag in terms of director recruitment and adds that some nominating and governance committees won't even consider a director who the committee feels has been ensnared by controversy. Other committees ramp up their due diligence and talk with more of the director's references to determine whether the person is really an effective director, possibly even one who pushed back at a troubled company but whose advice wasn't heeded.

The amount of time the director spent on the board of a troubled company may also be a factor that nominating and governance committees consider. If the director was relatively new, the board may not have as many questions as they would with a director who served for a longer time.

"On the flip side, directors who have been through something like this are often more aware of red flags indicating problems and [are] hyper-alert to risk issues," says Behan. "This can be attractive to some boards." ■

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1

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2

December 13, 2010

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3

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• Wanted: CEOs With CFO Experience
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• Governance Merger Reflects Growth in ESG Ratings
• Board Practices That Work
• Key SEC Staffer Mostly Praises 2010 Disclosures

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• How Should Boards Build Short Lists of Prospective Directors?

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4

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Top 10 Challenges for CEOs in 2011

List will require board cooperation

by Josh Martin

With greater public and shareholder scrutiny of corporate actions, CEOs will likely need to adopt a much more public role in 2011, while at the same time working closer with their boards to realize long-term strategic goals. In a poll of 50 CEOs at public companies ranging in size from $1 billion to $66 billion, **Stephen Miles**, vice chairman of **Heidrick & Struggles** and head of the firm's Leadership Advisory Services division, distilled a list of 10 key challenges top corporate officers will face next year (please see box below).

CEOs are being driven to seek help from their boards in part to address a raft of new **SEC** regulations, including disclosure requirements, enhanced shareholder proxy access and mandatory advisory votes.

Both parties may be driven to cooperate more in order to offset the rise in shareholder activism — a point that draws support from some outside observers.

"In 2011 shareholders will have an increased role and louder voice in corporate governance," says **Amy Goodman**, partner at **Gibson, Dunn & Crutcher**. "A board can help a CEO deflect short-term pressures in this situation."

But the need to work together is not likely to eliminate natural tensions.

"Whoever is in the leadership role on the board — whether it is the chairman or the lead director — can play a key role fostering CEO awareness in this environment," says Miles.

Some directors point out that circumstances will also compel boards themselves to stay more on top of economic and regulatory developments to provide relevant and thoughtful guidance.

"There is always a need to focus on alignment of shareholder value, the changing economy and compliance issues," notes **Pastora San Juan Cafferty**, a director serving on the boards of **Waste Management** and **Integrys**. "But we need to be prepared… 2011 may be a gear-shifting year for the U.S. economy. It will be a year in which a director should be focused on external environmental factors and their impact on the company."

Cafferty adds that this is a factor encouraging less confrontation between the CEO and the board in 2011.

But Miles warns that while creating a partnership between the CEO and the board may be important, it also carries the risk that a CEO could try to exercise undue influence on the board, or that the board might try to take over some management functions. ■

CEOs' Top Challenges

1. Moving from "business case" to "social business case"
2. Stepping into the role of "ambassador"
3. Repairing the corporate image problem
4. Making the board an ally
5. Building a global leadership pipeline
6. Grappling with China
7. Understanding shifting employee values
8. Operating in a world of social media
9. Driving diversity
10. Managing a globally distributed leadership team

Josh Martin (212-542-1211 or jmartin@AgendaWeek.com) covers compensation and legal developments.

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