CORPORATE
BOARD MEMBER®

2008 ACADEMIC COUNCIL SUPPLEMENT

Corporate Board Member's *2008 Academic Council discusses the board's role in risk management, how to structure the right compensation plan, and the issues that keep directors up at night.*

Emerging Trends in Corporate Governance

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Corporate Board Member*'s esteemed panel of academics and directors sound off on emerging issues, offering both theoretical and pragmatic insights for ongoing dialogue in today's boardrooms.*

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EXECUTIVE COMPENSATION

Dear Corporate Director:

When the board of directors sits down to contemplate the wisdom of embarking on a new strategic path, whether it be to expand, contract, or diversify the business of the company, there are two chief considerations: risk and reward. The board's role is to thoroughly vet the upside along with the downside, and make the ultimate determination as to whether the end will result in a net increase in value for shareholders, and if so, to understand the degree of risk the corporation is assuming. In this year's Academic Council, presented by *Corporate Board Member* and graciously sponsored by PricewaterhouseCoopers LLP and Steven Hall & Partners, the subject of the board's role in risk management generated lively discourse, as our panel of leading academicians pondered the best way boards should endeavor to reach the ideal risk/reward balance.

Likewise, our second esteemed panel debated one of the most contentious topics in governance of late—board compensation practices. The notion of aligning directors' interests with shareholders is widely accepted, yet as our roundtable speakers note, a multitude of paths can lead to a satisfactory outcome. But which one will you follow? For example, how would your board handle underwater options? Would you extend the holding requirement on restricted stock? How would you compensate directors who attend meetings by phone? Is it meaningful to pay a director based upon company performance metrics? These and a host of other issues were bandied among our council members in the second session.

This year, *Corporate Board Member* enhanced its Academic Council presentation by webcasting these sessions with a live audience—to directors who had the chance to respond to survey polls as well as pose their own pressing questions to some of the finest minds in governance today. We hope this published version of the 2008 Academic Council: Emerging Trends in Corporate Governance piques your interest to discuss some of the ideas inside with your fellow board members this year.

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2008 Academic Council

Corporate Board Member formed the Academic Council to identify emerging trends in America's boardrooms through council roundtables, interviews, and selected research. The council is composed of the leading academic authorities on board governance, representing some of the country's most prestigious universities, graduate programs, and corporate governance centers. Our belief is that directors, officers, educators, and students will benefit as we strive to be the premier journal and Web source of thought leadership on corporate governance and board issues.

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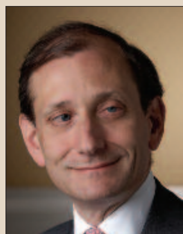

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Maintaining Balance: The Board's Role in Managing Risk

The board has the responsibility to weigh the risk against the potential rewards associated with every strategic development as well as to steer clear of known harm for shareholders. Corporate Board Member*'s academic panel offers the latest research and advice for directors charged with this critical duty.*

Charles M. Elson
University of Delaware

Stephen M. Wallenstein
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Catherine L. Bromilow
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TK Kerstetter
Corporate Board Member magazine

TK Kerstetter: Managing risk is one of the biggest challenges for boards today, but let's start at the basic level and discuss the board's responsibility for risk management. What kinds of risk should the board ensure management is addressing, and at what level should risk be addressed by the board?

Charles M. Elson: It depends on what kind of risk you're talking about. Obviously, implicit in being a director and in managing the company for shareholder profit has got to be some consideration for the balance of risk versus reward. In other words, if the company moves into a new area, how much potential risk is involved in that investment, and what potential reward is out there for shareholders? This depends on the philosophy of the business. From a director's standpoint, risk is implicit in everything you do.

The big question today, given what's happened in the market lately, is understanding how deep the board should drill down on specific kinds of risks. That's where it really depends on the kind of risk you're talking about, such as financial risk versus operational risk versus societal risk. You could start way up and inquire, "What is the risk of national or international conflict?" That's out of the board's control, but certainly it is something directors will want to think about from time to time. Likewise, general economic risk, such as problems with the national economy that affect the business, is out of the board's control, though it is something directors ought to be considering, going forward. Then there is industry risk, such as when oil prices hit a certain level, and how that affects a particular business. That's more specific and needs to be considered by the board on a regular basis. Then you get down to risks involving the company itself. "Where are our plants located? Where are our investments?" If you're in the banking business today, you're likely asking where have your assets been squirreled away, and what potential risk to the enterprise do those investments carry? So there's a sliding scale of risk. The board needs to focus, on an ongoing basis, on the very specific areas of risk that are the most threatening to the business.

This is why I think we are seeing the emergence of audit risk committees that are giving specific board committees responsibility for specific risks. The only problem that's arisen is when people haven't done a particularly good job at assessing the risk. This is the pickle a lot of companies find themselves in, which suggests that it is not the risk consideration that is problematic, but, rather, how we've been evaluating risk and the tools we've been using for evaluating that risk.

Kerstetter: Steve, isn't that what makes it a challenge, the fact that there are reputational risks, there are audit risks, there are different types of risk? What is the board's role with all of that, and how do you protect the company against catastrophic loss, which I would argue is one of the board's primary responsibilities?

Stephen M. Wallenstein: You're right–it's very difficult. The flip side of the board being involved in strategy is that the board is involved in risk. As Charles said, you adopt a certain strategy, and then you have to look at what the risks to the business are in that strategy. It seems to me there are certain risks to the business itself that might jeopardize the enterprise. Those should be the responsibility of the full board and should not be delegated to a committee. Then there are other kinds of risks that should be handled by a committee, such as financial statement risk, which is the province of the audit committee. Many companies have adopted risk committees. If you're an IT company, for example, a risk committee might focus on industry risks for IT–very specific risks. But if you look at the current financial crisis, management didn't see it coming; the rating agencies didn't see it coming. So how does a board get information from management to even know that these risks are on the table? That's a real problem. Many companies have instituted a chief risk officer who is empowered to look across the organization in some kind of enterprise risk management scheme that reports to the audit committee and then to the full board on an annual basis. This whole question is something all boards are struggling with.

Kerstetter: Catherine, we know from our joint What Directors Think study with *Corporate Board Member* and PricewaterhouseCoopers that managing risk is one of the top two areas in which boards feel they are least effective. What are the board's responsibilities in this area?

Catherine L. Bromilow: As we've been living through these challenging economic times, much of the focus on risk is on the downside of risk, or the negative. But as Charles indicated, it's important to remember that businesses are formed to take risks, because that's how you return money to your shareholders. So we start with that fundamental principle, and then we add on that it's really management's responsibility to manage, address, and understand risks.

When you step back and look at it from a director's point of view and ask, "What should you do?" it comes down to two main categories. First, as a board, you should ensure that management has a process in place to identify, assess, and address key risks–not just the risks you know about now, but also risks that are emerging. Second, directors need to make sure they know where the key risks are and make sure they are comfortable with the risk appetite that management has taken on.

In summary, where directors can really add value is by having both strategic and operational discussions with management around risk, using their collective experience and business knowledge. The directors' judgment can test whether or not management has identified all major risks and thought through various best- and worst-case scenarios. This is important because the current economic issues we're facing represent a worst-case scenario in terms of factors piling on that were unexpected.

"It's important to remember that businesses are formed to take risks, because that's how you return money to your shareholders. So we start with that fundamental principle, and then we add on that it's really management's responsibility to manage, address, and understand risks."

Catherine L. Bromilow
PricewaterhouseCoopers LLP

Kerstetter: Where does enterprise risk management belong in terms of the structure and purview of the board?

Elson: Traditionally, risk vis-à-vis financial risk rests within the audit committee. But what about generalized risk? Generalized risk is, in fact, just that, and as such, I think it belongs with the full board. I can understand some arguments being made for certain kinds of risk being delegated to a committee. In a number of companies, for example, the task of compliance risk has been delegated to the governance committee–not operational compliance, but rather financial compliance. Again, as a director, you can't escape the mandate that you must take into account risk when evaluating management and creating strategic direction for the company. It's implicit in the bigger picture, which is the return of shareholder value. So general operational risk, such as where we are going as a business and whether our assets are appropriately valued, should be the responsibility of the full board.

Kerstetter: Following up on this, when you think about the strategic planning process, which is certainly at the core of the board's responsibilities, one of the main components of that process is determining the scope of risks. Directors must be able to sign on to those risks, or if those risks are higher than the board is comfortable with, it must determine how it will mitigate those risks. So it seems that before a risk ever ends up in any committee, the board should have reviewed that risk as part of its strategic planning.

Wallenstein: I agree. As I said earlier, risk is the flip side of strategic planning. You can't make decisions such as where to

locate a plant, what line of business to enter into, or who to compete with, without thinking about what the risks are for each of those strategies. And a lot of this goes back to the quality of management, because the board meets 200 hours a year and still has its hands full with a lot of the compliance functions of Sarbanes-Oxley. One complaint is, "We don't have the time; we don't have the information; we don't have the resources." And in terms of resources, one of the things we talked about last year at this event was the role of independent service providers and whether the board should have its own counsel for certain aspects of its business. It's interesting to consider whether the board should have a separate independent risk counselor to help sensitize it to some of these risks or whether that should be a management function.

Kerstetter: Catherine, we have a question from the viewing audience. How different is the board's responsibility with respect to enterprise risk management compared to what it has been in the past?

Bromilow: What Sarbanes-Oxley did, to a large extent, was really focus on financial reporting risk and whether or not the internal controls for financial reporting were appropriate. So today, management, the board, and particularly the audit committee focus far more on that aspect of risk. Stepping back, it's always been the board's responsibility to make sure it is overseeing risk. But when we talk with directors, they tell us it's not necessarily the risks they know about that worry them, it's the risks they don't know about. We have seen it with some of the off-balance-sheet vehicles in both the pre-Enron and post-Enron eras. We saw it with stock option backdating. We're seeing it now with auction-rate securities and some of the other credit market issues that are emerging. Those situations are the ones that tend to make directors feel particularly vulnerable. So in part, as directors see more and more of these unanticipated risks happening, they probably do feel a little less secure. As Steve was saying, it comes down to whether you have a good management team making sure they understand the risks and can forecast and manage the risks. Some of the board's concern is whether or not management is doing that as fulsomely as the board thinks it should.

Kerstetter: In this case I suppose more education can be a scary thing, because pre-SOX, I'm not sure boards were even aware of the risks, but since then, the risks that are inherent in their jobs have been brought to light. One of the biggest unknowns today for companies that are dealing globally is the Foreign Corrupt Practices Act (FCPA). Take, for example, a company like GE that's in some 130 countries in 130 different businesses, and at least 20 of those countries have always done business by accepting bribes. All of a sudden the board of GE is responsible for making sure that the company operates within the Foreign Corrupt Practices Act.

Bromilow: The FCPA been around since the '70s. But over the last few years, directors and companies are paying renewed attention to FCPA compliance. The good news, post-Enron and post-Sarbanes-Oxley, is that we're hearing from directors, and audit committee members in particular, that they now have more confidence in the financial statements because there's much more focus on internal control.

"As a director, you can't escape the mandate that you must take into account risk when evaluating management and creating strategic direction for the company. It's implicit in the bigger picture, which is the return of shareholder value."

Charles M. Elson
University of Delaware

Kerstetter: Do you gentlemen feel the same?

Elson: Well, FCPA has been around for a long time, since 1977, although it was an area that was initially focused on the defense industry as a result of the bribery scandals of the early '70s. But apparently, for any company doing business overseas, particularly in developing areas where you tend to find less straightforward trade practices than in other places, it is now an issue. The act is designed so that if you have a program in place, and you make it clear that you don't tolerate such actions, and you have a strong compliance program set up, that effectively protects you from criminal liability or substantial fines if, in fact, something were to happen. But you've got to demonstrate that you've done something about it. And from a director's standpoint, you've got to satisfy yourself that the company has done everything reasonable to prevent an incident from occurring. Then, if something does occur, your fines are limited because you have a program in place. So, as a director, can you oversee 150 operations in 150 different countries? No. From a director's standpoint, legally the key is to ensure yourself that that kind of program exists, because it is risk management in its quintessential form. What is the risk? Violating the law, and substantial damage to the company. What can you do about it? You can put a system in place to minimize the occurrence of illegal activity, or if it does occur, to minimize the risk to the business of the government penalties that could result from such activity. Can you stop bribery? No, probably not. You can do your best to try to do so, but as long as human beings are involved, something could happen. The important

thing is to be able to show the outside world that the company and board don't tolerate such activity. I think that's how you mitigate that very specific risk.

Wallenstein: That point is very well taken. I do think it's ironic that today's financial institutions thought that they had a system in place to evaluate risk with VAR (value at risk). They thought they could only lose $80 million in any one day, which turned out to be completely wrong, as we know, because they didn't understand the risks inherent in the bundled securities that they had on and off their balance sheets.

Bromilow: One of the challenges is that audit committees often get tagged with overseeing risk management, and that puts a fair amount of pressure on them. The New York Stock Exchange rules require audit committees to oversee policies for risk assessment and risk management, which different audit committees and boards deal with in different ways. In some ways, the audit committee chair almost plays the role of air traffic controller–sitting down to understand where the key risks are and then very thoughtfully allocating them to various committees or to the overall board to oversee. But other boards have taken a variety of approaches. One board gives each different kind of risk to a different committee. Another board gives oversight of specific business units or business divisions to specific committees, which is one way to divide the work so not all the monitoring falls on the audit committee. And obviously, there's strategic risk and other true overarching risks that probably belong with the board as a whole.

Kerstetter: Panel, I'm happy to report that we have more great questions from our viewing audience. First, should board members be required to have some kind of formal certification to reduce overall risk? While I don't think certification guarantees any reduction necessarily, it would mandate that someone's gone through a certain amount of certification training. We all know the ISS has been an 800-pound gorilla that has influenced boards very strongly in making sure they obtain certain levels of approved education. Interestingly enough, Stanford just came out with a study that failed to find a positive correlation between ISS ratings and performance. Nonetheless, certification has been talked about for directors for some time. So why hasn't it been formalized?

Wallenstein: Some programs do exist. The National Association of Corporate Directors (NACD) has a board certification program. UCLA has what it calls a certification program. We [Duke University] have a Directors' Education Institute, but we've been very nervous about certifying anybody who attends the program as having any special competence, which is not a reflection on our program not being good, it's just a big responsibility for Duke to assume. Risk is such a large topic, and it's not only industry-specific but it also encompasses so many different possibilities that I'm not sure how you could run a certification program on risk. I think what's more important is who you choose as your directors. I think one of the great challenges these days may be that something like a third of the new directors on public company boards are first-time directors. And it's a huge responsibility for them to try to understand the business of the company and, at the same time, all the risks.

Bromilow: In our What Directors Think survey with *Corporate Board Member*, one of the things we found last year when we heard from over 1,000 directors is that the vast majority of them are only serving on one public company board. So not only are they new, but they also don't necessarily have a way to compare risk management information between two different sets of management teams to figure out if there are better practices to apply.

Elson: I think these programs are critical. Frankly, going to programs like this sensitizes you to the issues you're confronting, and because you're dealing with a lot of other directors in the same place, it sensitizes you to the issues they are confronting. So you realize that a lot of the things you're worried about are the same things a lot of people worry about, so maybe it's not such a bad thing to raise those as issues within your own boardroom.

That said, certification is probably not a good idea. I think that to certify, you have to suggest that there is a body of knowledge you must master, and that if you've mastered it, everything will turn out OK. Number one, no such body of knowledge exists. It isn't like taking the bar exam for a lawyer or a medical exam board for a physician. This is general business experience. So you're looking for someone who's smart enough to figure out that they need more knowledge in their area and who then goes and seeks it. That's the key.

Kerstetter: Well, we could easily spend a whole session on that topic alone, but I have some other great questions for us to consider. One of our viewers asks whether there is a common template, or universe, of risk available or under development to assure board members that risks are being addressed?

Bromilow: There are a number of different templates and philosophies around risk management and different ways of rating or ranking and classifying risks. Most major service providers or consulting firms can provide you with their template. There's also the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which, a few years ago, issued guidelines for enterprise risk management and offered a holistic view of how to think about and identify the key aspects of an enterprise risk management program.

Elson: There are always service firms offering risk templates, but they've been around for a long time and they've probably sold a lot of the banks those same templates. So the question

is, are they really worth anything? I think the answer is no. You have to develop a risk management program that is sensitive and specific to your own business. Using a general template is a bureaucratized response to risk, and the problem is, if you bureaucratize your response, there's a real disconnect between what looks great in court when you are sued for a loss and looking at what the board actually did. The reality is, from the shareholders' standpoint, they don't want the loss, and so the key is learning how to avoid the loss.

Wallenstein: That's a good point. I think the problem is you run the risk of creating another checklist, and boards already complain there are too many checklists around.

Bromilow: The one thing that some of those templates do, however, is to provide directors with a bit of a completeness check. Especially if they are in a regulated industry, or an industry that is changing, and there are some competitive issues, or if they haven't heard anything from management in terms of political risk.

Kerstetter: Charles, you brought up a reference to the banks and subprime. Another audience question is how do you explain so many bankers and their boards missing the risk of unqualified borrowers, which seems so basic and obvious? My question is, and it certainly wasn't just the boards' fault, but you have to ask, "Where were the boards?" And then, and perhaps most important, what are the lessons to be learned from this experience?

Elson: A real easy question, huh? Look, number one, I think the real problem is how we value assets. This is a crisis in asset valuation, because there were assumptions that if the economy did XYZ, you'd see a decrease in value of a certain percentage. These pricing models were based on certain assumptions, and it turns out the assumptions were completely wrong. But it's not just that the assumptions were wrong; it's how we value assets. That's really the scary thing that's come out of all this. I mean there's no way that a bank, which is regulated on the state and federal level about as heavily as you could possibly regulate any industry, could lose 90% of its value in six or eight months–it makes absolutely no sense. The question is, how could boards approve these risk profiles, but the problem was that no one understood the underlying value of the assets. And as dramatically as some assets were overvalued, I think we may have really undervalued them now.

The solution is not necessarily a new committee on the board to study risk at banks, it's getting a handle from the accounting side and from the valuation side on what assets are actually worth. That's the real challenge. Can a bank be worth 90% less a year later than it was a year before? You know houses are still there; the economy is still going. Obviously, you have a crisis in valuation, and that's an issue that goes beyond the board and beyond management and frankly comes down to an accounting issue. How do we account for value? What is value? What is fair value accounting? I wouldn't blame the board. I think it's a systemic problem.

So what do we do about it? I think we have to establish a system where we're comfortable with actual valuation, or design a system of asset valuation that is more effective than the one we've got. The problem, though, is until that happens, there's going to be a lot of turmoil. Do I blame the directors of the banks? I blame them for not asking enough questions and for not understanding what was in there. I blame them for not holding management's feet to the fire on the question of asset risk and valuation risk. On the other hand, I think if they had asked the question, they probably would have gotten the answer, "Hey, these are AAA-rated securities. We're very comfortable with this; thank you very much; ask the auditors." And the auditors would have said, "We're comfortable with valuations as they are." I don't think even if directors had asked the questions that they would have gotten an answer that would have pushed them further, which is frankly why, in the end, I think you need a real pain in the neck on every board. You need a curmudgeon who will ask those kinds of questions.

Kerstetter: I hope you're right, Charles, but I would think that in the banking operation, everybody should be doing a what-if stress test. And I think it gets further complicated because when a pile of revenue is flowing into the company, it's easy for the board and management to be blinded by that revenue growth. That's when it becomes tough for a director to say, "It looks good now, but at what price is this all good?"

Elson: I'll tell you one thing–the directors who didn't hold substantial equity in these banks ought to be very nervous. If I saw a director with minimal share holdings in a bank that lost that kind of value for the shareholder, I'd withhold a vote for that director in two seconds flat, or vote for an alternative. It's appalling to discover directors who didn't take the same risks everyone else did.

Wallenstein: Following up on the point about the massive revenues that were coming into the banks, there's another tack to this, which is the short-term orientation of the major financial institutions and management and the way they're compensated. Pressures from activist investors for short-term profits, as well as bankers taking home huge amounts of money without having much skin in the game in the form of shares, definitely played a role. So you have a compensation system that encouraged this sort of avalanche of using the balance sheet to generate fee income and getting loan exposure that would never have been taken at a traditional commercial bank. One might look back to the repeal of Glass-Steagall at the turn of the century as being part of the problem, allowing commercial bankers to go into this kind of fee-generating business, so perhaps we'll see a swing back. Now I don't think we're going to see a return of Glass-Steagall [restrictions], but I think we will see a lot of commercial banks slashing their investment banking

operations and returning to more traditional functions. The other thing is, back to the notion of money flowing in, if you have a mortgage business, it should generate perhaps a 10% return on assets, but if you leverage it enough, you can generate a 20% return on assets. Everybody's very happy until these banks are technically insolvent.

Kerstetter: Catherine, in a general sense, can you comment on the board's role and the processes that should have been in place in these financial companies?

Bromilow: When we talk with directors, they say they look at their peers who are on some of those financial institution boards, and they know they're intelligent businesspeople. To a certain extent, it's "there but for the grace of God go I."

Looking forward, there may be two lessons that come out of this. One is for directors to think through new products that the company is getting into. Does management understand the risks of the new products? Does the board understand the risks? With these new products, how does the risk appetite change or the whole dynamic change? Take a bank, for example, which got into subprime. If subprime is only 10% of your portfolio, that's one thing, but if it's grown to 70% of your portfolio, then that's a whole different kind of risk for a new product. So directors need to really think through the risks around new products and understand what percentage these products comprise of the total portfolio. The other lesson is exactly what my fellow panelists were talking about earlier. Don't be seduced by really good profitability. We were talking with one director who indicated that his board focuses as much on the really profitable areas of the business as it does on the less profitable, because, to get back to where we started this discussion, it takes risks to make rewards. So if your rewards are huge, does that mean theoretically you're taking a huge risk?

"One of the great challenges these days may be that something like a third of the new directors on public company boards are first-time directors. And it's a huge responsibility for them to try to understand the business of the company and, at the same time, all the risks.'"

Stephen M. Wallenstein
Duke University

Kerstetter: There is one last topic I'd like to turn to that touches on risk, and that relates to the International Financial Reporting Standards (IFRS). Catherine, I'm going to first ask you to bring everybody up to speed on what IFRS is and how that relates to GAAP and what it means to U.S. corporate boards.

Bromilow: Of course. IFRS, or International Financial Reporting Standards, is a set of standards that virtually every country and territory outside the United States has now either adopted or is planning to adopt over the next two to three years. There have been some major developments recently, in particular, non-U.S. companies registered in the United States that use IFRS are no longer required by the SEC to report their numbers under U.S. GAAP. The question then becomes, if you can have a major foreign competitor reporting here under IFRS, why can't a U.S. company report here under IFRS? The SEC is looking at that question right now. Within the next few months, we expect some proposed rule making from the SEC that might set some conditions for stability of IFRS that would be required before U.S. companies can adopt it. It may also set out a timeline for IFRS adoption that might allow certain companies to voluntarily convert to IFRS as early as 2009 and could set a timeline for mandatory adoption for other companies, possibly anywhere between 2013 and 2015. It's going to require effort, and there are many issues surrounding the transition from U.S. GAAP to IFRS. So companies are going to need to get themselves up to speed on IFRS and rethink their systems.

There are also structural issues, including the fact that students coming out of accounting programs across the United States don't have IFRS knowledge. At PricewaterhouseCoopers, we are conducting IFRS training right now, and we are leveraging resources internationally, but it is going to be a fairly substantial effort for companies to get up to speed. That does represent some challenges, and as always, major conversions have risks associated with them. On the bright side, the transition will, we expect, occur over a longer period of time. It won't be a Sarbanes-Oxley, 404-type situation where so many companies have to comply in one year. So some companies will have an opportunity to learn from the pioneers.

Kerstetter: Steve, what are you hearing, either on your board or in your institution, on this topic?

Wallenstein: I think 404 will seem inexpensive compared to the efforts involved in converting to IFRS. But I certainly think for money managers in the global capital markets, it has the potential to be a very positive development in terms of valuing companies. But as Catherine said, in the meantime, it's going to be a real challenge, especially when the accounting industry itself is not up to speed.

Hitting the Right Mark: Compensation Challenges and Solutions

It is a challenge to design a compensation plan that rewards, motivates, and aligns directors' interests with those of shareholders. Moreover, directors face a bevy of prickly issues today: underwater options, performance metrics, stock holding extensions, virtual meeting pay, and more. In this session, our academic panel delves into the issues surrounding these and other topics.

Stephen N. Kaplan
University of Chicago

F. Daniel Siciliano
Stanford University

Steven E. Hall
Steven Hall & Partners

TK Kerstetter
Corporate Board Member magazine

TK Kerstetter: Welcome to our Academic Council session on director compensation. I'll address the first question with this preface. Previously, shareholder activists wanted directors to think more like shareholders, so they wanted them to have stock positions that were held mostly through options. When it seemed options were not effective enough, shareholders wanted directors to have more skin in the game, so the emphasis turned toward directors owning stock or receiving restricted stock. Now there is a hint of a movement toward a philosophy that holds that directors should be compensated primarily via retainers and/or board fees and shouldn't have large stock positions because that could affect their risk tolerance. So first, Steve Kaplan, are you aware of programs that link compensation with good performance, and second, what are your views on the issue?

Stephen N. Kaplan: The empirical evidence regarding director ownership and director options and performance for public companies is pretty weak or nonconclusive. I think there were a couple of papers in the 1990s that found that shareholders reacted positively when stock and option compensation plans were announced for directors. There's also some data that shows that directors who own more stock and options are more likely to fire a CEO for poor performance. [University of Delaware Professor] Charles Elson and [University of Colorado Professor] Sanjai Bhagat wrote a paper where they found a mixed relationship between stock options and subsequent performance. So the results are somewhat positive in terms of saying that ownership of options and shares for directors is a good thing, but I wouldn't call it determinative.

However, I think there is unequivocal evidence in favor of the route taken by the private equity and venture capital firms, which care greatly about increasing value for shareholders–because that's how they get paid. And when they bring in outside directors who don't work for the private equity or venture fund, they give them options or stock, and they ask them to buy stock in the companies when they go on the board.

Now, however, one thing to keep in mind is that the private equity and venture capital boards are illiquid. They can't sell until the company goes public or is sold, so in that sense, the directors are completely tied to how the company performs. That would be my view about how public company boards should structure their director compensation: with stock and options. But there should also be a limit on the amount of stock you can sell while you're on the board. Some companies have a rule that of all the restricted stock and options you're given while you're on the board, you have to retain a percentage of that, such as 25%. I would actually make that number higher if it were up to me. Such a rule requires directors to keep the shares for the long run, which means they won't care so much about short-term fluctuations, and I think that is what people were concerned about with the options.

Kerstetter: Dan, you may come to this with a little bit of bias since you are from the technology-rich West Coast, which certainly was the lifeblood of options at one time.

F. Daniel Siciliano: We like to say we have a penchant for options. But let me expand on a couple of points. First, as a point of clarification, I think the notion that it might not be a good thing for an independent director to end up with a relatively large stock position is wrong. I think it's a good idea for independent directors to end up with a lot at stake in the company and the question you need to ask is, are there any unintentional perverse consequences of [having that stake] that you need to mitigate? One of them was already mentioned, which is if the mechanism causes a director to be very focused on the short-term, you can solve that in a lot of ways, such as by creating holding periods. But beyond that, it seems that the intent here is to put independent directors as much as possible in the shoes of long-term, value-seeking shareholders, and the best way to do that is to have them think like [shareholders].

So first, as a minimum, director stock ownership should be three times the annual cash retainer, as a goal. Second, the deferral, or vesting, which ISS and a lot of commentators combine as a single concept but for which I want to explain a slight difference, should be at least three years. I should note that vesting can be separate from the ability to liquidate. Therefore, the ability to turn that stock ownership into cash can be separate from the vesting. It's important to think that way because you might say, "We want our independent board members to hold X percentage for the entire duration of their directorship." That said, if they depart before a certain amount of time, they may not have vested into all of that. But even if it's fully vested, that doesn't necessarily mean they can liquidate it. The final point is that there should be a cash/equity balance. This is where I think it goes in a strange direction, because there is an implication that you should be paying some percentage of cash. Some cash is OK, but it doesn't seem to be a bad goal to have a dominance of equity compensation, so long as the long-term incentives are correctly aligned. And you need to look at the tax implications and the like, although half to two-thirds of after-tax total compensation locked up in long-term compensation seems like an OK position with which to argue to the shareholders, "I'm thinking like you are; I'm here for the long term."

"The amount of risk is a challenge for public company directors. In fact, public companies are struggling today to recruit directors, so we've found them changing their compensation programs."

Steven E. Hall
Steven Hall & Partners

Steven E. Hall: I'm wondering whether the director in the private equity model–which is high risk/high reward and which certainly has been very successful in creating value–serves the true function of a public company director. [Such directors] are, in many cases, more of an adviser in private equity. They are ready to jump in and take care of a problem. And I'm not sure that's exactly the role that many public company directors play. Therefore, what we have found is that the amount of risk is a challenge for public company directors. In fact, public companies are struggling today to recruit directors, so we've found them changing their compensation programs.

I agree that holding periods are necessary and, in fact, in some cases they're mandated. If a director tries to sell shares without a good reason and something happens to the company afterward, he or she will have massive problems. We don't have the problems we had 20 to 25 years ago when I started in this business, with directors who owned no shares or just a hundred shares. We now meaningfully see their ownership with grants and there are requirements surrounding them. Five times or more is not uncommon to see, as well as retention requirements for longer periods of time.

We just finished our survey of the first S&P 250 companies and what we found is that roughly two-thirds, or 60% I think was the exact number, of pay was in the form of equity. So we are driving equity, and we're driving more toward restricted stock now than in options. I'm not fully convinced that the reason we did it is because we thought options were too much of a short-term vehicle, as opposed to not yielding a lot of value the first part of this decade. I think people wanted something that was real. If you really wanted risk in the program you'd use only options, because with those, either the shareholders win or you as a director don't win at all.

The other thing we've seen is that on a total basis, cash compensation, or total compensation levels for directors, has flattened out. There's very little difference between people who are on the audit committee versus the comp committee or the governance committee, or who don't chair any committees at all. The numbers have flattened at roughly a median of around $220,000 right now. Also, this is probably the slowest increase we've seen in the last five or 10 years. Last year, it was about a 3% increase going forward. So director pay is being modified as it goes forward.

Kaplan: I disagree with you on the issue of outside directors who sit on private equity boards being different. I've been on both private equity boards and public boards. I take the same type of view of the company whether it's public or private, which is, you want to increase the value of the company. The people who may be different are the private equity partners or venture capital partners.

The other thing that goes on in public companies that we all hear about is that the public company boards are becoming more bureaucratic. What that means is they care about the downside. If all you're doing is covering your downside, you'll pay more cash. In that sense, it's all about downside risk as opposed to equity. In fact, at this point, if you're going to err, you may want to err on the side of more risk taking, to offset the increased bureaucracy that apparently has come about.

The other point you made was about people not serving on the board because there's not enough cash pay. That's great! If they don't believe in the company and don't want stock in the company–good riddance. I want somebody on the board who believes in the company and believes that they can make a difference and can help increase the value of the stock.

"If [directors] don't believe in the company and don't want stock in the company—good riddance. I want somebody on the board who believes in the company and believes that they can make a difference and can help increase the value of the stock."

Steven N. Kaplan
University of Chicago

Siciliano: I think that while, to a certain extent, the roles may be different, the objectives aren't different. And let me highlight what might sound like a theoretical point, but I believe it's valid. Sometimes I hear people say you don't want to cause whoever is making the strategic decisions–the independent directors in this case–to be too much of a risk taker if they have a lot at stake. This is just building on what Steve Kaplan mentioned earlier, which is the idea that you want a director who's kind of a shepherd, and reduces risk all the time. I think that is a bad idea. In fact, you want to have very strong incentives for directors to be aggressive, strategic risk takers, because investors can diversify away from the idiosyncratic risk of any given company. Right? So if people try honestly and make strategic bets, and some lose and some win, as an investor I can invest in a variety of different companies and make that risk go away. But what I can't get out of is if we haven't incentivized independent directors on the upside enough that they will take time to invest effort in finding these strategic risk-taking opportunities. If all you're giving them is cash, then there isn't enough pull to see that stock price go up. And the way the stock price goes up is not by making sure you don't have disasters–that's how you avoid calamitous declines. But the way stock prices are pushed up is by innovating–making bets and winning. You can't do that without upside pull. So I think, at a bigger level, this is what we might lose.

Hall: The numbers I gave you said that 60% of pay is in the form of equity. Whether that's a big enough bet or not is something we can argue or disagree with, but it is substantially tilted toward the equity side.

Kerstetter: Steve, did your study identify an emerging trend that would indicate more companies are extending the holding periods? To me, that is a very relevant part of this whole debate—making sure that boards are extending the holding requirement for all stock.

Hall: The trend we've seen over a long period of time has been to shift to real ownership in the form of full-value grants, thereby reducing the amount of cash compensation and increasing the opportunities to turn that cash compensation into ownership of full-value shares. We've seen scattered approaches with regard to retention requirements, whether you are saying directors must keep a certain percent of the stock they receive, all the stock they receive for a certain period of time, or just retain it after they get to five times or three times cash retainer, after which they can do whatever they want. Those are the trends we are seeing. Other than a Coca-Cola plan that came out a couple of years ago that had real performance criteria attached to how someone would get paid, we've seen nobody pick up on or use that kind of approach.

Kerstetter: It seems critical to make sure that a director is thinking long term—which has always been a concern for companies. So it would be interesting to see how many boards are really going ahead and following through on extending those holding requirements.

Kaplan: This interest is not coming from ISS.

Siciliano: You are right. But one interesting observation is that there are some positive externalities for boards that adopt longer holding periods and require a high enough percentage. One is that it means there are meaningful board evaluations, because you're paying attention to what board members are doing. But more important, there's pressure to evaluate whether or not you make the choice to leave the board so that

you can enjoy the locked-up value. You know, we are always looking for ways in which to manage the nonproductive, long-term independent board member. A lot of boards talk about how to deal with that, with evaluations or mandatory retirement. This brings one other tool to that arsenal, where if you lock up two-thirds of all the after-tax stock grants for the duration of board service, at a certain point, someone's going to sit up and say, "Well, I think I want to enjoy my well-earned gains, and perhaps depart." That's one example of an incentive that emerges that is nicely aligned in favor of shareholders.

Hall: Do you think one of the issues we're dealing with here, though, is a basic difference in the makeup of the individuals who are board members in public companies and board members of private equity companies? And does that create some differences? Because I've got to be honest, while I don't have a lot of discussion with directors about how much money they make out of a stock, I don't hear a lot of, "We've got to drive the stock, we've got to drive the company, because that'll make me rich." They want to look good for the shareholders. They want to do a good job and be well regarded. I don't hear the greed factor coming out.

Kaplan: I think many of these people are very well off to start with—the CEOs and former CEOs for sure. But there's no doubt that having a meaningful position keeps your focus. It's just a wise thing to do. And for the people for whom it is meaningful, they're clearly going to be focused. I think what you are seeing is the increase in shareholder activism by the hedge funds. The hedge funds are pushing hard on the directors. And I don't know how that will go, because if you have the hedge funds, which are very incentivized, pushing, then the directors become their instruments. So how do you incentivize the directors?

Kerstetter: You're right, Steve, that is a challenge. But right now we have a question from our audience for the panel. What are your views on meeting fees versus annual or quarterly retainers?

Hall: I used to dislike the idea of a retainer only. I preferred meeting fees, but everybody thought it was really great to fix that number and be done with it. And generally, people are happy with the simplicity of it. The challenge is, when a problem arises, and you find you're having triple the meetings you thought you were going to have, people tend to get cranky for not being recognized for all of the things that are taking place. If that prompts you to say, "You made your own bed, you should be lying in it and fixing it," then paying people by retainer only is exactly the way to go. And I think more than 50% of the companies we're looking at in that world are moving that way right now.

Kaplan: I think meeting fees–strange as it may be, because they're not always a lot of money–get people to show up. And maybe it's the behavioral or psychological thing that says, "I'm doing the extra work. I'm showing up; I ought to be paid for it." And there is, in fact, an empirical paper written by Renée Adams that finds that meeting fees, even though they may be small, actually generate attendance.

Siciliano: Although, it's not good to say that's how a company should solve its attendance problem. I don't have a strong feeling about meeting fees per se, but it's not the right way to solve your attendance problem overall.

Kaplan: Well, most people show up to most meetings, but on the whole, I agree with Steve. I think [a meeting fee] has motivating effects, and it may not be large, but the evidence is it's there.

Kerstetter: We're also seeing a trend, though, that people are paying less if the directors hook up by telephone. And we all know that it's never quite the same at a board meeting with somebody calling in versus being present. But isn't paying a fee for phone participation almost promoting that phoning in is OK?

Kaplan: For public companies, the record of how people attended will show up in what they've been paid. It will be documented, and I think it will persuade people to appear in person rather than on the phone.

Kerstetter: Well, now I'd like to discuss performance-based director compensation. It is usually linked to stock price, but there are plenty of situations in which a company has driven tremendous performance in its bottom-line growth in revenue and growth in earnings, but depending on where the market is in its cycle, it may not be worth much. So the question is two-pronged: First, does performance-based director pay make any sense? Second, what do you tie it to?

Hall: Well, if I recall correctly, in Coca-Cola's recent program, fees were paid out at the end of a three-year period based on growth and earnings over that period of time.

Kaplan: It was targeted at 8% compound rate on growth and earnings.

Siciliano: Which was its midpoint for its forecast over 10 years.

Hall: And if they didn't get that they could conceivably get nothing. I've been very uncomfortable, from a conflict-of-interest point of view, in performance-based criteria other than stock. Delivering value to the shareholders is the ultimate performance. Other than that, we've got risks of conflicts of interest with financial reporting, with audit committee considerations, and so on. Stock price is the ultimate performance criteria in this case to show what Coke has done. To me, that seems most appropriate. I get very nervous with goal setting and everything else that could take place using performance.

Siciliano: I worry that in trying to make [compensation] truly tied to a performance metric, you're chasing your tail; it's hard to figure it out, and there are always unintended consequences. And secondarily, this fiduciary concept covers most of what you have to do. I assume that the individuals put on boards as independent directors are honest, hardworking folks. So you just want a generalized incentive structure that makes sense. I would avoid very specific, all-or-nothing benchmarking because you just don't know how it could come out. And if it comes out all wrong, or in a way you didn't expect, just from a practical viewpoint, you're going to look bad because then you're going to try to fix it. So if it all goes wrong and they award a bunch of cash payments–ouch! That might have been the just and fair thing to do at the end of the story, but the board will take a lot of heat for that.

Kerstetter: What about the reverse? I believe it was GM and Ford where the directors have actually taken compensation cuts. Now, I'm sure that sends a good message, but what is your perspective on that?

Hall: I think it's probably more of an "I'm feeling your pain" kind of message. The last couple of years have been a little bit different. Around 2000 or so, we saw situations where directors were saying, "Don't even consider an increase for me, because it's going to send the wrong message if we're trying to hold down executive pay." So now it's saying, "All the executives are taking hits, the unions are taking hits, let's just hold it back and show that we're not being greedy. In fact, let's set an example of sacrifice."

Kaplan: I'm somewhat sympathetic to that, but at the end of the day, what they cut to–$100,000 for being on the GM board–was insane. I don't know how many meetings they have, but I would suspect it's quite a few. So I'm guessing that is far too low for the time these directors put in. I would have preferred to give them $200,000 a year, with a certain amount in restricted stock and some amount in cash.

Siciliano: I don't think anyone's fooled. I mean, no one has a sense that the directors are really feeling the pain, after taking the cut. I think a real signal is derived from restructuring the upside and the way in which directors compensation works—not simply by reducing the current compensation.

"It seems that the intent here is to put independent directors as much as possible in the shoes of long-term, value-seeking shareholders, and the best way to do that is to have them think like [shareholders]."

F. Daniel Siciliano
Stanford University

Kerstetter: I'm starting to feel there's too much uniformity here, so I have a topic that I think will touch off a spirited discussion: repricing stock options. Unfortunately, with markets like we have seen today, this becomes an issue. It is obviously not new, and it created a firestorm in the past. So how should companies handle this difficult situation? Dan, we're going to start with you, since you come from the land of stock options.

Siciliano: First, I'm restricting this answer to independent directors. So with regard to stock options that are catastrophically underwater and likely will remain so forever, do you or don't you reprice them? I think the answer for independent directors is you don't. And the reason is that it is a point in time with certain expectations, and you have the ability to move forward because your tenure is long. In that scenario, maybe it also argues for the cash component having been modest, so I'd be forced to back off my wish that it was 100% equity. But you don't reprice the stock options. I think you say, "Each and every year we're getting another bite of the apple, and so at least it has averaged out, because we're going to be issuing options at a different rate."

Kaplan: You don't reprice. I think this is an argument for using restricted stock, to some extent, rather than options, because with restricted stock, if you're given 100 shares, it's still 100 shares, no matter what the stock price is. That's why companies have moved to more of a mix of restricted stock and options, which makes sense. The nice thing about using options is it really gives you an incentive for the upside, and the restricted stock protects you on the downside. So some combination of the two is a good idea.

Hall: If you're talking board members only, I think it's an emphatic "no." There's no way you can go out and reprice options for those people. Politically, it's a problem; businesswise and reputationwise, it would be a disaster. Those people who've just bought in are going to have to suffer with whatever they've done.

Kerstetter: Well, I know I'm getting a lot of questions from our viewing audience, so I've got to ask about the other side of this. What if you're a director sitting on the comp committee and the issue of repricing management's stock options comes up? What now?

Siciliano: This question is a lot harder. I think you have to take time to evaluate in what context you're having this discussion. Is this a macro downturn that is affecting your entire industry, and as it turns out, your company is performing better than its peers, but that means you're down 20% instead of 55%? What role did the current management team play in sowing the seeds of the current issue that leaves the options being so underwater? And finally, is this an opportunity to retain talent that might otherwise be drawn away to a private company, where private equity can appropriately incent them? If the answers to all these questions are favorable toward management, I'm not sure that you so much have to reprice options as consider a slightly superior strategy. That is, you might consider reenergizing or reissuing a new equity package that gives the right incentives moving forward without failing to recognize the fact that there was a lot of performance previously, and because of factors outside of the control of the executives, they needed to be incented correctly on the upside. That's the board's objective–to retain effective talent moving forward and to give incentives to management to perform for shareholders. Just because you are in a downturn doesn't release that obligation. I think you have to do new equity strategies in a hurry sometimes to keep the right talent. So it's a different answer compared to repricing for board members.

"There is a hint of a movement toward a philosophy that holds that directors should be compensated primarily via retainers and/or board fees and shouldn't have large stock positions because that could affect their risk tolerance."

TK Kerstetter
Corporate Board Member magazine

Kaplan: I would more or less agree. To the extent you have restricted stock, it's going to be less of a concern, although the fact is, if you've got talent and you need to keep them, then you need to create an incentive plan that will do so, but yet, you don't reprice. You might provide some extra options or some extra restricted stock. That would do it.

Hall: Repricing is still a really tough issue. However, we are seeing it starting to occur again. I think there are some other important factors that go into making the decision to reprice, such as how long the stock has been down. This isn't a situation where the stock drops in one month and everybody goes out and reprices. So you have to assess how sick the situation is. The challenge I have with just saying, "I'm going to leave the options out there even though they're underwater" is an allocation and burn-rate issue–that is, we may not be able to get approval for extra shares going forward. So can we somehow recapture these to use either for the management team that we have in place or a new management team in order to make things happen? Today, repricings are being done in a completely different way than they were five years ago–and certainly 10 or 20 years ago. They're on a value-for-value basis. They start a brand-new vesting period. They also, in many cases, are now adding on performance criteria. So you've got to make a tough decision. Do I want to give up my option that's $20 or $30 underwater, and in doing so, accept an option that is fewer in number, but also has a performance criteria that I may not meet? So there's some risk for the executive or employee. I think you've got to look at the circumstances, what caused the problem, and understand it situation by situation. There's not a blanket yes or no answer.

Kerstetter: Is there ever a time where it's appropriate to pay a director an extra fee, for example, in a case in which he or she was part of an M&A transaction or for consulting on a special issue that goes beyond normal director obligations? And if so, what risk do you take when you do that?

Hall: This is generally not a part of normal compensation plans. However, once again, it depends on the circumstances. I wouldn't rule it out, but I'd make it one of those things to think hard about before doing. I've seen situations where special committees are formed, and those special committees are compensated in a fixed amount for recruiting a new CEO, for example, or dealing with some other issue. I've seen special cash awards that were made to chairmen of audit committees for companies that are undergoing massive audit problems, and for the poor person who thought he or she had a 200- or 300-hour-a-year job and who found themselves with a 1,500 hour-a-year job. So there are some circumstances in which it makes sense. By and large, though, I think the answer should be no.

Kaplan: I think the distinction is whether it's a board duty versus a company duty. In the examples you gave, TK–M&A and consulting–it's really a company duty. The example Steve gave was a board duty, and I think for board duty, if you're an audit committee chair, you're probably working harder, so you might get paid more, and many companies do pay more. If you're on a special committee, you're having more meetings, so that's where the meeting fee comes in. When you start talking about company duties, there are other people you can hire to do that, and I think that's when you start getting into conflicts and the strange behavior we have seen in some of the corporate scandals like Tyco.

Siciliano: There's also a practical constraint, which is where does that extra compensation come from? One risk is that it comes from management. And I think that, all by itself, whether or not it's a true conflict, creates the perception of conflict–it creates a certain emotional indebtedness, and so it is probably a bad idea overall. Just the practical aspects of this scenario makes me recommend against it.

So my general answer would be certainly not to pay in cash; if it's a material amount of money, you're going to attract attention. And I think you're going to have issues explaining it. People will look for conflicts even if there aren't conflicts, and you will bog the board down in issues that don't advance the interests of the company. Find a different way to either augment your board so you can split up duties or hire the talent you need to turn it into a company role, even if it's quasi-board. So I would avoid this situation at almost all costs.

Hall: That's why some companies' criteria for selecting a board member include finding someone whose talent you can't hire.

Siciliano: You can still supplement board staff. You can hire outside counsel for the comp committee to deal with certain issues. You can hire supplementary audit advice services. You can supplement the capacity of board members who might have that unique talent, but you don't want them setting up spreadsheets late at night. So hire those people. I agree that we need to search for unique talent, but there are still ways to expand capacity without having to take even more time from very busy board members.

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Point/Counterpoint: Directors and Professors Debate the Hot Issues

Corporate Board Member*'s esteemed panel of academics and directors sound off on emerging issues, offering both theoretical and pragmatic insights for ongoing dialogue in today's boardrooms.*

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David Baker Lewis
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The Kroger Co.

F. Daniel Siciliano
Stanford University

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North European Oil
Royalty Trust
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TIAA

TK Kerstetter
Corporate Board Member magazine

TK Kerstetter: Welcome to our director/professor debate, which we expect to be a spirited event. Our viewing audience has had the chance to observe the two prior sessions and now we have invited two sitting directors to join two of our Academic Council members here to comment on some of the topics we discussed earlier. David, I'll start by asking, what were you supportive of, and what did you take issue with?

David Baker Lewis: Well, the panel gave an academic overview of risk by classifying various categories of risk, but I think one element that was missing was the focus on tailoring a risk management approach that is unique to a particular company. I think the essence of risk management is to first define what constitutes risk for a particular company, whether it's a private company or publicly held company, and then to assess those risks and have a good dialogue with management about those risks. You should also plan for remediation efforts with respect to those risks, which is principally a management function, but you need to have board overview to execute on the remediation plans, because that's really going to be the controlling factor on whatever risks are outlined. Finally, you must reassess the risk [scenario] again at some point down the road.

Risk management is a high-profile topic, not just because it's included in the New York Stock Exchange listing standards, but also because it really is an inherent responsibility of a board. The definition of risk management from a board perspective is to be concerned about anything that could have a detrimental effect, in a material way, on shareholder value. That is as uniquely a board responsibility as selecting the right leader for the company.

Kerstetter: Rosalie, what are your initial observations?

Rosalie J. Wolf: I have two other concerns about risk management that come to mind. To put it in perspective, we are in the middle of a credit and financial crisis that many people have said is the worst since the Great Depression. I don't want to debate that, but it happens to coincide with a time when we've had more focus on risk management at the board level, at the corporate level, and certainly in the press, than at any other time in our history. So there has been a lot of focus on risk management and a huge, largely unforeseen crisis. So there is something about risk management that we're not getting right.

The second point is that risk management has become very fashionable. It has a rather amorphous characteristic to it. You could really define everything that happens in the corporate world as risk management. By the time we start taking an inventory of those risks, there's almost nothing that gets done in the business world that doesn't have a risk connotation! So if you set up a risk committee, and I'm on the board of a company that has done so, what does this committee focus on? It could focus on absolutely everything! If you say [risk is] the responsibility of the audit committee, which is, as we all agree, already overburdened, that committee has a license to focus on practically everything. So I think the term "risk management" has taken on a load of responsibility

that is unfair, and we need to be a lot more focused about what is necessary.

The last point I would make is that it is folly to assume we can anticipate, plan for, and mitigate all risks. It can't be done. Human beings want to be in control, but ultimately the things that are unknowable will get to us. That light at the end of the tunnel is probably the headlight of an oncoming train, and what we don't see is tomorrow's risk, not yesterday's.

Kerstetter: Well, risk management is certainly critical in the boardroom, but it doesn't get the attention of an issue like compensation, which is more controversial, in the media. Dan, what would you add to Rosalie's thoughts?

F. Daniel Siciliano: We know that risk management is something you have to engage in, and even though an issue like compensation will draw more attention and is a sexier topic in the general media, that doesn't mean you shouldn't focus on risk management. I think one of the ways to draw interest, to make a shareholder activist really sit up and pay attention, is to be very specific about certain risks and be public about addressing them with a plan. The one that comes to my mind consistently is succession, although whether or not it manifests as a crisis, which represents a type of risk that needs to be mitigated, is uncertain. But chances are, inevitably there will be a succession issue, with or without a crisis component. So you can talk about succession, which I do think is attractive and newsworthy and does resonate, and hint at the risk management templates or approaches that you're using on that specific topic to bring to the floor other issues of risk management.

Kerstetter: Charles, your thoughts?

Charles M. Elson: First of all, I think risk management is a general function of the board and is part of its core responsibility, and if you're not doing it, you're not acting effectively as a director. However, I would say that while compensation is easy to talk about, easy to quantify, and lends itself to great headlines, it is important because it is a window into the board itself. TIAA-CREF has long talked about compensation practices in its governance standards and how those practices are a window into the general function of the board. If a board isn't effective in its compensation practices, it's probably not acting effectively on a lot of other things. In other words, if you're too closely tied to management on a comp issue, you're probably not doing an effective job overseeing it on everything from managerial performance to risk analysis. The concern is that you become dominated by management and don't have a circuit breaker or an oversight mechanism, so you become a rubber stamp for its prerogative. This is why I don't view compensation and risk assessment as all that unrelated. They're different topics, but they get at the same thing–how effective the board is in doing its job. It's perhaps easier to quantify compensation. With risk assessment, if you've done a good job you never know it, because you've avoided the risk. If you've done a bad job, or even if you've done a good job, and the risk appears, your performance is a lot harder to quantify.

"There has been significant movement in the last decade to align the interests of board members with the interests of shareholders, and the acceleration in the percentage of compensation that's based in equity is a good reflection of that."

David Baker Lewis
Lewis & Munday PC

Kerstetter: David and Rosalie, can you share with the audience how your boards handle risk? Do you have a special committee or is it done during the strategic planning process?

Lewis: I've been a member of a bank board. As you know, in banking, which is highly regulated, there has to be a risk committee to rate the risk of loans. For two other companies on whose boards I sit, Kroger and H&R Block, we're elevating the discussion around risk management and we've had a presentation made from a third-party source about a variety of tools that different companies have adopted to address their risk management needs. On the H&R Block board, we are just beginning to get into a discussion about risk management. In both companies, there is a risk management system in place for the business units, but I think the important element is to have the board develop its own approach to risk management issues. What is the board's policy with respect to risk management? How does the board oversee and monitor risk management from the company perspective? I've heard about a number of different approaches. Some companies have risk management officers or risk management committees. I've also heard of a board that took members from each standing committee of the board and had them comprise the risk management committee. I think the whole issue of risk management is getting much more attention–as it should–within the boardroom, and in the next four or five years, we'll see some new best practices and new approaches in risk management.

Wolf: I have trouble separating risk management as a topic from whatever it is the company is engaged in. The question

is, of course, are the risk management functions effective? When you start looking at businesses that make, sell, or distribute something, then the kinds of risks they are subject to are industry–and company–specific. And here's something that's probably true of many boards, whether they have a risk management committee or not, and that is that there is a bureaucratic aspect to risk management–a certain check-the-box mentality. Not that it shouldn't be done, but I don't think that's helpful at the board level. I think the board needs to sit back periodically and, whether with the help of outside expertise or not, ask itself certain questions. What are the key risks we're dealing with in our current strategy, in our current markets, in our current objectives? Are we comfortable with how we're dealing with them or do we need to shore them up? And you know, boards are not unlike managements in some ways. We're all the victim of in-boxes. You go to a board meeting, there's an agenda, and you start functioning on that agenda. But sometimes the most important things are not on the agenda, and that is what I think distinguishes a really good board from a more workmanlike board. I serve with some very thoughtful, creative people, some of whom are academicians, and often they will come to a situation with a completely different perspective. That perspective frequently reminds us that we have, in our very left-brain way, left out some extremely important factor that could be much more of a risk issue than anything we've been checking off.

"It is folly to assume we can anticipate, plan for, and mitigate all risks. It can't be done. Human beings want to be in control, but ultimately the things that are unknowable will get to us. That light at the end of the tunnel is probably the headlight of an oncoming train."

Rosalie J. Wolf
Botanica Capital Partners LLC

Kerstetter: Thank you. Let's now take a look at the results of the questions we polled our audience on earlier, and then I'll ask the panel to comment. Our first question: Do you feel comfortable that your board has the appropriate expertise to understand the ramifications of the risk the company faces? Thirty-five percent said yes; 53% said somewhat comfortable; 10% said not really comfortable; and 1.6% said that they were unsure. So we've still got a fair number of people who say they are not very comfortable with where they stand, which doesn't surprise me. Rosalie, what are your thoughts about that?

Wolf: Well, it comes back to my point that we'd like to assume we can identify all the risks. I think most of the people who responded to that question are aware that you can't identify all the risks, and therefore, being fully comfortable, at best, is an exercise in fantasy.

Kerstetter: That's a great point. Dan, any comment?

Siciliano: I have a different take on this, which is if people are using risk management as a proxy for the concept of risk avoidance, I think it might be very wrong-headed. What you're actually trying to avoid is mistakes and errors, given a set of probabilities and a bunch of unknowns. You're trying to ferret out the unknowns so you know as much as you can. Then you make estimations, and then you take risks. I almost wish boards had a risk-taking committee because that's the point, isn't it? We put our capital in the hands of entrepreneurs and others to source out opportunities to put that capital at risk and generate positive returns. In a way, I think one of the biggest risks here is not seeing what you didn't do. So I wonder about rephrasing the question to say, "Are you comfortable that at a strategic level–which is where you have the largest exposure to the downfalls of companies via strategic risks–you've been presented with all the options to assure that you have given feedback to management about taking effective risks?"

Elson: Let's look at it a couple of ways. Number one, anyone who said they're completely comfortable with how they're dealing with risk makes me very nervous, and I would be very uncomfortable with them as a director of a company I invest in because you never should be too comfortable with risk. The idea is so broad and amorphous that by getting too comfortable, you're actually putting yourself at greater risk.

Point two, given what's happened the last year or so, is that the number of those who are more uncomfortable has probably grown relative to those who are more comfortable. You have to have been through a nightmare to really understand it. And having been on a couple of boards where we've been through a nightmare or two, I'm always uncomfortable, but unless you've been through it, it's hard to take that stance. However, I think it makes you a better director because you realize that everything that is presented isn't necessarily how things are operating. And the way to hopefully avoid bad times is to think ahead and ask tough questions. That being said, I think this notion of risk is implicit in the nature of being a director. I find it very difficult to separate it from the rest of directing. One of the problems with separating it out is that it becomes, to Rosalie's earlier point, bureaucratic. Once it becomes bureaucratic then, frankly, you're doing a lousy job of

assessing risk because risk is simply assessed to meet a bureaucratic requirement or what is believed to be a legal requirement as opposed to really doing your job as a director.

Kerstetter: On that note, let me pose another question to our sitting directors. As a director, what risk area keeps you up at night? Rosalie, I'll start with you.

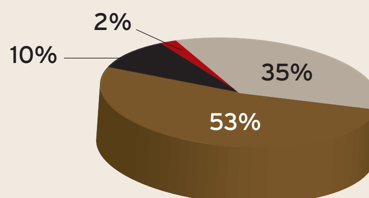
Wolf: What really keeps me up at night, first and foremost, is that something might happen to the key people who are running the organization. There are always a handful of people who seem particularly effective, and even if there are replacements, the time that will be lost and the adjustment in the whole mechanism while that happens will be enormous. So I always worry about the people. Two of the boards I serve on do a tremendous amount of financial processing–millions and millions of transactions a day. So if you say we have a one-tenth of 1% error rate that sounds wonderful, right? Except that translates into thousands and thousands of errors, and every one of those is affecting someone's investment account. So second, I worry about systemic issues that are caught too late and therefore cost a lot—both in reputational risk as well as actual remediation risk—to address.

Kerstetter: David, before we move on, I want to pick up on Dan's earlier comment relative to risk and analyzing the positive side of risk. I've always operated under the premise that directors have two foundational responsibilities, and one of them is to make sure you have the right management, particularly the CEO, in place. The second one is that directors have the responsibility to prevent catastrophic loss that would significantly impact shareholder value. So that's why the negative side of risk analysis plays a role in directors' duties. How do you feel about that premise?

Lewis: I wouldn't argue with that at all. From a fundamental point of view, it's like the doctor's creed, "Do no harm," as far as the independent director is concerned. That is, make certain there is good, solid, talented leadership to take the company forward on a day-to-day basis. Getting back to your previous question, there are a couple of things that keep me up at night. First, have we taken enough time to talk about major initiatives—business direction and strategy? Sixty-five percent of the issues fall into the strategic bucket rather than in the financial risk area, so we really have to allocate time along those lines. Second, have we done a great job of assessing risk up front with any new initiatives, new programs, or new products? Have we set the right boundaries with management? This is always a question we need to return to. On an ongoing basis, are we certain that there's no project or mission creep that goes beyond the boundaries the board might have set? And most important, do we have controls, information, and intelligence in place to assess whether those boundaries are actually being adhered to by management? Are we getting all the good news as well as the bad news? And how do you ferret out that information and make certain it gets to the board table? That's a very difficult

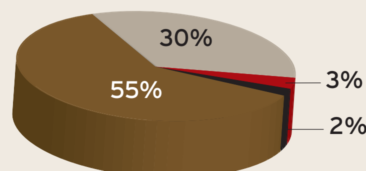
The following are the results of three questions posed to the webcast viewing audience during the Academic Council Director/Professor Debate.

Poll Question 1
Do you feel comfortable that your board has the appropriate expertise to understand the ramifications of the risks the company faces?



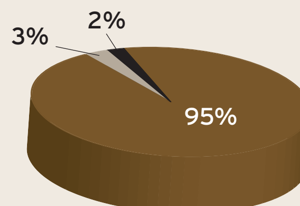
- Yes, completely comfortable
- Somewhat comfortable
- Not really comfortable
- Unsure

Poll Question 2
How does your board address the oversight of risk management and gain comfort that the risk management processes are effective?



- We get direct presentations from management
- We have a risk management committee focusing on this topic
- We use an outside consultant to provide us with assurance that all major risks are being appropriately addressed
- A combination of the above

Poll Question 3
Should directors be paid for performance?



- No, not at all. Directors should be paid solely in cash
- Prevailing practice of cash and annual equity awards (time-vested restricted stock/options) provide enough of a link to performance
- Yes, entirely. Directors should be paid only for achievement of predefined performance targets

issue to address when management is focused on identifying the successes in what they're doing.

Kerstetter: I'm now going to turn the question over to the members of our Academic Council. What do you believe should keep the directors up at night?

Elson: I think the directors have correctly identified personnel issues. What happens if someone dies, walks out, or becomes incapacitated, creating a leadership vacuum? You can plan for succession as much as possible, but when the rubber hits the road, you don't know how someone new is going to perform in a job. So that's tough. A second area is general financial risk–misstatements in the company's financials, whether it is intentional or unintentional negligence. Either way, you get sued, which is harmful to the company. After that, I would say general societal issues, such as increases in oil prices, changes in customer conduct, things like that. But I think the most pressing thing would have to be the human factor, because frankly it's the humans who drive the results. And if you lose a driver of results, à la a CEO, CFO, chief marketing or operating officer, that should keep you up at night. So you need to ask whether you have a deep enough bench in the event that happens. Having been through some unpleasant management succession issues, I think that's the hardest challenge of them all.

"If a board isn't effective in its compensation practices, it's probably not acting effectively on a lot of other things."

Charles M. Elson
University of Delaware

Siciliano: I'll concur and then add one more, which I'll refer to as the impeachable, impaired, or inert executive. If suddenly, senior executives become impeachable, impaired, or inert, or just depart unexpectedly, then you have a problem. And it's embarrassing if you can't show evidence for having anticipated that event. Now, hopefully your company is not in the position of Apple, for example, where there's almost no easy solution to succession issues in terms of someone like Steve Jobs. But if you're below that threshold, there are things you can do, so here is my second point. If you don't have a crisis response process in place that's at least modestly general in nature, when a crisis hits and it takes out senior management, then who is your spokesperson? Who's in charge? If you don't have that process at least modestly articulated so that you can activate a crisis response plan, you should be losing sleep because some day, something bad will happen. It will probably sneak up on you, and you'll need to respond as a board or as an organization or both. If you don't have that planned out, then you'll have a problem.

I'm going to throw in one more point, which is related to risk taking. I think the other thing you should lose sleep about is if you universally agree with TK's comment that one fundamental approach is to avoid catastrophic loss. I agree it is the director's job to avoid accidental, unintentional, or ill-informed catastrophic loss, but it doesn't mean you aren't supposed to sometimes make big bets. An example would be a pharma company developing a drug. It reaches a crossroads and can go for a larger chance of developing a billion dollar revenue stream, or it can go for a smaller chance of developing a $10 billion dollar revenue stream. And those paths are mutually exclusive. It's got to pick. In most circumstances, all else being equal, it should probably be taking the chance of the $10 billion dollar revenue stream. That's a very shorthanded example, but choosing the lower risk strategy without accounting for the long-term outcomes and upside is a dangerous thing to get in the habit of doing. And I think we've been scared into that a little bit. I doubt most boards have a chance at such a clear choice, and it's usually much more complicated, but if you are mainly risk mitigating in your role as a board member, I would lose sleep.

Kerstetter: Yes—and I wasn't a proponent of that. Your point is very well taken because that gets back to the trend of getting boards out of compliance and into strategic planning, which is something we hope boards have been transitioning to after Sarbanes-Oxley. But there still is that foundational basis of risk management for which directors have responsibility, which should spur them to ask tough questions.

Wolf: I think Dan just added an important dimension. We don't realize this, but when we say risk management, there is a negative connotation to it. We're implying downside risk, problem risk, and of course that's also reinforced because we're living in a troubled moment in history. But Dan makes a very good point: I've never heard of a risk management committee organized to look at the opportunity risk provides. So we need to keep that in mind. Focusing on the opportunities risk provides is an important role for the board to have as well.

Lewis: Let me just add that, in my opinion, what keeps board members from sleeping at night is one thing and what keeps management from sleeping at night is another. And I think Dan's point goes more to the management side, because it's members of management who really come forward to the board to identify those areas where the risk/reward formula

is good for shareholders. But the board's role really is to question, probe, dig deep, and be the risk manager in that process.

Kerstetter: That's a great point. I now want to just quickly mention the result to our second poll question which asked, "How does your board address the oversight of risk management and gain comfort that the risk management processes are effective?" Looking at the results, you can see that more than half use a combination of all the possible responses we offered, but almost 30% said their board gets direct presentations from management, which was the largest single response.

Since we have covered this topic fairly well, I'd like to switch gears and ask our director panel to share their observations on our academicians' earlier director compensation discussion.

Wolf: Well, I heard more agreement than disagreement. My view is that there are two different ways of compensating directors, either with a retainer only or a retainer plus meeting fees, and I think you can make arguments for both. I've been in both circumstances. I have never decided whether to go to a meeting because there was or wasn't a meeting fee. But there are two different ways of structuring it. I think it's a very good idea, whenever possible, for directors to be in a position that's aligned with shareholders. So for them to get restricted stock, it must be held for a substantial amount of time or according to some financial equivalent thereof. In a mutual fund group, for example, directors are typically expected to have a substantial amount of assets in at least a portion of the mutual fund family they oversee and to maintain that exposure. I think that's a good alignment of interests, and I felt like the group was quite in sync on that.

When it comes to compensating directors on a performance basis, I think the group was pretty much opposed, and I would share that opposition. I think performance-based pay opens Pandora's Box and will almost surely give life to my favorite law–the law of unintended consequences. So director compensation is usually a very lively topic. It's a very lively topic within TIAA-CREF because a lot of our constituents are professors and they don't think directors should be compensated at all, except, of course, for the professors who are on our board. So that's generally a topic of conversation when we talk with our constituencies. But for the most part, I think it's management compensation, typically CEO compensation, that has really hit a vein in the United States. It hit a vein in Europe ages ago and, of course, has created a much closer relationship between top and bottom compensation. But in the United States–and this is another example of the law of unintended consequences–I think the issue emerged many years ago after compensation consultants pointed out that CEOs would not have their interests aligned with shareholders unless they had a substantial amount of stock. This coincided with the beginning of a wonderful run up in the stock market. So a lot of CEOs ended up with astronomical pay packages, and there was a huge public reaction against that–and there still is.

"If you don't have a crisis response process in place that's at least modestly general in nature, when a crisis hits and it takes out senior management… who's in charge? If you don't have that process… you should be losing sleep, because some day, something bad will happen."

F. Daniel Siciliano
Stanford University

Lewis: I think we need to take into consideration the fact that there has been significant movement in the last decade to align the interests of board members with the interests of shareholders, and the acceleration in the percentage of compensation that's based in equity is a good reflection of that. This has led to the norm being a combination of cash and equity, and that's where the comfort zone seems to be. Companies are doing a lot of fine-tuning now in terms of whether the equity is in the form of options or restricted stock or some other form of compensation. And some companies that are under a lot of market pressure are being even more innovative–cutting director compensation or perhaps aligning directors' compensation totally with shareholder interests and going to an all-equity model over a three-year period, as Dan outlined with the Coke example.

I think, though, that you need to know your shareholder base; all shareholders are not long-term shareholders, so the board has to take that into consideration. I was also thinking we probably wouldn't talk about these ideas in the same way with management as we do with the board. You'd never really suggest that management be given all equity, for instance, though maybe there is an argument out there for it. So I think we're in a fine-tuning mode, and the movement to 60% equity compensation for directors as a norm is a significant movement that's been made in recent years. There has been much more attention at the board level to aligning interests with shareholders on a number of other matters besides how much skin you've got in the game. Things like say-on-pay proposals, periodic meetings with shareholders, and good governance proposals that are intended by boards to signal to shareholders that there is a clear understanding at the board

level of what the shareholders are seeking have all gotten increased attention.

Kerstetter: David, are you and Rosalie comfortable with what you describe as this blend of equity and retainer and/or fee-based pay?

Lewis: Yes, I'm comfortable with it, but I'm also focused on the consensus and listening very closely to other board members' views. I think the fact of the matter is that board compensation, just like CEO compensation, is going to be driven by peer surveys. And unless we come up with a different methodology to set board compensation, the norm is going to prevail.

Wolf: I'd just add a minor note. The boards I'm on do not have equity compensation, and that has to do with the structure of the companies and the nature of the enterprises. For most public companies, I think it's probably very appropriate to have a combination. I don't have a particular view on what the ratio should be, but I think each company should look at what is expected of its directors, both in time and in responsibility, and look at how that compares with similar organizations. That is a rational way of going about it.

Kerstetter: Let me turn now to our last survey question for our viewing directors and we can discuss their response. The question is, "Should directors be paid for performance?" As you can see by these results, the prevailing view is that the practice of cash and annual equity awards provides enough of a link to performance.

Siciliano: I wonder if it would come out differently if you had specified a specific holding period requirement, like if you added that two-thirds of the past-tax equity grants must be held and are not liquidable for the duration of the term of the direction? I think that may have changed the results.

Elson: The vast majority of directors never sell their stock, and it's nice to see those numbers. The idea is, if you're representing the shareholders, then you ought to be a shareholder yourself. But, you've got to represent the long-term holders–the owners of the company [who care about] the long-term health of the company, and I think the directors have got to think of themselves that way.

Kerstetter: Sitting directors, I thought perhaps the most significant point that was made in the director session was about the need to have some type of holding requirement. I'd like to hear your views on that and if you can, please share what your own companies do.

Wolf: We don't have a holding requirement. In the mutual fund world, we do have a requirement that you invest your own money, not restricted stock, and that those investments be held for as long as you're in that board role, and those investments have to be a multiple of your annual board compensation.

Lewis: At H&R Block we just recalibrated the board compensation to a higher percentage of equity and a lower percentage of cash with a limitation that the equity awards that are granted going forward may not be sold until the director leaves the board. At Kroger there is no limitation, although it is highly unusual, as Charles indicated, for directors to sell their shares for a lot of different reasons, including the fact that those sales are very carefully tracked, even before any adverse event may occur. So a sale is a signal to the marketplace to some degree, or it could be interpreted that way.

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