CORPORATE
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Board Governance Series

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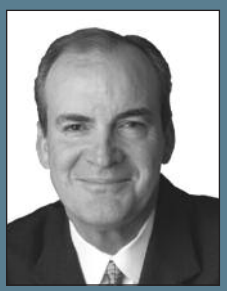
Dear Corporate Director:

As 2008 draws to a close, we're watching unprecedented events unfold across corporate America. Tumultuous stock declines have ripped through Wall Street, leaving even the most experienced market players shaken—or worse. As a result, investors and politicians are demanding accountability, and corporate leaders are searching for strategies that will sustain them in the coming months. Against this backdrop, the media has again trained its eye on CEO pay, shining a bright light on executives from those embattled financial firms. Not since Enron and WorldCom made a household word out of Sarbanes-Oxley has there been such intense scrutiny on corporate governance and risk management. So with all that's happened in recent years, it begs the question: How did we get here?

In good times and bad, the importance of sound corporate governance and leadership cannot be underestimated. Today, there's never been a more critical time for directors to ensure their company is operating in a risk management culture that will sustain their organization through times of turmoil—as well as prosperity. Even for the best boards and management teams, however, the solutions for the challenges faced by corporate boards will not be simple and will require more time spent both in board meetings and ahead of time, preparing for them.

To aid in this endeavor, *Corporate Board Member* magazine and The NASDAQ OMX Group proudly present this 12th volume of the Board Governance Series—a collection of informative commentary from leading corporate governance experts. As you peruse this publication you'll find discussions on the new business combinations standard, fair value accounting, CEO evaluation, and navigating antitrust issues during strategic acquisitions. In addition, directors won't want to miss the articles on CEO evaluation and executive change-in-control agreements—two very critical topics that fall squarely on the board's shoulders.

We invite you to visit the Board Governance Series contributors online and to watch the webcasts highlighted in this printed special supplement to *Corporate Board Member* magazine as part of your continuing education efforts to stay apprised of the top corporate governance issues facing directors.



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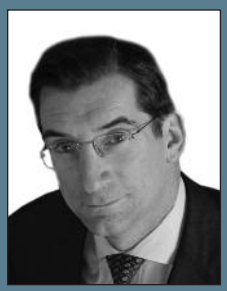

ROBERT GREIFELD
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Executive Change-In-Control Arrangements: What Directors Need to Know

Change-in-control agreements have two primary purposes. The first is to protect executives against a possible job loss or financial insecurity. The second is to neutralize an executive's self-interest. In other words, if there is a potential transaction and an executive is not protected, he or she may look for another job when the company still needs that person to be there. Without protection, the executive may actually hinder, or not support, the transaction. On the other hand, the company does not want the executive so well protected that he or she looks for transactions that are not necessarily in the shareholders' best interest. Thus, when looking at the purpose for these programs, it is important that they protect against job loss and enhance financial security, yet are fair both to the executives and the shareholders.

There are a lot of issues with change-in-control agreements. I'd like to focus on the five most important—and maybe the most controversial as well. These five issues generally relate to provisions that are the basis for triggering benefits under these programs. If a company does not critically evaluate these provisions, it may end up paying more than it should.

The first of these issues is eligibility, and obviously this is important because the broader the eligibility, the more costly it is to shareholders. The compensation committee must critically evaluate who is eligible for change-in-control protection. And in answering this question, I always look back to the objectives. Who is most susceptible to job loss? Generally, those are corporate, and not operating, positions. The committee also needs to look at who will be important to the transaction's success, including during the transition period, if a change in control occurs. Those individuals should be protected as well, because they could either hinder or help the transaction.

Roberta D. Fox
Principal and Senior Executive Compensation Consultant
Hewitt Associates

Another provision that should receive a fair amount of attention is the definition of a change in control. This is important because it is the first trigger for the payment of benefits. Directors need to review this definition and ask, "Is this the type of transaction that will trigger the payment of benefits, is that what is intended, and is that fair to both shareholders and executives?"

The trigger for the payment of cash severance and other benefits is another very important provision. Is the trigger a single trigger, a modified single trigger, or a double trigger?

A single trigger occurs when the payment of benefits is triggered by the change in control. Generally speaking, those types of arrangements are becoming more and more uncommon, especially for the payment of cash severance. However, we still see single triggers, particularly with respect to the accelerated vesting of equity awards. Again, going back to the objectives, if we ask, "Is there a job loss?" the answer on a single trigger is "Not necessarily"—only a change in control has occurred. For that reason, I don't think single triggers are usually appropriate.

A modified single trigger is a variation of a single trigger and basically provides that during some limited period of time, both a change in control and either an involuntary or good-reason termination are needed in order to trigger benefits. Maybe that period of time is 12 months, but at the end of that period, there's a small window of time, perhaps 30 days, whereby the executive can leave for any reason—just say, "I'm done," leave, and collect benefits. Again, looking at that type of a provision, generally speaking, the executive has all the leverage. That executive knows he or she can leave at the end of perhaps a one-year period and collect benefits. Is there necessarily a job loss? No, not really. And what we have found with these provisions is that they end up being very costly to shareholders because if a company wants to keep an executive, it is going to renegotiate the contract.

The third trigger is a double trigger, which requires both a change in control and an involuntary or constructive or good-reason termination. The double trigger for the

payment of benefits is most consistent with our objectives because there is a job loss as well as a change in control.

The definition of "good reason" is another very important provision because it is often the second trigger for the payment of benefits. Unfortunately, the good-reason definition historically has been overly broad and subjective. For example, some common definitions of good reason are a reduction in pay, a change in responsibilities, a change in title or reporting relationship, or a change in status. How does a company determine whether there's been a good-reason termination? It is a good idea for companies to try to tighten that definition up as much as they can.

Probably the most controversial provision is with respect to tax gross-ups. It can be very costly to a company and its shareholders to gross up an executive for the excise tax that is imposed on what are called excess golden parachute payments. The excise tax is a 20% penalty payment, which the executive ends up paying. The problem with the tax law is that it ends up with very arbitrary results due to the way it is structured. For example, I could have two executives who are paid virtually identical amounts, yet end up receiving very different net after-tax change-of-control benefits because of what they have done during the five-year period preceding the change of control, which is the period of time used to determine whether there are excess golden parachute payments.

Because of this arbitrary result, I feel that companies should look at what is called a modified or conditional gross-up. If the total parachute payments exceed the safe harbor amount imposed by the Internal Revenue Code by a significant amount, then the executive will be grossed up. However, if the total parachute payments only go over the safe harbor by a small amount, the executive's payments will be cut back to the safe harbor and the shareholders will not absorb the cost of a gross up. To me, this is a responsible approach because it is fair to the executive, despite an arbitrary tax code, but it is also responsive to shareholder concerns regarding the costs associated with gross-up provisions. Having said all of this, it is vital that the compensation committee consider the cost of these arrangements when it is deciding which provision to implement.

Finally, it's important that the compensation committee establish a reasonable process for implementing change-in-control agreements. The compensation committee needs to review its objectives. Has it designed a program that is consistent with its objectives, and is it fair to shareholders and to executives? The design should not be a proexecutive design. The compensation committee members also need to be knowledgeable about the disclosure rules, because they will have to explain in the proxy why these programs have been implemented. The committee should be prepared to know why, and understand the dollar amounts associated with the program.

Bottom line, committee members need to make sure the program they have implemented meets their objectives and balances the interests of executives with those of shareholders. The compensation committee should provide a program that protects executives against job loss, but at the same time, is sensitive to shareholders' concerns. At the end of the day, what is ultimately important is that you have a program where the compensation committee feels it has been responsive to the concerns of both executives and shareholders and both parties feel they have been treated fairly.

» The compensation committee should provide a program that protects executives against job loss, but, at the same time, is sensitive to shareholders' concerns. — **Roberta D. Fox**, Hewitt Associates «

What a Director Should Understand about Fair Value Accounting

Don, I'm sure most of our audience knows that fair value accounting was at the center of the subprime debacle, but let's take a moment to talk about why fair value accounting is important to corporate boards.

Fair value accounting is a more recent, rather than historical, phenomenon. The recent Financial Accounting Standards Board's pronouncements, numbers 157 and 159, have instated a financial reporting requirement that certain instruments must be reported at fair value and describe how those fair values should be measured. The pronouncements have unified how that measurement is to take place and give guidance about the proper levels of evidence required to produce measurement of financial instruments.

There are three levels of assurance. Level one is the assurance from a trading market in the instrument, which is the best you can get. With level two, there are similar instruments and similar inputs, such as interest rates and duration, that give an indication of value. Level three is a situation where there is no trading and there are no similar or like instruments you can use as a valuation basis, and as a result, this is the least reliable of the levels for financial reporting. This is important in today's world because many of the financial instruments that the press have reported to be causing losses are very hard to value. They are not trading, they have limited trading, or they may never have traded at all, and to value them is as much an art as it is a science.

We've seen very large losses, and they've been held to be the result of fair value accounting. What that means is items that are carried on the balance sheet at fair value must be adjusted at the end of every accounting period, and if the market or the indicated market for those items has gone down after they are adjusted, those losses need to be recognized in the profit and loss statement and included in earnings per share.

Don Walker
Senior Managing Director
FTI Consulting

What are the pitfalls of fair value accounting that directors need to understand?

Directors should understand that if you're carrying instruments, assets, or liabilities at fair value, the changes in those fair values from period to period will show up in the earnings statement and affect earnings per share. When they do, directors should be asking management, "What happened?" and "How did something decline in value during this period of your stewardship?" If it's a public company, the directors sign the 10-K forms and the quarterly 10-Q forms that are filed with the SEC, and those carry liability. So the directors are responsible for understanding what the major changes and major charges to income are about.

Let's look at a hypothetical situation. A public company reports in the current quarter a loss of $100 million, and that $100 million is due to changes in fair value of financial instruments. When that happens, the people who read those reports carefully—analysts, the press, and regulatory agencies such as the SEC—question whether further investigation or examination needs to be made of the company. When that kind of a question comes to the company, it may be the precursor of an investigation, which could be lengthy, very expensive, and perhaps end up in a restatement.

Restatements are to be avoided at all costs because they cast aspersions on the company, its management, and its soundness overall. Restatements can occur as a result of fair values not being applied or measured in a consistent manner. When a company has a significant loss, that significant loss impacts its capital. So if there is a large loss because fair value of its financial instruments has gone down, that reduces the capital. Now the marketplace, if it's a public company, and the regulators, if it's a regulated company such as a bank or a broker/dealer or an insurance company, get concerned when capital

goes below certain levels, called regulatory capital requirements. A loss as a result of fair value accounting could end up reducing regulatory capital and create problems with the regulators and in the marketplace for the company's valuation.

What should directors be doing to mitigate these fair value accounting risks?

Well, the first thing they need to do is recognize that they have a responsibility for overall risk management within the corporate structure. They need to understand the risk limits management is placing, as well as the kinds of investment decisions it is making. In other words, they need to know the organization's risk appetite, and be comfortable that, in using that kind of a risk appetite, there are proper controls to keep the company from going over the line or from getting into riskier situations than it had planned. The board is responsible for overall conduct and for seeing that there are proper controls, and one way to do that is by asking penetrating and unstinting questions at board meetings about risk appetite, risk management, and the kinds of controls that are operating within the company. They also should be asking, "What is happening?" "How are we doing as far as our risk limits?" "Are we managing to make a profit but also staying within our risk limits?" "What happens if our risk limits are violated?" "Have we taken appropriate action under those circumstances?" "Do we have appropriate internal audit oversight of the application of the corporation's risk controls to see that they actually are working and that the reports coming to management and the board are accurate and timely and allow management and the board to manage risk in a well-informed way?" Even though a board and management do their best, there are times when markets change, and sometimes, as shown in the recent past, markets change very dramatically and in such a fashion that risk can only be mitigated and softened—it can't be wished, measured, or managed away. There still will be losses, but good controls and good oversight can reduce those losses.

One of the concerns we have is reputational risk. The company's reporting must be reliable, and it should be transparent so that you can compare the company's results against another company's results. To reduce reputational risk and manage communication, a company should have clear, unambiguous, and detailed communication in its press releases and in its management statements about what has caused losses and what the impact of changes in fair values of financial instruments has been so that investors can understand what happened and can make a clear judgment.

» Even though a board and management do their best, there are times when markets change, and sometimes, as shown in the recent past, markets change very dramatically and in such a fashion that risk can only be mitigated and softened—it can't be wished, measured, or managed away. — **Don Walker**, FTI Consulting »

Don, can you summarize the fair value accounting issue?

In order for a director to help discharge the board's responsibilities properly, he or she should see that there are proper controls in place, that the company is controlling its use of fair value models, that it's using proper accounting, that it's using good inputs, and that it has oversight by an internal audit function of how fair value accounting is being used. If directors take these steps and make sure that the controls are in place and ask good questions about the controls, they can discharge their responsibilities in a fair value accounting world.

The New Business Combinations Standard Is Coming—Is Your Board Ready?

In my last webcast I talked about how U.S. and international accounting standards are converging, with the long-term expectation that U.S. companies will eventually report using International Financial Reporting Standards, or IFRS. Today, I'd like to discuss a result of one of the joint projects between the international and U.S. standard setters that was released in December 2007– the new business combinations standard.

I'll first describe some of the main changes under the new business combinations standard, and then I'll discuss areas that corporate board members may want to probe.

One of the first key changes involves the date when purchase price is calculated. Under the old standard, the purchase price date was the date the announcement was made, but under the new standard, it's the date you acquire control of the company, which, in effect, is the deal closing date. That's significant, because between the date the acquisition is announced and the date it actually closes, there could be volatility in stock price. So there is going to be uncertainty—perhaps even a fair amount of uncertainty—over what the purchase price ultimately will be. And you won't really know the price until the day you close.

The second key change is that assets and liabilities will be valued using fair value, including any acquired contingencies. And, companies will have to use the new definition of fair value. Fair value is no longer based on how your company values the asset or what it is worth to you. Instead, fair value now takes an exit price notion. So it's what someone else would pay to acquire the asset from you. That can be important for some companies because they may acquire assets in a business combination that have little or no value to them, and so under the old rules, they would have reflected those on their balance sheets at little or no value. Now, they will have to go through a process to value them and recognize such assets on their balance sheets.

The third and fourth points are very similar and relate to deal costs and restructuring charges. Under the old rules, those generally would be incorporated into the purchase price and, in effect, capitalized by the company. Under the new rules, they will be expensed. So companies are going to see a hit to their bottom line—before and after they announce they are doing a deal. The other aspect with restructuring charges is that while benefits may come years down the road, you'll see the costs in the current period.

> If I were a director at a company and management was contemplating a deal, I would want to understand how management is incorporating the impact of the new business combinations standard as it relates to issues such as deal structure and process, everything from doing due diligence, to negotiating the deal, to doing the modeling. — **Catherine L. Bromilow**, PricewaterhouseCoopers LLP

Another item to note is that the definition of business combination is changing. So there may be more transactions that you're going to have to account for using the new standard. All told, the new standard is going to mean more transparency and potentially more earnings volatility.

Catherine L. Bromilow
Partner, Corporate Governance
PricewaterhouseCoopers LLP

Now that I've described some of the major changes, I'd like to look at what corporate board members should be considering. First, I think it's important to acknowledge that when we talk about deals, particularly in the current environment, the key things driving them are the capital markets and credit markets, and there are some challenges we're facing with those. That aside, if I were a director at a company and management was contemplating a deal, I would want to understand how management is incorporating the impact of the new business combinations standard as it relates to issues such as deal structure and process, everything from doing due diligence, to negotiating the deal, to doing the modeling.

Second, I'd want to understand and get comfort that management is reaching out to the external audit firm to discuss some of the complexities with the new standard. I covered them at a very high level, but, particularly for some industries, there are many issues to work through, and you want to make sure your management team is getting the best advice it can.

Third, since the new standard will provide a lot more transparency and earnings volatility, it is increasingly important that the management team reaches out and communicates to the various stakeholders—shareholders, ratings agencies, and analysts—to help them understand the results the company is reporting and expects to report, because there will be an impact from the new business combinations standard.

That, in a nutshell, is the new business combinations standard. It takes effect Jan. 1, 2009 for calendar year-end companies, and it will impact how you structure, and ultimately report, your future deals.

Note: *After this webcast was taped, the Financial Accounting Standards Board indicated it would be amending the accounting for acquired contingencies. The new guidance will be issued in the first quarter of 2009.*

Navigating Dangerous Territory: Boards, Strategic Acquisitions, and Antitrust

There has certainly been a lot less acquisition activity by private equity firms. Most acquisitions we're seeing these days would be considered strategic. From an antitrust perspective, what is the impact on today's corporate boards given the fact that this dynamic in acquisitions is changing?

Whether you're on the board of a buyer or seller, strategic acquisitions can be among the most important decisions that a board has to face. Unlike a financial acquisition, a strategic acquisition often can involve companies that are head-to-head competitors in major lines of business, so antitrust concerns will be an important part of what the board needs to consider in deciding whether or not the acquisition makes sense for the company.

There are two different antitrust issues a board should consider. The first is the substantive one: Is this a deal that would likely be blocked by the antitrust agency or would require some substantial relief to get the deal cleared? The second issue, which may not be as obvious but is perhaps just as important, is a question of process: How long is the antitrust review likely to take? If, for example, you're on the board of a prospective buyer and the antitrust review is going to take a long time, it may give your rivals a chance to mobilize and respond to your offer. Take Medicis's effort to acquire Inamed. Because of the length of the antitrust review, a competitor, Allergan, was able to come in and make a rival offer. Rivals may also try to launch a publicity campaign against your company, as Microsoft did, for example, in opposing Google's acquisition of DoubleClick. So delay can create important risks that need to be included in your analysis.

Sometimes, too, the substantive and procedural risks may be intertwined. For example, a possible risk for the buyer is that substantial antitrust concerns will drive the prospective target to seek acquisition by another buyer. That happened when Blockbuster was trying to acquire Hollywood Video, and Hollywood Video decided to seek out Movie Gallery because it was less likely to be challenged on antitrust grounds. Another risk is one that Whole Foods faced recently. After it won at the trial court, it went forward and consummated the transaction, but then a court of appeals reversed the decision and now Whole Foods is facing divestitures in several markets. So those are all possibilities that the buyer's board would want to think carefully about.

From the seller's side, a long process can lead to hemorrhaging of key employees and customers. Ultimately, therefore, the most critical issue from the seller's perspective is to make sure the deal is consummated. The higher the substantive antitrust risk, the more protection the seller will want to have built into the merger agreement. There are a number of contractual ways to handle such risk, but it is essential for the seller to address this issue at the outset, because once the agreement has been executed, the buyer largely drives the process.

Is it really something that boards have to worry about, because there's a perception that regulatory enforcement has become more lenient. Is that just perception, or is that, in fact, what's happened?

That's a great question. One thing that's important for boards to consider is which agency will be reviewing their deal. As you know, there are two federal agencies that have oversight over antitrust enforcement—the Federal Trade Commission and the Antitrust Division of the Justice Department. And each has a different political structure. The commission has five political appointees who are commissioners, and the Antitrust Division has someone who's appointed by the president and assistant attorney general. Because of their different structures, the political timing for these agencies can be quite different. For example, even though this is the Bush administration's last year, because of personnel changes,

Susan A. Creighton
Partner
Wilson Sonsini Goodrich & Rosati

the FTC this past year has been acting more like what you might expect if it were under Democratic control. So it has actually been very aggressive in its antitrust enforcement. A board should get informed antitrust counseling regarding the conditions at the agency that is likely to review the deal, because the headlines may not accurately reflect the regulatory risks you face in your deal.

What other steps should board members who might be involved in a transaction like this take?

There are steps companies can take during both the deal planning stage and once a deal has been signed, during the course of the antitrust review process. First of all, let me address planning for a merger. If you're on the buyer's side, one thing you can think about doing during the course of evaluating a strategic merger is making a careful assessment to see if there are particular overlap areas where there's likely to be major antitrust risk. For example, if it's not strategic for the company to keep an overlap product line, there are ways of structuring the transaction that would reduce or possibly even eliminate the antitrust risk. For example, I mentioned Medicis's attempted acquisition of Inamed. Allergan then came in as a rival buyer. Allergan had a product overlap with Inamed, so it decided to go to the Federal Trade Commission and offer, to allow its license for that product to revert back to the original licensor. That may have been decisive in Inamed's decision to go with Allergan rather than Medicis, and it made a huge difference in terms of accelerating the time of review and getting the deal cleared. So you can consider those kinds of structural changes.

From the seller's point of view, if you're representing the board, absolutely the most critical thing is to make sure the buyer has the incentive to go through with the merger once the process has started. As I mentioned before, if it's a friendly deal, once you've signed onto the deal, you lose a lot of control over the process. So you want to think about terms in the merger agreement that will give the buyer the right incentives to continue forward with the deal. One such term requires the buyer to do whatever divestitures are necessary in order to get agency clearance. You might also think about a term that allows you, as the seller, to walk away from the deal if it looks like the merger process is going on too long.

Another common provision is what's called a reverse breakup fee, which provides that if the buyer walks away from the deal or the deal is challenged, then the seller gets a big fee from the buyer. A seller's board needs to be very careful about relying solely on a reverse breakup fee, though, because increasingly, buyers are getting insurance for those fees, and in that case, the buyer doesn't necessarily have the right incentives to continue.

» A board should get informed antitrust counseling regarding the conditions at the agency that is likely to review the deal, because the headlines may not accurately reflect the regulatory risks you face in your deal. — **Susan A. Creighton**, Wilson Sonsini Goodrich & Rosati «

Interestingly, we've seen, perhaps in response to that problem, that the size of reverse breakup fees has been steadily increasing over the last few years. So for example, in a recent acquisition, Monsanto had a $600 million reverse breakup fee that it would pay if the Justice Department challenged the deal, which is a full 40% of the transaction size. So obviously a huge breakup fee is one alternative for the seller's board, but I would think carefully about other provisions, such as the divestiture requirement or an early termination or walkaway provision.

The Right Way to Evaluate Your CEO

Every public company has an annual requirement to review how its CEO has performed during that year, and the compensation committee has a requirement to take that information into account when it makes its annual compensation decisions for the CEO. When directors discuss CEO appraisal, it's frequently thought about only in terms of the financial aspects of performance—how the stock has grown, whether the budgets have been achieved, and other key financial ratios. In addition to the financial aspects of the performance of an organization however, leading companies' directors want to know much more in order to have a full sense of the CEO's performance. They want to know how well the CEO has developed and is building the bench strength of management talent at the step-up levels. They want to know how the strategic plan is being implemented and how successful it has been in realizing its objectives. They want to know how the organization has responded to different challenges in the market: Does it tend to wait, does it get too far ahead, or is it proactive? They like to look at the relationship the CEO has developed with the investment community and other constituencies that are a part of how the organization is viewed and valued as an enterprise. And they want to assess the quality of governance and see that the right processes are not just demonstrated at the organization's very top level, but are really a part of the organization's genetic code all the way down in its decision making. If I were a leading director in today's environment, I would ask how successful has the CEO been in creating a performance culture that carries the organization through the good times as well as the bad?

What are the best practices in CEO evaluation?

The best practice is to have the CEO appraisal managed by either the compensation or governance committee.

David A. Hofrichter
Principal and Leader
Hewitt Associates

One of these committees tends to take the lead on it, but at the end of the day, every director on the board provides input into the final evaluation. The lead director should take responsibility for assuring the process is done in a timely manner and that all directors have provided specific input. It is important to have the data collection and analysis process managed externally. This is for the directors' privacy as well as to ensure that the consolidated data is fully representative of the board's views, as opposed to giving more weight to certain inputs. The evaluation is typically conducted at the end of the year. The financial results are probably pretty well in by that point, and these other key performance dimensions that we talked about are evaluated at that time.

The final consolidated review comes together and is handled in a couple of ways. The lead director typically provides the feedback to the CEO in a discussion about the composite results. In the best companies, this is an open and productive dialogue that helps the CEO focus on future needs and clarifies what the board expects going forward. There is also a report made to the board about what the board has said collectively in its evaluation of the CEO. The compensation committee utilizes that report in its determination of various rewards that may be provided for the year. As noted, listed companies need to take this evaluation into account when making compensation judgments, although the rules do not specify to what degree they must be taken into account. Thus, it is up to each compensation committee to use the information in the most productive way for its situation.

While we're talking about the right ways to handle CEO evaluations, one thing we often see and get asked about is structured scales versus the "blank sheet of paper" approach. Should you allow a sort of free-form input or should there be a more defined process? What we have found is that it is best to have defined categories the director is asked to respond to, as well as a definition for each of those categories. Whether that is in the form of a rating scale or whether it is just a definitional category and you ask directors to supply their written input is more a matter of comfort for the directors. In either case, it is important to focus the directors' input. Without the focus

of scales or dimensions, you do not get the kind of evaluation that gives you insight into strategic direction and the specific things you want to know about. Without some structure, frequently you get more of a free flow of consciousness as opposed to targeted answers. It should also be noted that there may well be different focuses on some of these dimensions at different points in a company's history. So we recommend that there be some defined structure to the questions and performance dimensions.

Why is it important to do a CEO evaluation the right way?

The biggest gain is the opportunity for a board to coalesce around the critical ideas regarding what is needed to move the organization forward. Many times board members have divergent ideas regarding what is required to make the organization successful. Directors may not always be clear about those items with the CEO. In addition, among themselves, directors may not have challenged each other about whether it is just a bias one has or a necessary ingredient they all agree needs to be in the strategic mix. The assessment process itself promotes clarity and consensus around what the future requirements are for the organization and defines what, specifically, the CEO needs to develop further as the company's leader.

The second thing is that the CEO gets some very powerful market intelligence, if you will, about how different directors are viewing performance and the organization's needs. During this dialogue there's a lot of clarity of expectations, assumptions, and implicit requirements. It becomes a very helpful process for the CEO to have a better understanding of everyone's expectations, which means he or she has a better chance of addressing and meeting them. The process also provides an opportunity for board members to challenge themselves and confirm that these are their ideas and no one else's, that they are not responding to [issues of] two other boards they sit on, but are really seeing a need that this organization has to address through the CEO's leadership.

What is your best advice to board members regarding CEO evaluations?

Don't make it *just* an administrative event. You have to do an annual CEO evaluation by virtue of being a listed company, and unfortunately, a number of companies look at it in only that way—as a compliance requirement. They do it, they get it done, and they put a check in the "completed" box. Instead, see it as a real opportunity to engage in a productive dialogue that goes beyond simply the company's financial performance to how well the CEO is building and putting in place the planks and foundation that not only assures this year's and next year's performance, but sustained performance over a longer period of time. This is an opportunity to have that kind of dialogue, to bring the directors together with a common viewpoint, and to gain consensus about company needs. It also engages the CEO in not so much an evaluation, but a mutual planning exercise about the kind of things he or she needs to address to help move the company forward. The process, when done well, concretely links CEO behavior and focus with the strategy for the company and the needs of the enterprise.

> In today's environment, I would ask how successful has the CEO been in creating a performance culture that carries the organization through the good times as well as the bad?
>
> — **David A. Hofrichter**, Hewitt Associates

What Will Impact Board Members Most When a New President Takes Office?

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In each edition of the Board Governance Series, we ask our series partners to respond to a common question with insight that will be helpful to board members. In this edition we asked, "What will impact board members most when a new president takes office?

Catherine L. Bromilow: Actually, in the short term, we don't see a new administration in Washington having much impact on corporate board members. Although there will be changes to the heads of departments such as the Securities and Exchange Commission, or perhaps a new Treasury secretary, and changes to some of the other key posts that are important to American business, the impact will probably be over a longer term. As regulatory philosophy regarding public policy changes, there might be some impact in the boardroom. That said, when we actually look at where there have been particular changes in what directors are doing day to day, it's really come out of crises. For instance, we saw the Sarbanes-Oxley Act, which was a reaction to Enron and WorldCom. So looking forward, the one thing that will have the most impact on corporate board members that will come out of a new administration may be in response to either crises or to some of the challenges we're currently seeing in the economy surrounding the credit markets and energy.

Gary Kleinrichert: People tend to view political risk as it relates to the risk associated with investing in developing countries or those with more fragile social or political climates. But political risk is everywhere. It involves everything from who will be the new president of the United States to who could be your local council member. The primary issue is how companies manage that risk. There certainly will be a number of changes as a result of the election that will relate to regulatory enforcement and to other rule making and law making. Companies need to be prepared to address such risk. Another potential impact to board members is the effect of changes in significant cabinet members or positions that are tasked with regulatory enforcement. For example, a new SEC chairman and attorney general could have a profound impact on the climate with respect to enforcement, and their agendas could, of course, be different from the

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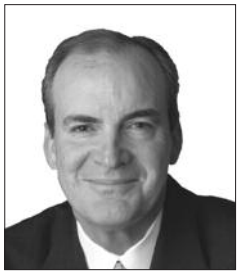

current administration's. A new SEC chairman could look at such issues as International Financial Reporting Standards, its timetable, and the manner in which that may be implemented, which of course has an impact at the board level. He or she could also look at other issues such as the ability for active shareholders to gain board seats and other matters that the SEC chairman and his agenda may impact. I've provided only a few examples of some changes that may affect boards as a result of the election. Rest assured, there are potentially hundreds of different types of changes as a result of new regulatory enforcement and rules that could impact board members. But we've been through this many times in the past, and the key for directors is to put a risk management program in place to be ready to address such change.

demonstrate the pay and performance linkage in their executive compensation programs—we're paying at this level, and compared to this peer group our results were in the following categories at this level, and therefore it justifies how we made these adjustments accordingly. The pay and performance issue will be the one that many others will get coalesced around. Unfortunately, before it gets to that point, I think there will be a lot of activity around simple compliance and the belief that if you tighten up compliance, you'll get better governance. However, I think the answer to better governance lies in the relationship with pay and performance.

» Regardless of how the presidential election turns out, I think we can expect strong Democratic majorities in Congress, and the potential for substantial new regulatory legislation.

— **Susan A. Creighton**, Wilson Sonsini Goodrich & Rosati »

Susan A. Creighton: Regardless of how the presidential election turns out, I think we can expect strong Democratic majorities in Congress, and the potential for substantial new regulatory legislation. Indeed, I think there is a good chance that we will see a more proregulatory environment than we have seen on Capitol Hill since the 1960s. So regardless of who is president, I believe that companies need to be seriously preparing for a great deal more regulation, not just in pharmaceuticals, oil, and banking, but also in legislation like Sarbanes-Oxley that cuts across all industries.

David A. Hofrichter: I do think there will be a continual push for greater and greater disclosure. In the compensation area, in particular, the need to respond to shareholders, whether through say on pay or other types of actions, will continue. Whether they'll be any more successful than they are today still remains a question. But the pressure will be there. One of the biggest issues that will be foremost for directors is the ability to

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