Volume 19, Number 1, 2012

Board Governance Series

Developing an Effective Long-Term Incentive Plan
Meridian Compensation Partners, LLC

Why Transformational Transactions Are Important to Boards
PwC

Lessons Boards Can Learn from Past FCPA Cases
Clifford Chance LLP

CORPORATE BOARD MEMBER®
An NYSE Euronext Company

Dear Corporate Director:

Communication. It's a critical component for today's boards of directors, whether it involves dialogue with shareholders, M&A transactions, or management's key reports to the board. In every circumstance, having clearly delineated internal and external communications is an intrinsic part of good governance today.

Along those lines, Corporate Board Member is pleased to share the first installment of Volume 19 of its respected Board Governance Series, now published four times a year. The online webcasts and printed supplements feature timely commentary by experts from the nation's top business advisory and law firms, who address critical issues to support your board's decision making. This quarter, we offer the latest information and advice surrounding transformational transactions, long-term executive incentive plans and the impact of the ISS's new proxy test, and the critical nature of FCPA compliance.

As always, we invite you to visit each of our series contributors' websites for further insights, as well as to view online (www.boardmember.com) the webcasts highlighted in this printed publication. I hope these resources will become an integral part of your continuing education efforts to stay apprised of the most pressing issues for boards of directors in the months ahead.

TK KERSTETTER
President
Corporate Board Member
An NYSE Euronext Company

Board Governance Series

Volume 19, Number 1, 2012

4

Developing an Effective Long-Term Incentive Plan

Bob Romanchek
Partner and Senior Consultant
Meridian Compensation Partners, LLC

Proxy advisory firm ISS's new test may impact long-term incentive design. With this in mind, directors and C-suite executives need to look at the company's business strategy, where it is in the business cycle, and what it is focusing on from an operations perspective.

6

Why Transformational Transactions Are Important to Boards

Catherine L. Bromilow
Partner, Center for Board Governance
PwC

Transformational transactions are mergers or acquisitions companies undertake that are both material and strategic, but they also carry with them potential risk. How can directors be effective when overseeing such deals?

8

Lessons Boards Can Learn from Past FCPA Cases

Wendy Wysong
Partner and Foreign Legal Consultant
Clifford Chance LLP

Directors need to understand the risks of expanding globally. There are a number of proactive steps they can take, though, including appointing a fully empowered compliance officer who has the clout to implement and enforce the compliance program.

CLIFFORD
CHANCE

Developing an Effective Long-Term Incentive Plan

We'd like to talk about compensation and, specifically, about developing an effective long-term incentive plan. It seems like we have perpetual change in the catalysts that impact the area of long-term incentives. Where do we stand today?

If you look back at the last seven to 10 years, it seems like we have a new catalyst every year—changes in accounting rules, tax rules, securities disclosures, etc. This year is no different. Proxy advisory firm ISS just introduced a new test that may impact long-term incentive design. The first level of the test (which if you pass, by the way, indicates you should generally be fine) focuses exclusively on the financial measure of total shareholder return (TSR). The test compares TSR on a one- and a three-year basis to CEO compensation, and then relative to similar measures within an established peer group. The remainder of the test in that quantitative category looks at absolute TSR over a five-year period, again looking specifically and exclusively at the CEO compensation relationship.

Without getting into further details of the mechanics of the test, since TSR is the only financial measure that's being utilized in this new approach, some organizations are already reacting. Do we need to have a TSR plan put in place? Or if we've got a plan in place, do we need to further enhance or put more weighting on that program? Do note that if you don't pass this part of the test, there is a secondary, qualitative measurement where there are six general categories of additional items that ISS is going to consider. Within these subjective categories of the test are the traditional financial measures of performance which, thereby, ISS is treating as secondary in nature. So if you pass the first part of the test, you need not go further. If you score low, then you go to this subjective area, and ISS is going to determine whether those additional factors mitigate or actually contribute to the pay misalignment. But the bottom line is if you want ISS support for your executive compensation programs, you're really going to have to pay attention to total shareholder return. Thus, this new ISS pay alignment test appears to be the primary catalyst for the 2012 long-term incentive design year and it may drive design practices to some degree.

Bob Romanchek
Partner and Senior Consultant
Meridian Compensation Partners, LLC

Let's stay on the issue of the test. If a company doesn't score well on the test, what happens to the company? And I assume when you say "score well," that's relative to the ISS test—is it also relevant to say on pay?

First off, again, looking purely at the financial measures, if you pass the TSR test, the whole analysis stops and you have ISS support, generally speaking, for say on pay, and you need not go further. However, if you score low, ISS applies the subjective portion of its test and then at the end of the day determines whether it will give you support or not. If it is determined at that point that you're still not scoring high enough, and you have not taken sufficient abatement measures with your shareholders, ISS will likely give you a no recommendation on your say-on-pay vote. That's really its first form of attack and the most likely occurrence. The next step is for ISS to recommend a no vote for outside directors on the compensation committee who are up for reelection. If the practices are egregious, they may actually extend that further to the entire board and recommend a no vote for all board members. The third category applies to companies going for a new, equity-based long-term incentive program or simply trying to replenish the share pool on the existing plan, both of which require shareholder approval, so ISS can and will, based on this test, also recommend a no vote for such a plan. So all three of those categories—say on pay, outside director renomination, and new equity-based programs—are in ISS's arsenal now, so we really do need to pay attention to these tests.

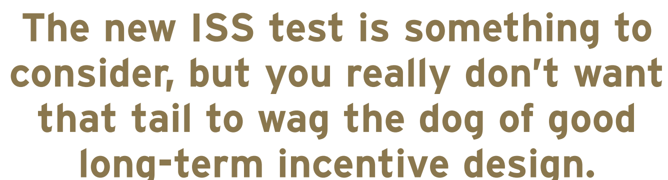
Last year, companies did fairly well with say on pay as a rule, but this is a change and a new test that will be looked at. What effect do you think it will have? Is it going to stir things up a bit?

Absolutely. In the area of long-term incentive design, we do know, just based on stock performance this past year, that total shareholder return is down compared to the prior year; therefore, we are immediately aware there will be less-favorable results on a relative TSR basis for a number of organizations. So it's going to impact long-term incentive design. With that, there are a number of points to be made.

First, ISS is not the only proxy advisory firm out there. Other firms, such as many of the pension funds and even the larger mutual fund families, still do their own back-door analysis, and for the most part none of them are focusing 100% exclusively on TSR as ISS is now doing in the first step of its test. These companies are considering some of the historical financial metrics in measuring pay for performance alignment. So you have more constituencies out there that you'll have to cater to, not just ISS, although ISS seems to be getting a lot of the press with this new test. Second, if you look at the ISS analysis and its documentation, ISS clearly admits that a TSR program is not

necessarily appropriate for every organization out there. It does note that it expects organizations to continue to use traditional financial measures involving profit growth, return on investment, or capital, free cash flow measures, and potentially relative TSR, or some combination of those measures. The argument that ISS makes is that with those traditional plans, if you are enhancing those financial measures, secondarily it should have a positive impact on TSR as well.

So if ISS is saying that it doesn't expect you to use TSR, and you won't get a no vote if you don't have a TSR plan, then why is it focusing exclusively on the TSR measure in the quantitative portion of its tests? Here's why. If you take a step back and think about what ISS analysts do for a living, they advise shareholders and firms that invest in shares. So to look at total shareholder return as a performance measure, from their perspective, makes a lot of sense. When you flip the coin over and look at those of us who are practitioners in designing actual long-term incentive programs, and trying to create an appropriate long-term incentive performance alignment, clearly there are many financial and other measures you may want to consider, not just TSR.



So with that, where do you start? How is this going to impact long-term incentives? You really should take a major step back and chunk up, so to speak. This new ISS test has not really changed the long-term incentive design analysis. You need to look at the company's business strategy, where it is in the business cycle, and what it is really focusing on from an operations perspective and hoping to accomplish. With business strategy in mind, most organizations have translated that into a formal executive compensation pay philosophy. That pay philosophy, in many cases, is publicly disclosed in the CD&A portion of the proxy statement. So along with the business strategy, the executive comp philosophy still needs to be the blueprint for the appropriate design of a long-term incentive program.

Finally, with that, I would step back, and if you have a blank slate, although many do not, here is a good starting-point exercise to attempt to design the most appropriate long-term incentive program. There are three traditional categories, or buckets, of long-term incentives. I would start with equal one-third weighting on all three, which are first, stock appreciation-only vehicles such as stock options or SARs, where you're really looking to incent future stock price appreciation and growth; second, full-value, equity-based incentives, restricted stock, and restricted stock units, and we know restricted stock has become very prevalent, particularly as a retention hook; and the third category is performance programs, i.e., performance share or performance units linked to a traditional, three-year performance cycle, based on the achievement of preestablished growth and/or return financial measures, cash-flow measures, TSR, or some combination (note, TSR is still a very relevant measure). Within these categories, in the first level of its new test, ISS ignores financial and cash-flow measures from its quantitative analysis to determine if a pay-for-performance alignment exists. So this places additional emphasis on the third category where the relative TSR lies.

In designing a long-term incentive plan, I would start with these three categories and take a step back and work backward from the executive comp philosophy and business strategy to determine whether you can simplify and get those three vehicle categories down to two, and then really look at the design parameters of those vehicles to see if you can customize them so they'll work to incent the strategy you're after. Bottom line, the new ISS test is something to consider, but you really don't want that tail to wag the dog of good long-term incentive design.

I know that Meridian Compensation Partners is in the process of launching a new app, which is a creative tool that compensation committees can use. Will that help in long-term incentive design as well?

Call me biased, but the new Meridian executive compensation app absolutely will assist greatly from the perspective that the app has a significant amount of information with just about everything you could imagine within executive compensation, including the category of long-term incentive design. There will be white papers, a description of these types of tests, plan design elements, and a lot of data. So as a resource, it will help tremendously. As an overlay, obviously, you're still going to need input and the discussions that go along with that, but it contains a lot of the background information that will assist with the long-term incentive design and process.

Why Transformational Transactions Are Important to Boards

PwC recently published a book called *Board Effectiveness—What Works Best*. It's a practical guide to help directors function more effectively in the boardroom, and includes insight PwC solicited from numerous directors and governance experts. One of the issues covered in the book is transformational transactions.

What are transformational transactions, and why do directors need to focus on them?

Transformational transactions are mergers or acquisitions or joint ventures that companies undertake that are both material and strategic.

Today, companies have amassed a great deal of cash on their balance sheets, and so increasingly are considering transactions, particularly mergers and acquisitions. That said, we also know that many mergers and acquisitions don't return the shareholder value anticipated when they were approved and entered into. And so transformational transactions represent potential risk for companies.

The other complicating factor is that very often after a merger or acquisition is announced, there is an announcement of a lawsuit. And so these are deals where directors focus not only on ensuring that major transactions add shareholder value, but also that their own processes are robust in the event there is some challenge or question about what they've done in the boardroom.

Catherine L. Bromilow
Partner, Center for Board Governance
PwC

Knowing all the challenges and risks that are involved in these transactions, is there any particular process or structure that directors should expect management to follow?

There are frameworks that management can follow to better assure these deals will be successful. Two key elements to determine are the objectives for the transaction and the nonnegotiable deal drivers.

In terms of the objectives, it's important that any potential transaction align with the company's strategy. Is the strategy reliant on gaining access to new technology or entry into new markets? Will a potential deal feed into and support the company's strategy?

When we talk about the nonnegotiable deal drivers, we mean those elements the transaction must have or must avoid. For example, must-have nonnegotiables may include requirements such as if we're going to acquire a company, it's got to be either number one or two in the market, or it must retain at least 90% of the customer base, post transaction. In terms of nonnegotiables involving elements to be avoided, you may decide to steer clear of scenarios where there is substantial customer concentration in the target company, such that one customer makes up 30% of the company's revenue, or you may want to avoid companies where there are potentially significant corruption issues or lawsuits.

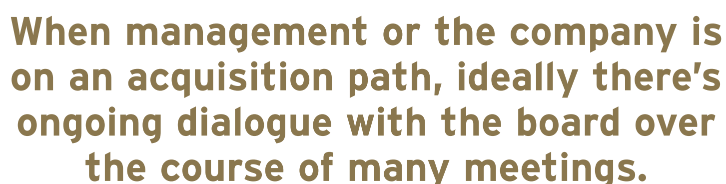
Having such deal objectives and nonnegotiables defined upfront, even before considering any transaction, helps management maintain discipline. Executives can better avoid becoming enamored and engaged in a potentially inappropriate transaction if they can refer back to the basic objectives they're seeking in a deal. They can save company resources and be positioned to walk away early on if a deal doesn't meet the nonnegotiables, freeing up time to look for other opportunities.

The term transformational transaction sounds daunting, but I would expect most companies will have these transactions in front of them at some time during their business cycle. So what are the other things directors should keep top of mind?

Once management identifies a target that meets the strategic objectives and satisfies all the nonnegotiable deal drivers, the question becomes, "What kind of due diligence should directors expect management to perform?" The nature and extent of the due diligence depends largely on the risks and importance of the transaction. So the riskier and the more important the transaction, the more due diligence you would expect to see performed. The due diligence should be sufficient to identify the issues and the opportunities and provide a sound assessment so the company understands what it's possibly bidding on. Those issues may range from what kind of compliance or tax issues there may be to what kinds of opportunities are available. Say you're buying technology—the due diligence should determine whether the technology is really everything you think it will be.

The other element we've seen work well with overseeing transformational transactions is for the board to be engaged in ongoing dialogue with the management team. It's never ideal for the management team to come to directors in a board meeting and say, "By the way, we just found this great acquisition, but we need to act fast; let's approve the deal today." Instead, when management or the company is on an acquisition path, ideally there's ongoing dialogue with the board over

the course of many meetings. That conversation describes the handful of companies that executives are considering, and then at subsequent board meetings, there is an update for the board on how the due-diligence process is coming along and where management's thinking is shifting. This approach allows directors to engage with management and provide feedback early on or even ask management to delve into another area as part of the diligence. A board can be much more comfortable with a transaction after it has heard about the target over a period of time. And after management has finalized its due diligence, is happy with the potential price, wants to move ahead, and is finally at the stage of recommending board approval.



Of course, another aspect for directors to consider is management's track record. If you're on a board where management has a great track record of not paying too much for acquisitions and being able to integrate them well, you have more comfort as a director and a better sense of how engaged you need to be.

It's interesting that communication keeps cropping up as a valuable tool in so many boardroom situations. When a transaction is closing, which always ends up being a critical time, what should boards be focusing on?

When the deal is about to be finalized, boards will want to look at management's preparedness to integrate the acquisition and whether management understands all the elements that impact integration plans, including how robust the management team is. As companies have downsized and gotten leaner, one of the questions is whether the company has the capabilities and the right advisers to assist it. It's also important for the integration plan to set a target date—often 100 days after the transaction closes—to achieve key milestones. Why? Because management has to get operations integrated, and fast.

When management or the company is on an acquisition path, ideally there's ongoing dialogue with the board over the course of many meetings.

This period also gives management the opportunity to dig more deeply into what has been acquired, particularly to see if there are issues the company needs to address. It also is the time to start melding the two cultures, because if the tone at the top and the culture that you want in the combined company aren't established early on, the culture that ultimately is adopted may not be the culture that the board wants to see in place.

Transformational transactions are just one part of this book. If directors are interested in getting a copy of *Board Effectiveness—What Works Best*, how would they get their hands on it?

Information on ordering the book is available from our website: pwc.com/us/centerforboardgovernance. Transformational transactions are discussed in one chapter; in other chapters we address additional board responsibilities such as overseeing strategy, risk management, corporate ethics, and management evaluation and compensation.

Lessons Boards Can Learn from Past FCPA Cases

I want to talk a little about FCPA lessons that global boards can learn from to understand what's happened out there. But before we get into that, the Foreign Corrupt Practices Act (FCPA) has been a very hot topic. Just talk for a second on why it's such a big deal for boards right now.

Sure. It's really the result of two very separate developments that have been converging in recent years. The first development is that companies have become very interested in expanding globally, particularly into emerging markets. This is great because those countries need that investment, but at the same time, companies need to recognize that there are risks involved as well. These emerging-market countries, in particular, have very weak legal and regulatory systems. They're characterized by endemic corruption because their public officials aren't paid very well. And there is a high degree of government involvement, so you might be partnering with state-owned corporations. You might have licensing, permitting, customs duties, and all kinds of interaction with government officials, which create a great risk for corruption. So companies need to understand what the risks are when they're expanding globally.

The second development that's occurring parallel to this is the expanding and increasingly aggressive enforcement of the FCPA by the U.S. Department of Justice and the Securities and Exchange Commission. What we've seen is that these agencies are not just holding the companies liable for paying bribes, but officials have also stated that they're going to hold individuals, in particular executives and board directors, accountable for corruption that occurs in those companies.

Wendy Wysong
Partner, Foreign Legal Consultant
Clifford Chance LLP

Do you have a good example where a company has run afoul of this? What can board members learn from others' mistakes?

I think one example that a lot of people might be familiar with is what happened with Siemens. Siemens, as you're likely aware, is a German multinational conglomerate that expanded globally and then in 2001 decided to become a U.S. issuer by listing on the New York Stock Exchange. In doing so, it became subject to the Foreign Corrupt Practices Act. The company had trouble adjusting to being subject to FCPA because the culture was different than in companies that have always operated in the United States and have been subject to the FCPA restrictions.

In 2008, Siemens was fined a very heavy penalty for FCPA violations that occurred all over the world. It paid $800 million in penalties to the U.S. government and another $800 million to the German public prosecutor, and that's in addition to investigative, compliance, and remediation costs that have been estimated to run another billion dollars.

Recently, and people have been expecting this, some former executives and one former board member of Siemens were indicted by the U.S. Department of Justice and charged by the SEC for FCPA violations that occurred in Argentina. Essentially, they are accused of offering about $100 million worth of bribes to obtain a $1 billion contract to produce national identity cards in Argentina. They allegedly conspired to pay off high-level Argentinean government officials. These executives are being held accountable for the corruption and bribes that occurred. I think that may serve as a lesson that companies, and board members in particular, need to understand that it isn't just going to be the company that could be held liable, but it could also very well be the board members who are going to be held personally liable. In addition, we've had a number of boards that have been sued through shareholder derivative suits and targeted as a result of follow-on civil lawsuits arising from FCPA violations.

It must be unnerving for directors of a public company to be sitting on a board and be in a situation where they've got 25 different businesses and they're operating in 25 different countries. Some of those countries have a history of officials taking bribes or doing things that would be considered fraudulent under FCPA. But here these directors are responsible, even though they can't possibly oversee all of what's going on out there. So what would you tell a board of directors? What should it be doing to prevent this from happening at its institution?

We tell board members that their duty is to prevent misconduct, but to look at the issue very realistically as to what they can actually do. They're not managing the company. What they are doing is overseeing the company and making sure there are adequate procedures and programs in place to prevent bribery. And so the challenge is for a board member to be able to accurately assess those risks and then deal with them realistically.

We tell board members that there are a number of specific things they can do. The first one is to understand the risks the company is facing, that is, to look at where the company is doing business, whom they're doing business with, and what their industry practices

are. They should evaluate those points to see where the risks are. The second thing we tell board members is that they need to oversee the implementation and development of a written compliance program that's not just a paper program, but an active program that is adequately resourced. They need to test that program to make sure it's adequate and is being respected. I emphasize to boards that this is a very active involvement, and that they should take the training right alongside their employees to set an example—we call it tone from the top—and make sure they are seizing the opportunity to create and really affirm a culture of compliance.

They should also make sure they appoint a compliance officer who is fully empowered and has the clout to implement and enforce the compliance program. That's one of the things we learned from Siemens, where the compliance director was also the general counsel and head of HR and had a number of other responsibilities that called for his attention, in addition to anticorruption. You need to make sure that the person appointed as the compliance officer is empowered and has the resources to be effective.

You need to make sure there are periodic reports to the board. Ask the compliance officer:

- How is the compliance program being implemented, and is it effective?
- Have they looked for measurable results?
- How many people have taken the training? Have they been tested?
- Have third parties been vetted? Have some third-party agents been rejected because they don't meet company standards?
- Have there been complaints of corruption made by employees? How are those complaints being handled?

So directors should actively oversee how the program works.

We also recommend that board members continually assess whether or not the compliance program is being updated. If the company is expanding into a new industry, a new country, or if it's acquiring a company that is in a country of high risk, then directors need to make sure that their compliance program addresses any new risks that might arise under local laws.

One of the things our firm does is really try and pay attention to the local laws as well as to FCPA to make sure that companies are being consistent with both. Then when issues arise, the board needs to make sure that these issues are investigated, that they're addressed, that remediation measures are taken, and that decisions are made as to whether or not there are violations and whether or not they should be reported. The board needs to know where things stand and be active in overseeing how these issues are addressed.

Series Host

Corporate Board Member, an NYSE Euronext company, is the leading information and education resource for senior officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. The quarterly publication, Corporate Board Member magazine, provides readers with decision-making tools to deal with the strategic and corporate governance challenges confronting their boards. Corporate Board Member further extends its governance leadership through an online resource center, conferences, roundtables, and timely research. The magazine maintains the most comprehensive, up-to-date database of directors and officers serving on boards of publicly traded companies listed with NYSE Euronext and The NASDAQ OMX Group stock exchanges. **www.boardmember.com**

Series Contributors

Meridian Compensation Partners, LLC is one of the largest, independent executive compensation consulting firms in the industry. Founded in 2010, Meridian is wholly owned and operated by its partners, and provides trusted counsel to compensation committees and senior management at hundreds of preeminent large and mid-cap corporations. Averaging more than 20 years of tenure, Meridian's Partners have industry-leading knowledge and experience, along with depth of resources, to provide expert advice and support on executive compensation and governance related matters. **www.meridiancp.com**

PwC's Center for Board Governance helps directors meet the challenges in carrying out their responsibilities. The Center shares its practical governance knowledge through timely thought leadership and sponsored events. With more than 161,000 people, PwC provides assurance, tax and advisory services to companies in 154 countries. **www.pwc.com**

C L I F F O R D

C H A N C E

Clifford Chance is one of the world's leading law firms, helping clients achieve their goals by combining the highest global standards with local expertise. The Firm has unrivalled scale and depth of legal resources across the four key markets of the Americas, Asia Pacific, Europe and the Middle East, and focuses on the core areas of commercial activity: capital markets; corporate and M&A; finance and banking; real estate; tax; pensions and employment; litigation and dispute resolution. Clifford Chance has 34 offices in 24 countries with some 3,200 legal advisers. The Firm also operates a co-operation agreement with Al-Jadaan & Partners Law Firm in Saudi Arabia. **www.cliffordchance.com**

Board Governance Series is © 2012
by Corporate Board Member, an NYSE Euronext Company.

Director of Publications **Deborah Scally**
Editor **Jamie Reeves**
Copy Editor **Kimberly Crowe**
Art Director **Alli Lankford**
Graphic Designer **Pam Dotts**

For more information, contact Corporate Board Member,
5110 Maryland Way, Suite 250, Brentwood, TN 37027;
(615) 309-3200, fax (615) 371-0899. The opinions expressed are those of the participants and are not necessarily endorsed by Corporate Board Member. Nothing in this supplement should be construed as legal or accounting advice.

Gain access to the Board Governance Series by visiting www.boardmember.com and navigating to The Boardroom Channel. There is no charge to view the webcasts.
To purchase additional copies of the Board Governance Series, please contact us at (615) 309-3200.

CORPORATE
BOARD MEMBER®
An NYSE Euronext Company

5110 Maryland Way, Suite 250
Brentwood, Tennessee 37027
(615) 309-3200
www.boardmember.com