

Focus on governance
initiatives

As part of an effort to avoid future crises, policymakers and regulators are exploring changes to corporate governance practices. They want enhanced transparency, greater director accountability, and a greater voice given to shareholders in certain boardroom decisions.

Ultimately, the final rules may be different from the many proposed rules described in this section. It's clear, though, that companies will want to monitor the pending regulatory changes and prepare directors for the impact.

Executive compensation

Executive compensation remains under intense scrutiny, particularly for financial services companies and others receiving government aid. The focus is on how pay policies align with performance, risk, and a company's long-term growth. One key concern: whether compensation programs focus overly on short-term incentives and on metrics that do not take risk into account, and thus could encourage employees to take actions that harm the long-term health of the company. Another concern: the size of compensation packages.

In July 2009, the SEC proposed rules requiring all public companies to expand their proxy disclosures to describe how compensation policies may create incentives that affect the risk the company takes on. The disclosures would need to consider policies for employees across the organization, not just at the executive level. With this change, compensation committees might want to become familiar with how management:

- Designs incentive plans, sets metrics, and mitigates risks in the compensation policies across the company
- Identifies business units that may constitute a significant portion of the risk profile or that have unique compensation structures
- Administers the incentive plans, including qualitative processes that may override, when necessary, proposed bonuses that might have rewarded employees for actions that exposed the company to inappropriate risk

The SEC also proposed a change for the value that companies report in various Compensation Discussion and Analysis tables for stock and option awards. Companies would have to disclose the aggregate grant date fair value of the awards granted in a given year, instead of the amounts recorded in the income statement (which include partial attribution of awards that may have been granted in previous years). Interestingly, many companies have already been providing this information to explain the decisions made during the year. While determining the amounts to be disclosed is relatively easy, sharing the board's perspective on the rationale for the amounts and explaining volatility from year to year may prove to be more challenging.

Policymakers are attempting to address concerns about executive compensation levels by seeking to give shareholders an advisory vote on executive compensation and severance arrangements (a say on pay). Although the ultimate legislation is not finalized at the time of this writing (a bill passed the House; one with similar provisions awaits action in the Senate), many believe it will ultimately pass. Indeed, companies receiving TARP funds already have to allow “say on pay” votes, which commenced with the 2009 proxy season.

Companies that either voluntarily adopted say on pay, or were mandated through TARP to do so, typically received overwhelming shareholder support in those votes. But given the sensitivity and high-profile nature of executive compensation issues, companies shouldn’t be complacent that these votes will pass with such support in the future. Directors should help management ensure that descriptions in the proxy of the company’s executive compensation philosophy, policies, and procedures are logical and clear, and they should understand shareholders’ perspectives when considering any fundamental changes. Further, companies may want to consider approaches to engage with their shareholders on executive compensation issues more directly.

Say on pay questions on proxies also may lead institutional shareholders to rely more heavily on recommendations from proxy advisory firms. Why? Investors may not have the resources to adequately review and analyze compensation disclosures for the hundreds of companies in which they invest. Ultimately, say on pay may further increase the influence of proxy advisory firms.

With all the focus on compensation at financial institutions, the US Department of the Treasury also weighed in, issuing principles (see box) to better align compensation practices with sound risk management and companies’ long-term growth.

The Treasury principles encourage companies to:

- Properly measure and reward performance
- Structure compensation to account for the time horizon of risks
- Align practices with sound risk management
- Reexamine golden parachutes to ensure they align shareholder and executive interests
- Promote transparency and accountability in the process of setting compensation

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The Treasury principles are targeted to all companies, not just financial institutions. The principles focus on how to avoid incentives that promote unsustainable short-term performance and how to discourage behavior that may put the company in a worse position over the longer term. Accordingly, companies are using a number of approaches, including:

- Considering alternative or additional performance measures that account for risk.
- Modifying payout mechanisms and time horizons associated with incentives—for example, by paying significant portions of bonus rewards in stock instead of cash, and deferring portions of those payments until the performance being rewarded is ultimately deemed to be reliable and sustainable. Interestingly, as regulators seek greater deferrals of compensation, current tax rules discourage many deferral arrangements.
- Reviewing compensation governance and related processes, such as the role of management control functions (financial reporting, risk, and HR) in determining and reviewing incentive amounts.

Compensation committees and compensation consultants

Shareholders and regulators who are concerned with compensation levels are also often skeptical about the independence and effectiveness of compensation committees and their advisors. Pending legislation would require stronger independence for compensation committee members, preventing them from receiving any consulting, advisory, or other fees from the company, other than what they earn in their capacity as directors. In practice, this change may have little impact—many companies already curtailed hiring their own directors for such special projects.

Policymakers are also seeking to set independence standards for compensation consultants. Although compensation committees would have the authority to retain any advisors, companies would have to disclose the process and rationale underlying the choice of advisor.

The SEC proposed having companies disclose the nature and extent of additional services provided by the compensation consultants, as well as the fees they were paid. This disclosure would cover compensation consultants who provided other services to a company beyond advising on the amount or form of executive or director compensation. The disclosure also would cover the extent of management's involvement in deciding whether to engage the particular compensation consultant for these additional services and whether the board or compensation committee approved the services.

Greater transparency around the company's use of compensation consultants can be useful for investors. Such transparency may also help boards to retain the decision-making power to hire whomever they believe will provide the most value. Boards may find it more efficient for consultants to leverage their experience from past projects to deliver new services for a company, and in many cases compensation consultants may work with both management and the board to deliver such services. Regardless of the services provided, the board should consider the impact of the potential new disclosures when hiring a compensation consultant and consider the shareholders' perception of the consultant performing such services.

Director elections

The voting process

The director election process will be different starting in 2010. A new rule prohibits brokers who are members of the New York Stock Exchange from voting in uncontested director elections unless they've received specific instructions to do so from their clients.

The rule change is extremely important. Brokers traditionally vote uninstructed shares in support of the company's recommendations on routine matters, including director elections. Estimates are that brokers hold approximately 80 percent of stock, a significant percentage of which is held for institutional shareholders. While institutional investors typically do provide voting instructions, many retail investors don't. Without brokers casting such uninstructed votes, the overall number of votes cast in a director election likely will decrease. That means institutional investors who coordinate their efforts could have greater influence in "withhold vote" campaigns. Companies concerned about how voting results may change in light of the new broker nonvote rule could analyze voting history to get better insight. A proxy solicitation firm may be helpful in understanding how—and whether—groups of shareholders have traditionally voted their proxies.

Some companies also have moved to the electronic distribution of proxy materials, the "notice and access" model. This allows them to save printing and mailing costs of delivering paper proxies. But many also are experiencing a sharp reduction in retail shareholder votes. These changes impact director elections and highlight the need for companies to assess their approach to reaching and educating shareholders on the importance of voting. Companies with high levels of retail shareholders could consider sending physical proxies and implementing outreach campaigns to "get out the vote."

On a related note, the SEC has proposed a rule to improve the timeliness of reporting the results of shareholder voting—requiring companies to file results within four business days after the annual meeting. With this earlier deadline, management should critically review voting results to be satisfied with their accuracy so the company can report correct information in the shortened time frame.

Expanding information about nominees

Providing investors with more information about director nominations is another developing area. The SEC proposed rules that would require more information about director nominees' backgrounds and qualifications, specifically, a nominee's:

- Experience, qualifications, and skills to serve on the board or on a committee
- Directorships held during the past five years at public companies
- Involvement in any legal proceedings for the past 10 years (versus the current rule of five years)

Companies may find it beneficial to approach this potential disclosure by first describing the skills the board collectively needs to be effective. Such disclosure can provide context for the discussion about the specific skills and experience the individual directors bring and how they fit into the broader picture.

Easing rules for shareholders to nominate directors

Director elections may change even further if rules are adopted to allow shareholders to place their director nominees in the company's proxy statement. The SEC once again tackled this controversial issue by proposing new rules in May 2009. Shareholders' access would be based on company size and ownership thresholds. (See box.) Shareholders could nominate up to 25 percent of the board nominees and would have to represent that they are not seeking a change in control. The proposal would allow access based on a "first in the door" concept: The first shareholder (or group of shareholders) meeting the required thresholds can nominate director candidates. The proposed rule also would allow shareholder proposals that modify a company's bylaws surrounding director nominations. This provision could conceivably allow shareholders at an individual company to agree on lower thresholds at which they could nominate directors. The SEC is assessing the more than 500 comment letters it received and is expected to issue a final rule in 2010.

Which shareholders get proxy access rights under the proposed rule?	
Company size	Ownership threshold
Large accelerated filers (companies with worldwide market capitalization of \$700 million or more)	Shareholders who hold at least 1 percent of voting securities for one year or more
Accelerated filers (companies with worldwide market capitalization of \$75 million or more but less than \$700 million)	Shareholders who hold at least 3 percent of voting securities for one year or more
Nonaccelerated filers (companies with worldwide market capitalization of less than \$75 million)	Shareholders who hold at least 5 percent of voting securities for one year or more

Importantly, during 2009, federal and state law changes were proposed or enacted to address some of the legal issues that had prevented proxy access from moving forward. For example, Delaware state law now allows companies to adopt bylaws permitting shareholders to have their director nominees included in the company proxy, and bylaws requiring reimbursement for proxy expenses. This is important given the number of companies incorporated in Delaware. Bills also have been introduced in the US House and Senate to expressly allow the SEC to establish proxy access rules.

Despite the fact that shareholders have long sought to nominate directors, relatively few proxy battles have occurred in past years. That may reflect the expense shareholders had to bear under existing rules. Companies may reduce the chance of a contested election by engaging shareholders on director nominees—and even canvassing shareholders for potential director candidates when the board is looking to add particular skills and experience.

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Risk management

Under other proposed SEC rules, companies would disclose the board's role in overseeing the key risks facing the company. Some companies may find it challenging to articulate how the board oversees the broad range of risks.

Companies may find these general risk management concepts useful when drafting the new disclosures:

- Management is responsible for managing risk.
- The board's responsibility is to oversee both the risk management process and how management handles the major risks. Elements of this oversight may be allocated to different committees or be handled by the entire board.
- The board should define with management the information it needs to form its own views on risks.
- Board members should possess diverse skills and experiences to provide different perspectives on risks.
- The risk management process should:
 - Address a broad range of risks, not just financial risks
 - Approach risk management systematically across divisions and functions
 - Establish a robust business continuity plan and consider various business scenarios for unknown risks

For the 2010 proxy season, the SEC also announced changes to the way it considers shareholder proposals that ask for more information about risks that relate to major policy issues. Companies will no longer be able to automatically exclude such shareholder proposals from their proxies. That might mean a proposal asking for more information about the board's role in overseeing risk could have to be included in the proxy.

Many believe risk oversight is most effective when the full experience, knowledge, and skills of all directors are brought to bear on this complex subject. Legislation introduced in 2009 proposed requiring all companies to establish a risk committee of independent directors. The final legislation may not ultimately include this requirement. Nevertheless, directors should monitor its status, and consider how best to oversee risk.

Separating the chair and CEO roles

Another element of the SEC's proposed rules focuses on disclosures about board leadership, including whether the positions of CEO and board chair are combined or separated. In situations where the two roles are combined, the company would further disclose whether it has a lead independent director and what role that person plays in the company's leadership structure. Other legislative proposals were made to require companies to separate the roles of chairman and chief executive; however, they appear less likely to pass.

Many believe that each board is best positioned to determine what leadership structure works for its specific situation. That said, a CEO transition provides a good opportunity for the board to consider whether there should be a change in board leadership. As a point of reference, the roles of CEO and board chair are combined at 63 percent of S&P 500 companies, according to the Spencer Stuart 2009 Board Index. Splitting the CEO and board chair roles is a practice common in the UK, much of Europe, Canada, and Australia.

Similar to the changes on shareholder proposals about risk, the SEC also announced that, starting in the 2010 proxy season, companies will no longer be able to exclude from their proxies shareholder proposals that request information about CEO succession policies, including the board's involvement in the process.

Directors' actions

- Discuss with management how it will assess whether compensation policies for all employees may create incentives that promote inappropriate risk-taking.
- Be comfortable that management is building productive relationships with key shareholders to engage them on sensitive issues such as director nominations, leadership structure, risk management practices, or significant executive compensation changes.
- Understand the voting policies of significant shareholders and the possible impact of the elimination of broker discretionary voting on future director elections.
- Discuss with management any shareholder pressure to adopt say on pay, and monitor any legislative or regulatory action, particularly on proxy access.
- Consider whether the board has a robust process to oversee risk management.