Issue Alert *November 16, 2009*

Get on Board: Should You Serve as a Corporate Director Today?

By Susan F. Shultz, President, The Board Institute, Inc.

ferf financial executives research foundation

Section 407 of The Sarbanes-Oxley Act of 2002 requires at least one financial expert to serve on the audit committee of the board. This legislation was codified in January 2003 by the Securities and Exchange Commission (SEC) when it issued Final Rule #33-8177, "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002."

In today's uncertain climate, FEI members and other senior financial executives may wonder whether they should serve on a board of directors, and whether they should be identified as "the financial expert."

Financial Executives Research Foundation (FERF) brought together a group of FEI members who serve on corporate boards and are also members of the FERF Research Committee. This group met by conference call with Susan F. Shultz, President, The Board Institute, Inc. (See page 2 for a list of participants.) The conference call participants discussed the following questions:

- Why serve?
- Is there a director shortage?
- What experience and attributes are most valuable?
- What is the opportunity for financial executives?
- How do you get selected for a corporate board?
- What are steps that you can take to help acquire a board seat?
- Is it the right board for you?
- What should you know before joining a board?

This Issue Alert provides many of the insights discussed during that conference call. It also provides statistics on director compensation and recent trends affecting boards of directors.

Members of the FERF Research Committee who participated in the Round Table conference call discussion:

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting
Terry College of Business
The University of Georgia
Fannie Mae, Kimberly-Clark Corporation, Legg Mason, Inc.

Prat Bhatt
VP, Corporate Controller and Principal Accounting Officer
Cisco Systems, Inc.
Cisco Systems Foundation: Audit Committee

Frank Gatti
CFO/Senior Vice President
ETS
Blackboard: Chair, Audit Committee, Member, Governance Committee
Princeton Regional Chamber of Commerce: HR Committee

Dr. Kenneth A. Merchant
Deloitte &Touche LLP Chair of Accountancy
University of Southern California
Entropic Communications, Inc.: Chair, Audit Committee

Mary Kay Scucci
Financial Consultant
Y & M Ventures, Inc.
Power Medical Interventions, Inc.: Chair, Audit Committee

Susan Shultz
President
The Board Institute, Inc.

William M. Trust, Jr.
Innovation Management Consulting
Nyack Hospital: Chairman of the Board
Presidential Life Insurance: Chair, Finance/Investment Committee
Nominating & Governance Committee

FERF Staff Participating:

Cheryl de Mesa Graziano, Vice President, Research and Operations
William M. Sinnett, Director of Research
Thomas Thompson, Jr., Research Associate

WHY IT MATTERS

Warren Buffett says it best: “The real action has to come at … the board. Directors stand at the pinnacle of power.”

Essentially, the role of the board is to add value and to address the big issues–and avoid the big mistakes, the fatal mistakes. The role of the board is to ensure that the right leadership is in place with appropriate resources, provide strategic input, and oversee operations.

Good boards are key to a vibrant free enterprise system. Where free enterprise flourishes, so does wealth creation and a healthy economy. If we don’t have confidence in the leadership of corporate America, capital markets–and our democratic system–will weaken.

We must not confuse governance with compliance. As the value of good governance becomes apparent, there is danger in reducing governance to a formula–to a set of lists. Boards are about the business of the business, well beyond process. As Frank Gatti, CFO/Senior Vice President of ETS says, “think of risk, strategy and governance as being closely related.” The value and the power of a strategic board cannot be overestimated.

We hear about the failed boards. Rarely do we acknowledge good boards. Because board business is private, we almost never learn details of how most boards add value. Yet, almost every director can share a story of how their board helped their company. Such as ProLink when the CEO needed to raise a second round of funding and received 16 recommendations from his board members–one of whom did the deal. Phelps Dodge (now Freeport McMoran) benefited when a major international acquisition was forestalled by their board–the large South American company that was to have been acquired went bankrupt soon after. Another board for a growing technology company had just approved a succession plan when the CEO was unexpectedly diagnosed with terminal cancer.

In a discussion with the members of the Research Committee of Financial Executives Research Foundation (FERF), examples discussed included a situation in which a board’s lead director mentored a technology company CEO, when the company was having problems with a licensing partner. The lead director, with the advice of the board, helped the CEO mend that relationship. In the case of a disruptive director, the board gave input to the lead director, who then led a candid conversation with the director, suggesting he reform or leave the board. By the time of the directors’ evaluation, they were able to salvage the relationship and the formerly disruptive director’s contribution to the company.

In another situation, management thought that they were doing strategic planning when actually the strategic planning had drifted into an operating plan. In the course of reviewing strategy, the board drove an assessment of capital needs, focusing on longer term requirements. Ultimately, the board helped coordinate a secondary offering to meet anticipated capital needs three years out–and thus forestalled an almost certain crisis. Management had never had to deal with generating capital for long term needs and was focused on short term imperatives.

Constructive, independent boards are responsible for untold millions going to the bottom line. The value of a single idea or introduction, of strategic succession planning, of risk avoidance, is incalculable. These are the stories that rarely get told. Or measured.

WHY SERVE?

If a board is a good fit, board participation can be fulfilling and gratifying. Benefits include:

- The ability to think strategically in a way not possible when immersed in the day to day operations of your own company;
- Serving with and learning from respected peers;
- Developing expertise in new, relevant areas;
- The opportunity to transport best practices to your company and other boards;
- Learning how to deal more effectively with your own board;
- Gaining a perspective and appreciation for governance practice;
- The ability to make a difference;
- Obtaining exposure and building your reputation;
- Personal satisfaction and validation;
- Networking and career enhancement; and
- Public Service

IS THERE A DIRECTOR SHORTAGE?

Boards of directors have been transformed to a degree unimagined prior to Enron, WorldCom and Sarbanes-Oxley (SOX). More change is virtually certain as a result of the recent crises, and we will dramatically accelerate the move to accountability, transparency and independence.

Yet, throughout this corporate governance revolution, the *supply* of directors has consistently increased. Despite common belief, the supply of directors has not decreased. Rather, the supply of *recycled* directors has decreased. Also, the percentage of CEOs and retired CEOs per board has decreased. The myth that there are fewer available qualified directors is just that –a myth. In fact, when measured by engagement, commitment, independence and qualifications, the quality and the availability of directors has increased.

Consider that the average board size has decreased by 10% in the last ten years (1) and that directors are serving on fewer boards due to capacity and edict. Fifty-six percent of S&P 500 boards limit corporate board service by their directors. As recently as two years ago, only 27% imposed any limits. So, make no mistake, obtaining board seats is competitive.

Traditionally, the majority of corporate directors have been drawn from two sources–active and retired CEOs. At the best boards, this model is passé. CEOs currently sit on less than one (7/10) board on average, compared with serving on an average of two outside board seats 10 years ago. The number of active CEOs and COOs represent just 31% and 16% of directors added last year. Fifty-six percent of companies limit the number of other public company boards on which their CEOs may serve. Four percent don't allow their CEOs to sit on any other board.

Less than a decade ago it was common for directors to hold 10 or more public company board seats, such as Vernon Jordan on 10 boards; the CEO of Bell South, who sat on 9 boards; and the CEO of Coca Cola who sat on seven major boards. Doug Duniplace, an Arizona attorney, sat on 15 nonprofit boards until very recently.

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1 2008 Spencer Stuart Board Index, p.8.

Because directors are serving on fewer boards, and the number of "recycled" directors is diminishing, the number of new directors is up 13% and 24% for new directors and first-timers respectively (2). The quality of directors who are now serving is significantly improved–in terms of engagement, commitment, corporate governance knowledge, and balance and relevance of experience, intellect and perception. So we have a significant opportunity to strengthen boards through diversity of background, experience, functional expertise, age, geography, education, gender and ethnicity. Only 16% of Fortune 500 company directors are women, and a mere 162 minority directors sit on the boards of the top 200 S&P companies.

WHAT EXPERIENCE AND ATTRIBUTES ARE MOST VALUABLE?

Too often recruitment has more to do with relationships, co-workers, golf buddies, or celebrity, rather than strategic value. Too often, recruitment starts with the person, not the need.

When recruitment begins with analyzing and cataloguing the company's future needs and encompasses director assessment; when the board creates a matrix of talent, attributes and objectives; when each director position is profiled to complement existing strengths and fill in weaknesses; when the board has a choice of excellent candidates; and when director recruitment is a continuum–great boards are the result. When such a process is in place, it validates the board and it attracts the best.

Today, the NYSE requires companies to disclose the method of recruiting. Last year, 51% of companies disclosed the source of their new directors. As more companies reveal not only *who* recruited, but also *how* directors are recruited, objectivity–and thus independence–will be the norm.

WHAT IS THE OPPORTUNITY FOR FINANCIAL EXECUTIVES?

If you are currently employed, you have a significant advantage as a potential director. Almost 70% of new directors are active executives or professionals. There is strong preference for employed, operating executives.

Twenty-one percent of boards now limit other audit committee memberships for their own audit committee members. Most set the cap at two.

Because of these service limitations, and because at least one audit committee member must be a financial expert and all audit committee members (a minimum of three is required) must meet the applicable securities exchange definition of financial literacy or become financially literate within a reasonable period of time after joining the audit committee, there is significant demand for executives with financial expertise.

The SEC requires written affirmation (NYSE) or certification (NACD) regarding the independence and qualifications of audit committee members, and annual proxy statement disclosures regarding audit committee member independence. At least one member of the audit committee must have accounting or related financial management expertise.

2 Ibid. p. 10.

The top concerns of audit committees, according to KPMG's Audit Committee Institute are:

1. Recession-related risks
2. Risk intelligence
3. Increased risk of earnings management
4. Tone at the top

The special insights financial experts can offer into risk is increasingly valued. The CFO is spending more time with the audit committee as well as meeting separately with the audit chair. The process has changed dramatically from one of congenial reporting by the CFO, usually after the fact, to a new way of relating and reporting. The audit committee is more engaged, earlier, especially in the face of potential financial issues. Directors are unsettled. They are asking and learning to ask tougher questions, often coached by the auditors who used to be more closely aligned with management.

Directors with a background in finance bring a critical perspective to the boardroom. For example, without regular interaction, spending requests can sneak up on a board and lead to poor decisions. Michael Cangemi, formerly CEO of Etienne Aigner Group, a maker of shoes and handbags, recalls sitting on one board when the CIO requested an emergency waiver of an internal requirement that all tech projects demonstrate their return on investment. He needed to replace an accounts-payable system that a vendor was no longer supporting. "I had a hundred questions in my head," Cangemi says. "But the chairman said, 'I don't see that we have much choice, so let's just vote on it.' And so they voted to let $12 million go out the door. I abstained. None of the directors knew what was going on."(3)

In another critical example, boards have been surprised because, in many cases, they have not dealt with liquidity risk. Understanding cash flow and receivables management, a company's debt situation, including debt maturities and access to capital, are essential in today's economic climate. How many boards get information on cash forecasting to launch new product as well as for continuing operations? What if, in the middle of a new product launch, there is a credit crunch? Boards should be provided with a "what-if" scenario.

Being grounded in finance is a clear advantage. The percentage of new directors from financial backgrounds is up from 6% in 1998 to the high teens. Fifty-seven percent of companies are seeking new directors with financial expertise.(4) Both Bill Trust and Mary Kay Scucci are the financial experts on their boards. In Bill Trust's case, the board recruited someone else to be the financial expert on the Audit Committee, and he now chairs the Finance Committee. Dennis Beresford is the expert on the Audit Committee for financial reporting. There are many ways to serve.

Director Richard Nolan predicts that a major board-related scandal on the scale of an Enron or WorldCom may eventually erupt in the technology arena, typically under the purview of the CFO. Enron, says Nolan, "went bankrupt because the board didn't understand the accounting. IT is next. Do it wrong and it can shut down the company and cause it to be noncompetitive. There are huge amounts of exposure if you have poor oversight by the board."(5)

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3 *Corporate Board Member* May/June 2006 "The New Challenge For Directors," by John R. Engen
4 Ibid. p.10
5 Ibid., p. 9.

Over one-third of new board members are financial experts. With their knowledge of Wall Street, IPO experience, and other financial expertise, they can become invaluable. There is, appropriately, increased emphasis on strategy, and, despite the need for finance expertise, directors must be informed and vote on every issue. Thus boards want to avoid recruiting technicians instead of strategists. Directors must be capable of addressing a variety issues—not just those of a financial nature.

Again, a director is a director for all issues, not just the financial issues. As Mary Kay Scucci says, boards are looking for members with experience in risk and strategy. "Boards want members who understand an array of risks, such as brand risk, reputation risk", and, adds Frank Gatti, "in the manufacturing environment, warranty risk." International, technology and marketing expertise are in strong demand, and relevant industry experience is increasingly recognized as essential for some of the directors.

If the boards of the banks embroiled in the recent financial crises had understood the dangers of their leveraged derivatives and sub-prime loans, might things have been different? Only after the crash were their boards shorn up with financial services executives. How could $600 billion be invested in sub-prime mortgages by an AIG subsidiary with no reserves or collateral? Why was the board silent?

Boards are increasingly proactive and targeted in seeking directors. They are reaching for directors who complement the skills of existing board members. We completed a search for Tektronix, which had just made a sizable software acquisition in Texas. The current audit chair was a general who is meticulous and comprehensive, but was not a financial expert. Our criteria for the right candidate included someone who:

- was a CFO who could become audit chair;
- was a CFO of a software company larger than the acquisition;
- was a director from a public company who interfaced with the Street;
- had taken a company through SOX compliance; and, most important,
- fit the culture.

And if the candidate was both diverse and younger, so much the better, because the current board was comprised of white, older males. We were able to recruit the ideal candidate.

A proposed SEC Proxy Disclosure and Corporate Governance Revision requires proxies to disclose a director candidate's experience, qualifications, attributes or skills.(6)

HOW DO YOU GET SELECTED FOR A CORPORATE BOARD?

Sixty percent of new directors for Fortune 500 companies were recruited by executive search firms. However, in truth, the overwhelming majority of board seats are filled by networking and personal connections.

Since the New York Stock Exchange now requires their issuers to disclose how directors are recruited to the board, more directors will be recruited through an objective, proactive process conducted by an executive search firm. But personal connections will continue to prevail.

6 Executive Compensation: The State of Today's Environment, by Richard V. Smith, September 2009.

As Ken Merchant says, “My opportunities have come through personal contacts.” Adds Bill Trust, “Many directors get on boards because they knew the CEO. I got on a board because the CEO of the company was on another board with me.” In Frank Gatti’s case, “A company was doing an IPO, and their investment banker suggested that I join the board.” Dennis Beresford sits on three boards: for one he was recommended by a search firm; in the second, he had consulted for the company; and a prospective director who had a conflict referred him to the third company.

In a typical example of networking, Dennis Beresford “got a call from an individual. “He knew that I would retire soon from a particular board. He wanted to get on that board, and had the right kind of background, so he asked me to put in a good word for him.”

Once you are on one board, it is easier to get on another. It’s a validator. You are “safe” and you are visible. You are folded into the vast array of databases, and search firms are more likely to find you and to propose you. Plus, there is a higher comfort level when a personal relationship already exists as opposed to than when a director is unknown to the board and the company.

However, there are significant arguments against networking onto a board and “Interlocking” boards, in which directors sit on more than one board together. Interlocking boards and “a hand up from a friend” present serious potential for conflicted allegiances, in which loyalties can be to one another, rather than to the unseen shareholders without a seat at the table. It also can deflect diversity, because of the barriers to entry for those who are not connected. Despite that, many directors admit to having a higher comfort level when they know a prospective director or the director knows someone on the board or at the company. For the director, due diligence is easier if you know the company.

We tend to surround ourselves with those we know and with those we trust–people just like us. This is especially true at the board level. So, in many cases, we may as well be talking to ourselves. As Bob Walker (a director of Electro Scientific Industries and chair of Financial Executives Research Foundation) points out, “homogeneity leads to faster decision making and we can go willy nilly right off the cliff. With diversity, you will consider things in a much broader way. The key is to have enough trust–to have people you respect.”

What are steps you can take to help acquire a board seat?

- ✓ Nonprofits and advisory boards can expose you to key decision makers.
- ✓ Express your interest to bankers, directors, officers, CEOs, investors, corporate attorneys, auditors in the major accounting firms, retained executive search firms and others who are in the boardroom.
- ✓ Key decision makers include the Chair of the Governance Committee, the CEO, and the Board chair or lead director (95% of companies have an independent chair or lead director) as well as other directors.
- ✓ Be an expert. Speak at industry association conferences. Write articles.
- ✓ Target five companies whose boards you could benefit and would enjoy. Learn who the directors and officers are, who the outside counsel and auditors are. Circulate the company list and the names to your network and ask for an introduction. Ask for an appointment with the Governance Committee chair.
- ✓ There are a number of Lists created to help potential directors get selected to sit on boards. Because most directors are networked onto boards or proactively recruited, lists have not been particularly successful. However, because boards may be more

  - FEI fields a list of prospective directors (see FEI's Directors Registry at www.financialexecutives.org, *Career Home*);
  - the National Association of Corporate Directors (NACD) has a directors registry (see www.nacdonline.org/registry/); and
  - NASDAQ recently launched a Director Recruitment service for its issuers (see www.boardrecruiting.com).
- ✓ The best way to get on a board is to springboard from an existing board seat.
- ✓ When you have an opportunity to discuss a board opportunity with the decision makers, do your homework and be able to articulate how you would add value. And, "let your ego hang out there," recommends Bob Walker. "If you are not sufficiently enthusiastic, you won't get chosen."

Ultimately, as Bill Trust and Mary Kay underline, it all revolves around luck. And, as Ken Merchant points out, "luck comes to those who are prepared." "Getting on a board is much like trying to find a new job. Eighty percent is networking, five percent is working with search firms and the balance, who knows?" says Bill Trust. "You have to be out there." Good companies will never have a shortage of outstanding directors.

IS IT THE RIGHT BOARD FOR YOU?

It's about the people. If you can't respect and trust management and the board members, go no further. Once you have confirmed the integrity and diligence of the board and management, then it is about risk. As Bill Trust says, "Risk is relative to the amount of diligence involved."

First, ensure that there is appropriate insurance for directors and officers (D&O), appropriate in terms of both coverage and exclusions. Before accepting any board position, have a professional review the policy.

Although lawsuits are common and often triggered automatically by stock moves, it is extremely rare for directors to have to pay out of pocket. Enron and WorldCom directors are the exception. With Enron, the insurance was expended, and at least one director had to personally pay over $1 million. In total, Enron directors paid at least $20 million out of pocket; and directors of WorldCom paid $18 million. In today's economy, with more companies declaring bankruptcy, there are a significant number of actions that trigger exclusions in some insurance coverage, such as restatements.

"I was on the board of a company that went bankrupt," says Ken Merchant. "The insurance company would not cover any legal costs until a case was filed against the directors. As the directors wanted legal representation during meetings with the bankruptcy trustee, we paid out of our pockets." In the end, no case was filed against the directors, so there was no reimbursement for them.

Directors should worry about two things that could put them at risk.

One is that management is unable to do what is needed to successfully manage the business.

This can take many forms, including incapacity. Earlier this year, Apple shareholders were angered to read in *The Wall Street Journal* the story of CEO Steve Jobs' liver transplant and the potential impact on Apple's future. If Jobs had not recovered, would directors have been vulnerable to lawsuits and held accountable for concealing the truth from the shareholders?

The second area that should frighten directors is that managers could place their personal interests ahead of the company and its shareholders. Unfortunately, the market is flush with examples. Just look at Angelo Mozilo, former CEO of Countrywide Financial, who is being sued by the Securities Exchange Commission for insider trading and securities fraud. He allegedly characterized loans as "toxic" and "poison" while touting the company's practices and financial stability and continuing to promote and sell sub-prime mortgages.

We have reason to be risk averse. Corporate fraud cost rose 22% in recent years. The average company lost $82 million over the past three years.(7)

Restatements numbered over 1,200 last year in the US, and directors are being held increasingly accountable and individually liable. In fact, 39% of surveyed directors have turned down a board position because they felt the risk was too great.(8)

Although there has been some discussion as to whether an audit committee member is at greater risk than other board members because of greater expertise, there is no evidence to suggest this is the case. In fact, Dennis Beresford claims that, "As chair of an audit committee today, I can demonstrate greater diligence, and I can defend myself better under Sarbanes-Oxley than other directors."

Despite the fear of financial risk, the real risk is to your time and reputation.

The average amount of time required to meet board obligations is estimated to be 200 to 250 hours a year per board. Boards now meet an average of about nine times per year. Factor in committee meetings, which are no longer the perfunctory casual affairs they used to be. The time spent in committee meetings continues to surge also. On average, audit committees met more than nine times last year. Thirty percent of them met 11 or more times in 2008, and one met 28 times. With tremendous pressure on executive compensation, compensation committees met almost seven times last year, and 30% met eight or more times with one meeting 21 times.(9)

In this economy, exceptional circumstances and key events are increasingly common. Mergers and acquisitions, restatements, shareholder activism, new capital rounds or financings, strategic partnerships, market and product openings or closings all trigger more meetings.

During the hostile takeover of PeopleSoft, the audit committee met 80 times in 16 months. During the economic crisis, General Motors' directors had weekly phone meetings. Citigroup directors met twice a month as did numerous other boards. When one board was considering a large acquisition, the directors were meeting daily for months. As one of the directors points out, "You can't say 'I'm too busy'."

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7 Financial Week, May,2009
8 Korn Ferry, 34th Annual Board of Directors Study, 2008, p.34.
9 Spencer Stuart 2008, op.cit., p.26.

If your company is involved in a special investigation, says Ken Merchant, “your time commitment can be significant. As a director, you have obligations. When one of the companies I served had a potential Foreign Corrupt Practices Act problem, I was appointed to a special committee that had many, many meetings over a short time frame.”

Bankruptcy is another special case that can take a lot of your time. “When one of my companies went bankrupt,”, explained Ken Merchant, “we met every day for months, with no compensation, I might add, because the company had little cash available.”

Reputation risk ranges from discomfort in being caught up in a lawsuit to the Enron and WorldCom directors who are, essentially, blacklisted.

Regulatory overload and fear of risk can overwhelm a board to the point it becomes risk averse. A business can’t be successful just by checking the boxes and sacrificing innovation for safety. The focus on regulation can confuse governance with compliance. As Frank Gatti suggests, “think of risk strategy and governance as being closely related. You will look at things differently.”

Ultimately, you must be prepared to resign.

WHAT SHOULD YOU KNOW BEFORE JOINING A BOARD?

Don’t shortchange the homework. A sampling of questions to ask:

- ✓ How does the board manage and enhance ethics?

- ✓ Are there conflicts? The first potential conflict to address is a practical one—your calendar. If you are a financial officer and/or sit on other boards, look at existing commitments. Are there time conflicts, such as fiscal year end? When are your board meetings and your filing deadlines? If there is an irreconcilable timing conflict, go no further.

  Other conflicts could involve relationships with suppliers, customers, and other stakeholders—even charities—as well as competing businesses; existing restrictions by your employer on corporate board service; or independence issues such as personal relationships or interlocking directorships.

- ✓ What kind of turnover is there in the senior management team? Is there a strong succession plan in place? For directors, for the CEO, and for the senior management team?

- ✓ Is there a comprehensive evaluation process for the CEO?

- ✓ Are there annual, objective, anonymous evaluations for the board, the committees, and the individual directors?

- ✓ Have any concerns been raised relative to the compensation of the executive team or the directors?

- ✓ Have there been any shareholder actions against the company?

- ✓ How is the decision made to bring on a new director? Ideally, the governance committee oversees the process and makes recommendations to the full board. In practice, the CEO often makes the decision.
- ✓ What are the regulatory requirements and who are the regulators?
- ✓ Have there been any restatements? If yes, what were the causes, how were they handled, and what was their impact?
- ✓ Did the auditors raise any issues, such as internal control concerns?
- ✓ Is there an effective whistleblower process? As Bob Walker points out, "all companies should get some calls during the annual cycle…I'm uncomfortable when all you get is silence."
- ✓ Are you expected to be on the audit committee? Is the audit committee responsible for risk management?
- ✓ What is the tone of the discussion at the board? Is it open and based on trust?
- ✓ Are you a fit for the board? Ultimately, the decision hinges on culture and the people.

- ✓ Meet with the board members—particularly the lead board member or Chair and other independent board members.
- ✓ Meet with key management, especially the CEO, CFO and General Counsel, to see if the company is a fit.
- ✓ Sign a non-disclosure agreement. Then check with the auditors and the outside counsel, so they are comfortable disclosing confidential matters and areas of concern.
- ✓ Review non-public documents, such as those relating to acquisitions, patent lawsuits and litigation, suggests Frank Gatti. And, find out what the company's client base is saying about the company through blogs.
- ✓ Mary Kay Scucci requested a copy of the PCAOB report from the auditor before she joined one board.
- ✓ Read the board minutes.
- ✓ If possible, attend a board meeting.
- ✓ For a public company, listen to the analyst calls and read their reports.
- ✓ Talk to investors and learn why they invested, and if there are any issues.
- ✓ Look for state insurance regulatory requirements and regulatory investigations. For example, Bill Trust notes that the New York State Insurance Department does an audit of reserve requirements and operations.

As Ken Merchant emphasizes, everyone has to write his own risk criteria. Ultimately, risk hinges on the people and the culture. No amount of information, regulation or process will matter, if the integrity of the people and the culture is not absolute.

DIRECTOR COMPENSATION

Director compensation varies significantly according to size of the company, the industry, and whether the company is public or private. For the broad base of companies, average total compensation last year was $131,413.(10) For Fortune 500 companies, average compensation is near $218,000, with 60% paid in equity. Due to loss in equity values, director compensation for smaller companies ($50 million to $500 million) declined in 2008 from the prior year by 8% to approximately $78,000.(11)

Directors receive additional compensation for leadership and committee roles. Ninety percent of boards pay extra retainers to committee chairs, with audit chairs receiving the highest retainers at an average of $11,300. Fewer than half of boards now pay meeting fees, reasoning that Directors are responsible 24/7 and are expected to do more than attend meetings.

Almost 3/4 of boards award stock grants in addition to an annual retainer—a rise of 30% over the last 5 years. Seventy to eighty percent of Fortune 500 boards have share ownership guidelines for their directors.(12) (13)

WHAT TYPE OF BOARD?

All companies can make their corporate board a strategic force for success. Traditional ***public corporate boards*** listed on the exchanges are accountable, responsible, transparent and liable. They have fiduciary responsibility in carrying out their duties to the shareholders and other stakeholders and have significant and increasing authority for oversight, strategy and the business of the business. Process and compliance requirements can be cumbersome and overwhelming, if not dealt with effectively.

The best ***private companies*** are managed as if they were public companies. The CEOs understand that boards add value by giving a company a long-term perspective and helping to manage growth intelligently. The overwhelming percentage of these boards is assembled through referrals and word of mouth, although objective search is gaining in acceptance.

In the case of family-owned businesses—which comprise approximately 65% of all U.S. companies—an independent board can validate the business of the business and the commitment to that business over the interests of the family. As is the case with all boards, independent boards serve to validate the company to the financial community, the employees and other stakeholders.

Boards are especially valuable for smaller and private companies which generally lack the transparency, accountability and resources of larger, public companies. Strategic small,

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10 Directors and Boards, Director Pay Exposed, by Paul Hodgon, Corporate Library statistics
11 National Association of Corporate Directors, Director Compensation Report by Pearl Meyer & Partners, p.9.
12 Spencer Stuart, 2008 study, p.14.
13 Korn Ferry, op. cit, p.35.

family and private company boards tend to be more action oriented, more mentoring, and more likely to make introductions to key employees, affiliates, markets and customers. Liability tends to be less, process and structure is reduced, and more time may be devoted to strategy.

Some directors prefer to serve on ***Advisory Boards***. Liability is negligible, and directors do not get ensnared in the minutia of audits, compliance and regulatory matters. Thus, an advisory board has the luxury of focusing on strategy. They are a comforting way for CEOs to “test drive” a board. Regardless of whether the board is statutory or advisory, if the CEO or founder is not willing to be accountable, its value is negligible. For private and closely held companies, the owner or CEO always has the final vote.

THE TRENDS

The top eight governance issues are executive compensation, shareholder activism, the role of strategy, director recruitment, director compensation, risk management, CEO succession planning, and board, committee, and director evaluation.

Evaluations

As a rule, we find out governance counts when something really bad happens.(14) How do you know if you have a good board?

You measure it—independently, confidentially and professionally. If there is no assessment, no accountability, how can shareholders know the board is effectively representing them and doing its job?

The New York Stock Exchange and the SEC mandate annual board and committee evaluations; the overwhelming majority of board charters require them; and director and officer insurers and shareholder groups reward companies for conducting evaluations. For the first time, through The Board Institute’s tools (www.theboardinstitute.com), directors can fulfill mandates for evaluation and continuing RiskMetrics-accredited education in one simple, web-based, confidential solution.

Succession Planning

Succession planning is a critical responsibility of tremendous import. Making certain that the right leadership is in place is the most important responsibility of boards of directors. Yet, CEO succession planning has been historically deficient. Some 40% of CEOs are fired or retired within their first 18 months of assuming the position, and 64% of them don’t make it to their 4th anniversary.(15) Average tenure has fallen 30% to 40% in just eight years.(16)

Yet in 2008, 42% of all companies had no CEO succession plan at all.

Board Committees: There is more work in and more scrutiny of committees. The spotlight has moved from audit (risk and compliance) to governance and nominating (structure and composition) and now to compensation (government regulation and shareholder activism).

15 The Corporate Board, September/October 2009, p.17
16 Korn/Ferry Institute, 34th Annual Board of Directors Study, p.9.

About one-third of larger companies have Finance Committees to focus on capital structure and dividend policy. Sen. Schumer (D-NY) introduced the Shareholder Bill of Rights Act in May, 2009, which requires boards to create risk Committees.

Shareholder Activism

Shareholder activism will continue to escalate. Shareholders now measure, report and expect to influence governance practices. Directors will be expected to participate in annual meetings with shareholders.

A broad range of legislation and regulatory reforms are in process that will dramatically escalate the role of shareholder groups relative to corporate governance.

Proxy access is gaining momentum, a proposal that, if implemented, could upend corporate governance as we know it today. The SEC is now considering new rules to require, under certain circumstances, a company to include in the company's proxy materials a shareholder's, or group of shareholders', nominees for director. In the case of multiple submissions for one or more director positions, according to the proposal, the nomination(s) received first will be put on the ballot.

If shareholders can bypass the Governance Committee's objective selection procedure, both the recruitment process and the operation of corporate boards of directors would be politicized. The effectiveness of boards of directors could be diluted and marginalized.

Director Compensation

Full and detailed disclosure of compensation is now required. Additionally, various bills pending in Congress would require an annual advisory vote of shareholders on executive compensation and disclosure of golden parachutes; shareholder advisory votes for mergers and acquisitions or asset sale transactions; and shareholder approval (60% vote) for compensation of any employee who receives in excess of 100 times the average employee compensation.

Financial institutions would be required to disclose compensation structures that include any incentive-based elements. Federal regulators would prohibit risky compensation practices.

To elaborate—*Say on Pay* provides shareholders with an annual, non-binding vote "in favor of" or "against" a company's executive compensation program, and is already mandatory for companies receiving funding under the Troubled Asset Relief Program (TARP).

A major step towards mandatory *Say on Pay* votes at **all** public companies was taken on July 31, 2009, when the House of Representatives approved the Corporate and Financial Institution Compensation Fairness Act of 2009.

In 2008, at 69 shareholder meetings, say-on-pay proposals received an average level of shareholder support of 42%, a strikingly high percentage. The drumbeat for fair pay practices is quickening, and shareholders are driving transparency and moderation in pay.(17) For example, RiskMetrics expanded its list of "poor pay practices" for 2009 to

17 Wachtel, Lipton, Rosen & Katz memorandum, p.3; 2009.

include the adoption of new change-in-control agreements that include "golden parachute" excise tax gross-ups, tax gross-ups on executive perks and other compensation measures.

A Federal "Special Master for Compensation" has been appointed to police compensation practices. (18)

Often, compensation is more about optics than substance. Consequently, knowledge about and responsibility for good pay practices is an important director skill.

Risk Management

Shareholders, stakeholders, and insurers must scrutinize systems to avoid risk but also know when to take risk. Otherwise a company is stagnant. Risk oversight is a centerpiece of corporate governance. A July 2009 SEC proposed revision requires disclosure of the rationale for the company's leadership structure and the Board's risk mitigation role.

There will be hard scrutiny of the role directors played at companies like Countrywide, General Motors, Chrysler, Fannie Mae, Bear Sterns, CitiGroup, United Health and the numerous other companies burdened by excessive risk taking.

If you have experience addressing known risks and vulnerabilities, with a system that effectively targets future risk areas, and can help judge a company's risk management systems, you bring an important skill to the table.

Short Term Results

The number one problem with corporate governance in the United States is pressure to focus on short-term results.(19) A powerful group of directors including Warren Buffet, Vanguard Group founder, John Bogle, Duke Energy CEO, Jim Rogers, and former chair of Goldman Sachs, John Whitehead, have signed The Aspen Institute statement calling on Congress to enact policies to address problems with short-term investing. Concerns arise relative to the pressure to provide reliable and continuously improving quarterly earnings guidance triggering risk taking, numbers manipulation, leveraging up balance sheets, and restatements.

The Committee on Capital Markets Regulation, a research organization, recommends that boards become involved in creating a written policy for when and in what form forecasts will be provided and how they relate to the company's overall disclosure policy.(20)

"Are the reports too 'regular'?" asks Bob Walker. "Is the line too straight?" For example, he continues, when you look at an investment manager's performance, "you are tempted to fire the manager if the returns are below the benchmark." You should also consider firing the manager if the reports are above the benchmark, because it is out of the norm.

"I used to joke," Bob Walker adds, "in reporting news, when results are less than expectations, the CFO or Controller is trotted out to explain. If the results are good, the

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18 Executive Compensation: The State of Today's Environment, Richard V. Smith, Sibson Consulting, September, 2009.
19 Agenda Survey of Independent Directors, October 2009
20 Agenda, 9.21.2009, by Kristen Gribben

executive takes credit and delivers the report. You need the same amount of scrutiny in any case."

"It's all about the people," Walker continues. "It is not deterministic. Focusing on a single earnings per share number is a disservice to owners and managers, because that isn't the way the world works. A lot of things are estimates, and providing a range…is more helpful. It is about people making judgments."

If you have the financial skills to help negotiate this minefield, you can add value to the board.

Corporate governance, as we know it, is under tremendous scrutiny, and is a lightening rod for all those seeking to assign responsibility for and correct abuses in our system of free market enterprise. Boards of directors will no longer be free agents, but are exclusively entrusted with the care of the companies they serve.

Accountability will come through meaningful evaluation, transparency through clear communication and disclosure, and independence through awareness and more objective and proactive recruiting.

Now, more than ever, good directors can make a substantive difference and restore confidence and trust in the system. If we don't govern well, government will do it for us.

Serving as a director is a rewarding and often inspiring way to make a difference and contribute to the integrity and success of corporate America. Seventy-four percent of directors rate their board service as very or extremely satisfying.(21)

The thousands of dramatic untold stories are the companies that have succeeded because of the advice and counsel of their boards of directors. Great boards mean great companies.

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This Issue Alert was prepared by Susan F. Shultz, President of The Board Institute, Inc.

The Board Institute seeks to enhance boards by helping directors independently and confidentially educate, and benchmark their boards and committees. The Board Institute has developed the content of *The Audit Committee Index* to improve audit committees in cooperation with Financial Executives Research Foundation.

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21 Korn Ferry, op.cit., p.33.

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