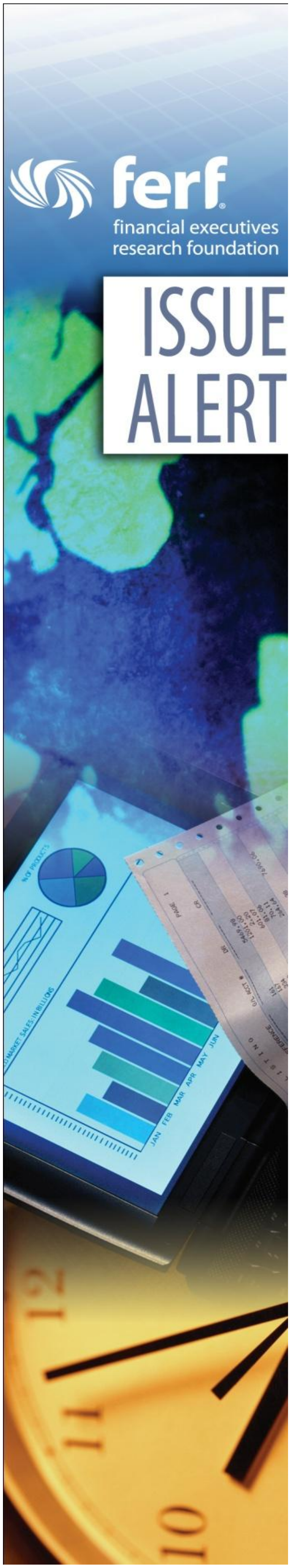

Issue Alert *November 11, 2011*

Boards of Directors:
Trends, Expectations and Threats
By Susan F. Shultz, President, The Board Institute, Inc.

Boards of directors are becoming increasingly transparent, accountable, and targeted. Compliance, regulation and shareholder activism are the drivers. Boards – and their constituencies – are clamoring for more strategic engagement and value add by the directors. Yet, this seems to be in stark opposition to the drumbeat of compliance and regulation. How should boards balance the pressures from their attorneys, auditors, and regulators to be risk averse – to be safe - with the Street calling for creativity, innovation and job creation? Challenges for boards have never been greater.

This Issue Alert will examine current trends, expectations and threats in:

- Strategy;
- Compliance and Regulation;
- Board Committee Makeup and Turnover;
- Evaluations;
- Risk Management;
- Shareholder Activism;
- Compensation;
- Diversity;
- Separate Chair/CEO;
- The Role of Committees;
- Communications;
- Global Boards; and
- Succession Planning.

Strategy

Boards are expected to review, discuss, challenge and enhance the strategy presented by management in an effective and coherent manner. Yet, in the face of compliance and regulatory demands, boards must carve out time on their agendas to make strategy discussion a priority. The challenge is to generate ample discussion, while limiting the board's role to oversight of, and not intrusion into, the development and implementation of corporate strategy. At the same time, boards must engage early enough in the process so that their discussions can be substantive and influential.

Compliance and Regulation

Dodd-Frank, the 2,000 page legislative overhaul, headlines the regulatory changes. Most (88 percent) directors expect government regulation to increase next year. SEC investigations and enforcement actions will also increase due, at least partially, to the rich whistleblower incentives enacted by the Dodd-Frank Act. These provisions provide that whistleblowers can collect between 10 and 30 percent of amounts over $1 million.

Proxy access is simmering. The D.C. Court of Appeals vacated (overturned) Rule 14a-11, which prescribed proxy access. However, the intent seems to be subverted, because through 14a-8, which was retained, shareholders and companies have the opportunity to establish proxy access standards on a company-by-company basis – rather than a specified standard like that contained in Rule 14a-11. The danger of proxy access is that the process of director recruitment will be politicized and skewed against truly balanced boards that include first time, younger, global, female or otherwise diverse directors.

Board Committee Makeup and Turnover

About half (52 percent) of S&P 1500 companies[1] had some level of board turnover in the last fiscal year. Board members are feeling the pressure of increasing time demands, so they are limiting the number of boards on which they sit. In other situations, companies are capping the number of boards on which their directors may serve. In some cases, officers are prevented from serving on any outside boards. Further, mergers, acquisitions and bankruptcies often result in board consolidation and elimination. And, in very rare cases, certain directors are asked not to stand for reelection, because they no longer add optimum value.

Of course, this trend has important implications for audit committees, all of whose members must be financially literate. Board makeup reflects this requirement:

- 17 percent of the directors serving today fit the category of investor/accountant;
- 33 percent are retired executives;
- 13 percent are current corporate executives, and;
- 11 percent of board members are consultants.

Despite the tendency to recycle directors, 83 percent of directors serve on just one board today. And, despite the turnover of directors, average director tenure is nine years.

1 Equilar study 2011

Evaluations

As a rule, we find out how much good governance counts when something really bad happens. Last year, more than 94 percent of corporate boards conducted evaluations. Most (79 percent) of directors say an effective board evaluation is the most important technique for ensuring that directors improve or continue to perform at peak levels. The trend is away from ad hoc, cumbersome, in-house questionnaires that are cobbled together and assembled by hand.

Directors are now seeking a professional solution, which could be an objective, web-based, easy to use evaluation and education tool. It is no longer appropriate for the board to simply ask and answer the same, recycled questions.

Risk Management

A plethora of charted dashboards are bubbling up to the board level, intended to provide easily digestible and actionable highlights. The trend is to consolidate the risk metrics and address risk on an enterprise wide basis, as opposed to looking at risks independently by function or division. 2010 was the first year for companies to comply with SEC rules that require disclosure of the board's role in risk oversight and the relationship between a company's compensation policies and employee risk taking.

Crisis management has assumed escalated importance and today is a critical aspect of risk management. Apart from financial services companies and others required by Dodd-Frank to have separate risk committees, most companies are choosing to address risk at the level of the full board.

Shareholder Activism

Shareholders are increasingly targeting and affecting corporate boards with precise checklists that enumerate expectations for good board practice. Shareholder groups now expect to meet with the independent board members on a regular basis. These groups are increasingly powerful, strident and specific. As a result of such input, boards will be concerned with understanding and effectively implementing fiduciary oversight, including investments related to union and public pension funds.

Compensation

Directors rank executive compensation as their number one concern2. The say-on-pay vote, although advisory, gives shareholders a vote on executive compensation practices. The possibility of a negative vote drives reform. In the last year, of the largest 2,400 companies with a say on pay vote, there were 37 companies which received more than a 50 percent negative vote against their existing compensation. Ten of those companies have been sued, despite the fact that these are "advisory" votes. Not incidentally, all of these no votes followed Institutional Shareholder Services (ISS) recommendations.3

New SEC rules also require companies to give shareholders a non-binding vote on golden parachute arrangements. Even more impactful is the Dodd-Frank mandate to disclose the relationship between executive compensation and the company's financial performance, as well as the ratio of the CEO's total annual compensation to the median annual total

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2 Corporate Board, re Akin Gump Corporate Alert
3 Michael Reznik, Frederic W.Cook & Co. 10.12.11.

compensation of all other employees. The newness and ambiguity of these regulations pose serious challenges and threaten to impose substantial compliance costs.

Diversity

The voices of women are muted, since women comprise a mere 13 percent of directors at the largest public companies in the U.S. (less in smaller and private companies) and in companies in countries without quotas. Minority women hold only three percent of those seats.

African-American directorships shrank to three percent in 2010, and the numbers of Hispanic board members declined from 1.8 to 1 percent. The percentage of Asian-American directors has dropped by 0.9 percent to 1.8 percent.

As of 2010, the SEC required companies to disclose whether and how the nominating committee or full board considers diversity, defined in the broadest sense, in identifying director nominees. Shareholders and other constituencies are demanding change, and, in the last quarter, almost half of new directors were women.

Separate Chair/CEO

The board is responsible for CEO selection, evaluation and succession. If the chair is the CEO, there could be some question whether he or she could be objective, especially in CEO evaluation. Does the board work for the CEO, or does the CEO work for the board?

Almost half (45 percent) of S&P companies have separate chairs. Just over half of the separate chairs are independent. The trend toward separate and independent chairs will continue because this is a high priority to most shareholder groups. Also, 54 percent of S&P company boards have lead directors.

The Role of Committees

The committees are important due to the complexity of issues and the enhanced accountabilities facing the board. Major considerations include:

- Increasing the use of independent consultants and experts to advise the committees;
- Rotating committee membership;
- Inviting all board members to attend committee meetings;
- Improving the caliber of reporting and interaction with the full board, and;
- Adding more meetings.

The relationship between the audit committee and the board is critical, as complexity drives more discussion to the committee level. The question of heightened and differentiated standards of care for directors with special expertise, such as financial, is troublesome.

Time required is increasing. In 2010, audit committees met an average of eight times per year, compared to six times for compensation committees, and four times for nomination committees. When PeopleSoft was acquired by Oracle, the audit committee met 80 times in 18 months. Clearly, if there is a critical event, the demands on directors' time can be tremendous.

Communications

Directors interact more frequently with shareholders. And, internally, directors are communicating beyond the CEO. It is no longer acceptable for all board information to be filtered through the CEO. It is appropriate for the CEO to know about communications further down the management chain. At the same time, directors must appreciate the sensitivity of going down the chain and must respect and support the role of the CEO.

For the audit committee, the auditors are no longer members of the team – they now are much like another regulator. In many situations, outside auditors simply decline to provide advice, because they fear liability – even though the auditors are in the ideal position to provide critical perspective and information.

Although auditors are now hired by audit committees, their closest relationships tend to be with management. Also, in several cases, CFOs have elected not to confer with their outside auditor about potential financial problems until *after* they are resolved. CFOs may have adopted this strategy because auditors can feel compelled to report any issues to avoid prosecution or recriminations.

Global Boards

As companies globalize, it makes sense to include proactively, targeted directors from other global geographies who have the knowledge, vision and experience to add value to the board. If your company makes a significant investment in a region, doesn't it make sense to leverage that investment at the board level? We have been engaged several times to identify Chinese directors for publicly traded U.S. companies to help negotiate that changing marketplace.

Succession Planning

Although this has long been a major component of board responsibility, succession planning at the board level has often been reactive and passive. Again, shareholders are driving change. The boards of almost all S&P 500 companies now discuss CEO succession at least once a year, and over half of boards address this issue twice annually. 86% of boards now have adopted an emergency succession plan.

Next Steps

In order to do a good job, boards must prioritize strategic engagement and implement a system that encompasses robust evaluation to demonstrate commitment to excellence. Boards can no longer be sidetracked by process. If boards do not govern well, the regulators will do it for them, and full engagement by the financial team is critical to their success.

About the Author

Susan F. Shultz is Founder/CEO of The Board Institute, Inc. The goal of The Board Institute is to improve boards through independent, accredited, web-based evaluation and education tools, including The Audit Committee Index, which was developed in collaboration with Financial Executives Research Foundation (FERF).

Susan is a globally recognized governance expert, speaking and writing on the competitive advantages of strategic boards and leading the governance practice of SSA Executive Search International/INAC. She is also author of **The Board Book** (AMACOM). Susan can be reached at sshultz@theboardinstitute.com

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