

Governance Challenges 2013 and Beyond

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Heidrick & Struggles

KPMG's Audit Committee Institute

Marsh & McLennan Companies

NASDAQ OMX

Pearl Meyer & Partners

Weil, Gotshal & Manges



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INTRODUCTION

Today, directors are operating in a new environment. Shareholders, regulators, and stakeholders have greater influence on the boardroom than ever before. In addition, risks and crisis situations are occurring with greater frequency and amplitude. Directors have a responsibility to ensure their companies are prepared for these challenges—present and future.

This compendium provides insights and practical guidance from the nation's leading boardroom experts—the National Association of Corporate Directors' (NACD's) strategic content partners—each recognized as a thought leader in their respective fields of corporate governance.

NACD is the only membership organization focused exclusively on advancing exemplary board leadership. Based on more than 35 years of experience, NACD identifies, interprets, and provides insights and information that corporate board members rely upon to make sound strategic decisions, confidently confront complex business challenges, and enhance shareholder value. With more than 13,000 corporate director members, NACD provides world-class director education, director training, and proprietary research about leading boardroom and governance practices to promote director professionalism and bolster investor confidence. Furthermore, to create more effective and efficient corporate boards, NACD provides independent board evaluations and custom in-boardroom education and training programs, as well as director-led conferences, forums, and peer-exchange learning opportunities to share ideas about current and emerging issues. Fostering collaboration among directors and governance stakeholders, NACD is shaping the future of board leadership. To learn more about NACD, visit www.NACDonline.org. To join, please contact Kelly Dodd at kkdodd@NACDonline.org or 202-380-1891.

WHAT TO DO WHEN AN ACTIVIST INVESTOR COMES CALLING

By Heidrick & Struggles

You first learn of it when you open the *Wall Street Journal* in the morning, or your lead director calls to tell you the news: an activist investor has taken an equity stake in the company you oversee. For most directors that news is usually unwelcome. It suggests that the company, at least from the activist's point of view, is underperforming, and that the board could be doing a better job. It could also portend a bruising proxy fight that distracts directors and management alike and unsettles the company regardless of which side wins. How should you react?

Understandably, your first impulse might be to circle the wagons, assemble a crisis management team to fight off the investor, and wage a vigorous campaign for support among institutional investors and other large shareholders. Certainly, the specter remains of the corporate raiders of the 1980s armed with junk bonds and focused on breaking up companies and selling off the parts, though today's activist typically takes only a small stake in the company and has no intention of a takeover. Nevertheless, such investors are often viewed as having a short-term focus and predatory instincts—neither of which is good for the company. But before adopting a war footing with the activist, there are a number of things you can do to mitigate the risk of mishandling the situation, taking care to consult with legal counsel along the way. Those steps include:

DO YOUR HOMEWORK. Not all activist investors are alike. Despite a number of high-profile and very public battles between activists and companies, many activists prefer to stay out of the limelight, and they aren't simply looking for the fastest internal rate of return (IRR) on their investment at the expense of the long-term health of the company. Find out what kind of activists they are. What is their track record? Do they have a fixed "duration of capital" for their investments that would allow little flexibility in their demands? What kind of strategic, operational, and financial changes have they urged on other companies in which they have invested?

Edward Garden, one of the founders of Trian Partners along with Nelson Peltz and Peter May, encourages board members to seek references on activist investors who have taken a stake in their company. Bankers, he points out, can be a particularly rich source of background information on the investor, providing valuable insight on the investor's reputation and past behavior.

SEEK PROFESSIONAL ADVICE. With money flowing into activist funds like never before, there are a growing number of resources available to assist companies in contested situations and engagements with their investors. Most companies at this stage should get professional advice before they start meeting with shareholders. In our experience, directors want and need a playbook to get them as comfortable as possible and to do their best job. This is almost always true of management engagement as well.

MEET WITH THE ACTIVIST. Even if your research and referencing have left you doubtful, it is important to hear what the activist has to say. First and most importantly, because they are owners of the company, the case may be far more nuanced and constructive than its description through the press or formal written communications. Second, other owners are likely to be much more sympathetic to their concerns than it might first appear to the board or management. Third, such investors usually have considerable resources to delve into the details of the companies on

which they focus, so they may have some genuinely new perspectives to offer—perspectives that management may have failed to provide. Fourth, uncomfortable as it might be to concede, activists do seek underperforming companies, and their advice could be helpful in improving performance.

INCLUDE THE CEO IN THE CONVERSATION. Management should hear the investor’s alternative strategies firsthand and in detail, along with the independent directors. It is not only a matter of courtesy to include the CEO but also an opportunity for board members to hear management make its case, respond to criticism, and defend its present course of action. This frank exchange of ideas between the activist and the CEO gives board members much firmer ground on which to base their subsequent decisions in regard to the activist.

OBJECTIVELY CONSIDER THE ACTIVIST’S RECOMMENDATIONS—AND THE ACTIVIST. After meeting with the activist investor, discuss with other directors and with management the merits of the activist’s business case. Whether the activist is proposing to return excess cash to shareholders, sell off a poorly performing business, reallocate capital, or take some other bold action, it’s possible that the move makes eminent sense in the context of current business performance and creates additional shareholder value. Even if following a particular proposal will lead only to a short-term gain, there is no reason to reject it out of hand if it doesn’t harm long-term prospects. Consider adopting the recommendations that have genuine merit. Such early adoption, where deemed desirable by the board, could preempt prolonged conflict and improve company performance rapidly.

PREPARE FOR A RAPID RESPONSE TO AN ACTIVIST’S DEMAND FOR SEATS ON THE BOARD. While many activists will be satisfied if you agree to implement some or all of their suggestions, others may want to bring in their own directors. Depending on the board’s perceptions of an activist’s intentions, the board may decide to:

- *Staunchly resist.* If the activist’s proposals seem badly flawed or largely self-dealing and the board’s experience of the activist’s working style, personality, and intentions have led them to suspect the investor’s motives, then the board may choose to take on the fight. Even so, the board can rightly claim that it is resisting the activist only after engaging in real dialogue and exercising due diligence in regard to the investor’s proposals. In situations where the company chooses resistance, we have sometimes been called upon to vet new candidates who have the stomach for such a fight and bring them onto the board rapidly.
- *Arrive at a compromise slate.* It’s possible that the board is ambivalent about the activist’s intentions—the proposals have some merit but the activist is seeking greater control than the board is willing to give up. Further, the board may be leery of the activists’ candidates for director. In that case, as we have also seen, the board can put together a slate that the company can take as a peace offering to the activist and try to arrive at a mutually acceptable group. Again, vetting of candidates must be completed rapidly.
- *Concede board seats without a fight.* If you have concluded that the activists’ proposals have genuine merit, their motives are good, their working style is collaborative, and their investment horizon is long, then you might want to concede some board seats to them. You can then avoid a long, costly, and rancorous proxy fight. You can begin cooperating sooner and bring them onto the board not as adversaries, but as team players. Your cooperation and your willingness to concede board seats could also lead the investor to reduce the number of seats being sought.

FULLY INTEGRATE THE ACTIVIST'S BOARD MEMBERS. Although activist board members may arrive with the intention of shaking up the board and the company, there is no reason not to extend to them the same orientation and onboarding program offered to any new board member. They will likely already be well versed in the company's financials and its strategy, but far less familiar with the culture of the board, the perspectives of its other directors, and the dynamics of the board's interaction with management. A cordial and complete onboarding process promotes the collaborative atmosphere that is desirable in the best of times and essential when there are significant differences of opinion about the direction the company should take. Instead of being riven with factions, the board can begin to operate as a cohesive group held together by the mutual respect that begins to develop in the onboarding process.

A Case in Point

These principles—both in their breach and their observance—converge in the recent experience of Heinz with Trian Partners. In 2006, Trian acquired more than 12 million shares of Heinz, representing a 5.4 percent stake in the company. In its Securities and Exchange Commission (SEC) filing, Trian said that more value could be created through “sharper strategic focus, better operational execution, and more efficient uses of capital.” Almost immediately, Heinz rejected Trian's request for representation on the board. A fierce fight began. Trian issued a report calling on Heinz to reduce costs, increase share repurchases, aim for higher dividends, and redirect promotional dollars into advertising and new products.

Though Heinz opposed Trian's proxy fight to gain six board seats, the company did adopt some of the investment company's proposals, including reduced spending and a share buyback program. Trian won two board seats and, for their part, instead of looking for rapid payback, they held onto their stake for seven years, working with other members of the board and management to improve company performance.

Subsequently, Heinz' shares provided an average annual return of almost 10 percent, compared with an average 4 percent return for the Standard and Poor's (S&P's) 500 Index. In February 2013, Berkshire Hathaway and 3G Capital offered \$23 billion for the company—a 20 percent premium.

Ultimately, observers and participants agree, this impressive result for shareholders was achieved through the cooperation of the board and management in executing the strategic plan, despite the conflict with which the story began. With no fixed “capital duration” on the part of Trian, with the willingness of the Heinz board and management to adopt the proposals of an outsider, and with the subsequent collaboration of all parties everybody won.

The Ultimate Principle

Whether you resist an activist or cooperate, the guiding principle should, of course, be the best interests of the shareholders you represent. It is likely that the activist already has some support among institutional investors or no stake would have been taken in the company in the first place. Further, a number of activist investors have the respect generally of many large and credible institutional investors. Nevertheless, if in your best judgment, the investor's proposals and intentions are ultimately destructive of shareholder value, then resistance is certainly called for. If, however, the result is likely to be greatly increased shareholder value, then that comes first—as it would not matter who was proposing a new course for the company.

KPMG's AUDIT COMMITTEE PRIORITIES FOR 2013

By KPMG's Audit Committee Institute

In 2013, audit committee agendas will be shaped by continued economic uncertainty, globalization, digitization, and increased government regulation. Focused, yet flexible agendas—and exercising judgment about what belongs and does not belong on the committee's agenda, and when to take deep dives—will be critical.

To help audit committees meet the governance challenges of the coming year (recognizing that priorities will vary by company and industry), we offer KPMG's audit committee priorities for 2013.

Audit Committee Priorities

STAY FOCUSED ON JOB #1: FINANCIAL ACCOUNTING AND REPORTING AND INTERNAL CONTROLS. The challenges of global economic conditions, coupled with the impact of major public policy initiatives—deficit reduction and tax reform, healthcare, financial services regulation, new accounting standards, and a challenging regulatory environment—will require the attention of every audit committee. Monitor fair value estimates, impairments, and management's assumptions underlying critical accounting estimates. Consider how the disclosures can be improved to tell the company's story. Are *all* financial communications—including earnings releases and analyst calls—consistent with what is being said in the quarterly and annual filings? Recognizing that financial reporting quality starts with the CFO and finance organization, maintain a sharp focus on management's financial reporting processes, and make sure they have the resources to succeed.

REINFORCE AUDIT QUALITY AND SET CLEAR EXPECTATIONS FOR THE EXTERNAL AUDITOR. Audit quality is enhanced by a fully engaged audit committee that sets the tone and clear expectations for the external auditor, and then monitors auditor performance—through frequent, quality communications, and a rigorous performance assessment. (See *Audit Committee Annual Evaluation of the External Auditor and Guide to PCAOB Inspections* at www.thecaq.org.) Pay close attention to Public Company Accounting Oversight Board (PCAOB) initiatives on audit quality and auditor independence, and consider how the audit committee can strengthen its oversight.

MONITOR THE IMPACT OF THE BUSINESS AND REGULATORY ENVIRONMENT ON THE COMPANY'S COMPLIANCE PROGRAMS. With supply chains, emerging technologies, and strategic growth opportunities tightening the interconnection of business and markets, companies are more vulnerable than ever to fraud, misconduct, and compliance risk. These vulnerabilities, coupled with the complex global regulatory environment (including the Foreign Corrupt Practices Act and the U.K. Bribery Act, the SEC's whistleblower bounty program, conflict minerals and other aspects of Dodd-Frank, and the sheer volume and scope of new regulations) will require continued attention. Ensure that the company's regulatory compliance and monitoring programs cover all vendors in the global supply chain.

UNDERSTAND THE COMPANY'S SIGNIFICANT TAX RISKS AND HOW THEY ARE BEING MANAGED. Oversight of tax risk is an increasingly important responsibility for audit committees, prompted largely by the complexity of operating globally in different tax regimes. Increased enforcement at all levels, demands for greater transparency and disclosure, prospects for business tax reform, and reputational issues have also raised the stakes. Ensure that the tax function is monitoring the

federal tax reform debate and analyzing the impact of likely tax legislative scenarios. To stay abreast of critical tax risks, establish a clear communications protocol for the chief tax officer to update the audit committee regularly on the status of tax risk management activities and important legislative developments. Ensure the adequacy of the company's tax resources and expertise globally. Make sure internal audit is properly focused and fully utilized. Consider the need to redefine internal audit's role—and focus internal audit on key areas of risk and the adequacy of the company's risk management *processes* generally. Internal audit is most effective when it is focused on the critical risks to the business, including key operational risks and related controls—not just compliance and financial reporting risks. What's changed in the operating environment? What are the risks posed by the extended organization—sourcing, outsourcing, and sales and distribution channels? Set clear expectations and make sure internal audit has the resources, skills, and expertise to succeed. Challenge internal audit to take the lead in coordinating with other governance, risk, and compliance functions within the organization to limit duplication in coverage and, more importantly, to prevent gaps. Help maximize collaboration between internal and external auditors. As internal audit moves to a higher value-add model, it should become an increasingly valuable resource—a trusted advisor and consultant—for the audit committee.

Broader Governance Matters

Beyond the audit committee's "core" areas of oversight, we believe audit committees can play an important role in supporting the board (and coordinating with other board committees) on the following governance matters:

CONSIDER WHETHER THE BOARD HAS THE RIGHT COMPOSITION AND COMMITTEE STRUCTURE TO PROVIDE EFFECTIVE RISK OVERSIGHT. In addition to their oversight responsibility for financial reporting risk, many audit committees have oversight responsibility for the company's enterprise risk management (ERM) *process*. Over the years (by design or default), many audit committees have also assumed responsibility for other major risks facing the company—such as risks posed by globalization, cybersecurity and information technology (IT) risks, and other operational risks, as well as legal and regulatory compliance. Given the substantial time commitment required by its core oversight responsibilities, does the audit committee have the time and expertise to oversee so many critical risks "beyond the core"? Is there a need for another committee (e.g., risk, technology, compliance)? Are risk responsibilities clear? Board and audit committee effectiveness and accountability hinge on honest self-reflection, meaningful board assessments, and continuing director education. In addition to board oversight processes, take a hard look at board and audit committee composition, independence, and leadership. Is there a need for a "fresh set of eyes" or a greater diversity of views?

UNDERSTAND HOW DIGITIZATION AND SOCIAL MEDIA ARE TRANSFORMING THE BUSINESS LANDSCAPE—AND IMPACTING THE COMPANY AND BOARD OVERSIGHT. The staggering pace of technology change and the accelerating cyberattacks have pushed IT risk steadily higher on audit committee agendas. At the same time, audit committees and boards have expanded their focus beyond "defensive" IT risks—such as data privacy and security, social media/brand reputation, and protection of intellectual property and non-public financial information—to consider the transformational impact of game-changing technologies such as the cloud, social media, mobile, and "big data." Is management making the most of new technologies? Absent a technology committee of the board, what is the role of the audit committee—versus the board—in helping to ensure that management understands the opportunities and risks posed by emerging technologies? What expertise/resources does the

audit committee or board require to oversee the company's efforts to manage the many risks (such as cyberattacks) posed by these technologies, and to understand the strategic and transformational implications of emerging technologies for the company's business model and data analytics?

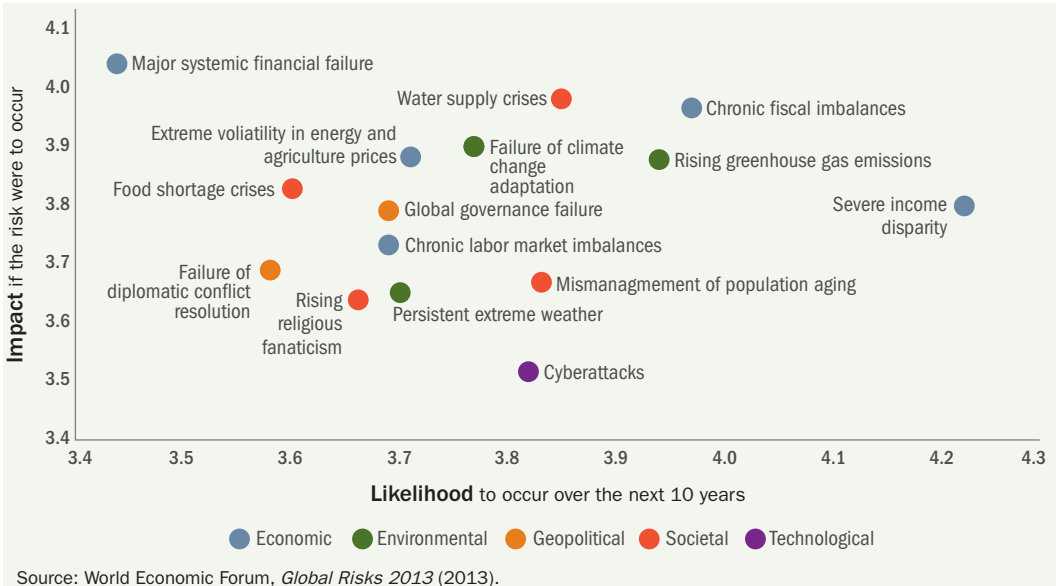
SET THE TONE AND CLOSELY MONITOR LEADERSHIP'S COMMITMENT TO THAT TONE, AS WELL AS THE CULTURE THROUGHOUT THE ORGANIZATION GLOBALLY. The year ahead will be one of tremendous pressure and change. In this environment, it is more important than ever to be acutely sensitive to the tone from (and example set by) leadership, and to reinforce the culture of the organization (i.e., what the company does, how it does it, and the culture of compliance, including a commitment to financial reporting integrity throughout the organization). Is the audit committee (and board) hearing views from those below senior management and outside the company? Are there dissenting views? Recognize when asymmetric risk—the over-reliance on senior management's information and perspective—is too high. Does the information provided by management, internal audit, and external auditors tell a consistent story? Make time to visit company facilities and attend employee functions. The tone and culture throughout the company's global operations and the extended organization is critical. Is the audit committee confident that it has a good sense of the culture in the company's global operations—in other words, those that are far away from the headquarters?

BOARD RISK CHECKUP—ARE YOU READY FOR THE CHALLENGES AHEAD?

By Marsh & McLennan Companies

Most boards would agree that developing a sustainable competitive advantage in an increasingly uncertain environment is the most challenging issue facing businesses today. Many of the variables that companies consider when making strategic decisions have become increasingly unpredictable. At the same time, there are signs of an economic rebound. With U.S. companies sitting on an estimated U.S.\$1.7 trillion, firms will be looking to increase capital investments and undertake growth activities. Effective decision making in this risky business environment is critical. The long-term challenges affecting the global business environment are highlighted in the annual *Global Risks 2013* report. For the eighth year, Marsh & McLennan Companies was among the partners working with the World Economic Forum to look at sources of long-term uncertainty and change. The report reflects the views of more than 1,000 diverse experts, business leaders, and policymakers worldwide and outlines the evolving risk landscape and interconnections between 50 global risks over the coming decade (Figure 1). Many of the risks and the interplay between them, as highlighted in *Global Risks 2013*, will affect corporate strategies and investments going forward. This chapter examines potential impacts of a selection of the top-ranked global risks. As boards consider these risks, they must decide whether their current risk oversight and governance processes enable them to effectively understand the potential impacts on corporate strategy. Further, boards must ask if current practices support their active input into management’s portfolio view of strategic alternatives and capital investments, with explicit consideration to the risk profiles and risk-reward trade-offs associated with each.

FIGURE 1: TOP-RATED RISKS IN THE 2013 GLOBAL RISKS REPORT



Chronic Fiscal Imbalances

The financial crisis has left governments with less financial capacity and increased debt. For example, the government debt of developed countries is 109 percent of their gross domestic product, according to the Organization for Economic Cooperation and Development, which is up from 74 percent in 2007. This strained fiscal capacity is a challenge and risk in itself, yet it also reduces governments' ability to proactively respond and develop risk mitigation efforts in the face of evolving global risks.

As a result, the world is facing declining resilience to global risks. Just when exposure to more frequent catastrophes and crises is rising, our ability to deal with these shocks is decreasing. Seemingly isolated global risks, such as economic crises and natural catastrophes, are becoming mutually reinforcing chronic risks, in large part because the world's ability to respond has been seriously weakened financially.

In the face of this, the private sector will be increasingly engaged as governments look for new ways to respond and finance innovative responses to long-term risks. Some examples include changing healthcare regulation in the United States, a growing focus on pension plans and programs, or an increase in public-private partnerships to finance new infrastructure projects.

Failure of Climate Change Adaptation and Rising Greenhouse Gas Emissions

Growing concerns about the world's ability to respond to greenhouse gas emissions and climate change emerged as a central theme among the experts surveyed for *Global Risks 2013*. Going forward, companies must consider how climate change may immediately impact resource availability and their supply chains. Companies should also consider secondary impacts such as a changing regulatory and legal environment for their operations, changing financial markets as investors increasingly target sustainably managed companies for capital, and the ability to capture a competitive advantage for customers and workforce talent.

Persistent Extreme Weather

The frequency of natural disasters is increasing due to climate change, and the scale of the resulting losses from the disasters is going up even faster. Economic losses from natural catastrophes worldwide have soared from \$387 billion in the 1980s to \$1.425 billion in the last 10 years. These impacts can be expected to increase with the growth of flood-prone megacities in some of the fastest growing global economies, including New Delhi, New York, Shanghai, and Tokyo. In the United States, about half of the population now lives in coastal counties and there is nearly \$10 trillion of insured value located directly on the coasts from Maine to Texas.

Companies must consider the exposure of their infrastructure assets, their supply chain, their employees, and their customers to the threat of extreme weather (including flooding), and also take into account immediate disaster recovery plans and their longer term resilience to potential weather events. Extreme weather events can also have lasting impacts on an entire industry: for example, the global technology industry is still reeling from massive cutbacks in semiconductor production after the hurricane and earthquakes in Japan and Thailand.

Volatility in Energy and Agriculture Prices

Increased volatility in commodity prices has become the norm and can be expected to continue—driven by growing demand for all commodities and due to the interplay of the effects of climate change, extreme weather events, and the fragility of aging infrastructure. International Monetary Fund data shows that the size of fluctuations in commodity prices has more than tripled since 2005 compared with the 1980s. Today, businesses ranging from manufacturers to retailers to bakers are all struggling to manage the effect of volatile raw material prices on their earnings. In the past, volatile commodity prices seemed to have a major impact only on a select group of companies, such as airlines. Now, some companies are discovering that non-core assets (e.g., suppliers of their electricity) are becoming core drivers of their earnings.

This volatility in commodity prices is fundamentally altering how companies need to conduct business. In many cases, companies do not have the internal resources they need to manage this commodity volatility appropriately. Companies must either invest in capabilities to address this need or contract out such services if they do not think that managing this heightened volatility is part of their strategy or risk appetite.

Chronic Labor Market Imbalances

Talent is the fuel that drives the engine of the global economy but a talent crisis is looming, propelled by serious imbalances in human capital markets. There are simultaneous talent shortages, high unemployment rates, and employability challenges due to underlying structural changes in the global economy and in many industries. Looking forward, boards and management must consider if their organizations will be able to find, attract, and retain the necessary talent for their business—both in the United States and globally.

To ensure an effective pipeline of necessary skills and labor, organizations may need to consider collaboration with other companies within a country, industry, or region, or across multiple constituencies worldwide (e.g., sectors, governments, nongovernmental organizations (NGOs), and academia).¹

Mismanagement of Population Aging

Current demographic projections for the next 20 to 30 years show that the next employment crisis is likely to stem from a shortage in labor supply linked to declining birth rates and a steadily aging population. Globally, the population of older people is growing considerably faster than the population as a whole: the population of older people is growing at a rate of 2.6 percent versus less than 1 percent for the entire population.

In this context, qualified people represent a strategic resource—one that companies need to pay far greater attention to than ever before. Studies show that while 60 percent of companies globally are investing more in talent, only 24 percent of those companies say their workforce plans are highly effective in meeting their needs. Interestingly, 4 percent of businesses globally are employing retirees to fulfill critical skills gaps. This underlines population aging and chronic labor market imbalances being inextricably linked as critical issues for companies to think about in developing growth strategies.²

¹ For more information, see World Economic Forum, *Talent Mobility Good Practices: Collaboration at the Core of Driving Economic Growth* (2012).

² See Mercer, *Talent Rising: High-Impact Accelerators to Global Growth* (2013) and www.mercer.com/talentbarometer.

Cyberattacks

As a growing number of people and devices connect to the Internet, cyberattacks are now a daily factor to consider in business operations. Thirty-five percent of the global population is now online, up from 8 percent just 10 years ago, and it is projected that one billion smartphones will have been sold worldwide by 2015. In addition, the number of devices—cars, kitchen ovens, office copiers, electrical grids, hospital beds, agricultural irrigation systems, and water station pumps—connected to the Internet is expected to reach 31 billion in 2020. With this level of connectivity, attacks that once would have been isolated incidents in the physical world, can now quickly achieve a cascading effect.

In light of the actual and potential effects of cyberattacks, governing bodies around the world have begun to promote transparency by enacting legislation requiring that a computer breach should be viewed as a potential material event requiring disclosure regardless of whether the breach involved release of confidential data. Companies should ensure they have a clearly defined process in place in order to respond to cyberattacks and be confident that they have considered the use of tools such as cyber risk insurance to mitigate impacts should (and when) an attack occurs.

Five Essential Risk Oversight Questions for the Risks Ahead

The global risk outlook over the next decade presents many challenges for companies. To successfully navigate this environment, boards and management must ensure they understand the company's current and potential risk profile under emerging and evolving business uncertainties, key risk drivers and their evolution, and risk volatility and the potential impact on strategy and performance. When heading into annual strategy meetings, boards must ask the following five questions to ensure risks are effectively considered:

1. What is the portfolio of strategic choices and the associated risk profiles and differing risk/reward trade-offs of each alternative?
2. What are the key risks within the strategy, and how do the risks contribute to the overall risk profile and volatility of operational and financial performance?
3. How do risks interact and aggregate under alternative scenarios?
4. How will the company measure and track performance against defined risk tolerances and risk appetite?
5. How will the company identify emerging risks and potential impacts on the organization's critical success factors going forward?

The uncertain business environment is here to stay. Firms that take a more proactive risk management approach in the current climate will be able to capitalize on strategic opportunities, thus helping to clearly differentiate themselves from their competitors.

BOARDROOM DISCUSSIONS

By NASDAQ OMX

As the economy shows glimpses of pulling out of one of the most trying economic periods in history, companies are moving beyond survival mode. Now they are beginning to assess their fundamental strategies and growth opportunities. To facilitate this momentum, we believe there are several fundamental issues that will require careful attention from the board in 2013 and beyond, and some considerations as to how to deal with them efficiently and most effectively.

Risk Management

Managing risk ensures increased corporate accountability, strengthens financial, strategic, and operational efficiencies, maximizes performance, and leads to better understanding of each risk and contributing factor. Doing so helps boards and senior leadership to truly be in control by continually balancing the company's performance with financial and reputational risks. Risk management is a broad topic with many disciplines; however, we believe the following require the most immediate attention.

Enterprise Risk Management

ERM is aimed at preventing events or actions from adversely affecting an organization's ability to achieve its business objectives, and is based on a systematic approach to identifying, assessing, mitigating, and reporting risks throughout the entire organization. The ERM approach covers all types of risks: strategic, financial, commercial, and operational. ERM is an integral part of the ongoing business processes carried out by line management, and it is directly linked to strategic and annual planning and follow-up. In addition to the integrated risk management processes, there are activities in place to monitor the total risk portfolio and to assist in the overall management and reporting of risks at a corporate level. In fact, several international regulations such as Basel II and Solvency II require a companywide ERM framework.

Reputational Risk Management

Where financial risk traditionally has had the most focus, reputational risk is the next frontier. Reputational risk is inherent in every other type of risk and has more than one owner within the company but ultimately kicks up to the highest level. It can bring a company down in a matter of weeks and requires serious attention from both the board and senior management. Financial implications can be devastating.

VENDOR RISK MANAGEMENT. As organizations rely more heavily on outsourcing key business processes, a comprehensive risk strategy requires awareness of both internal and external risks. Outsourcing and business partners are making headlines. In fact, an organization's ability to effectively deliver products and services depends heavily on them. Vendors that do not adhere to the same moral, ethical, and overall quality standards can quickly damage an organization's reputation with existing customers, as well as with the general public. Each vendor needs to be thoroughly evaluated throughout the relationship including analyzing their financial strength, business continuity plans in case of outage or failure, and data security policies, to name just a few.

BUSINESS CONTINUITY MANAGEMENT. Business disruption can be very costly. Drastic natural forces like hurricanes, tsunamis, heavy rainfall, blizzards, earthquakes, and other disruptive events can all

dramatically impact day-to-day operations. In extreme cases, the disruption can cause a complete wipeout. Business continuity management is a holistic management process that identifies potential disruptions to the business and provides a direction for building resilience, including capabilities for an effective incident response, thereby safeguarding the interests of key stakeholders, protecting the brand and the company's value-creating activities.

Organizational Impact and Considerations

Taking on all of these risk topics at one time can be overwhelming for even the most effective boards and companies. Though it is natural for each department within a business to focus on its own challenges, isolated planning isn't efficient. Risk management requires thinking beyond silo-based solutions because the best solution is an integrated approach. Some solutions to consider include: using an enterprise governance, risk, and compliance (eGRC) software platform with robust capabilities embeds the different risk topics into core business processes and provides a structure to track, measure, and manage key organizational risks in one integrated system.

Today, many implementations of eGRC platforms focus on automating a single regulation, such as Sarbanes-Oxley. The company will often address operational risk management and then seek separate solutions for Basel II/III, Solvency II, ISO 9001, or Food and Drug Administration regulations. Then the next step on a step-by-step "eGRC journey" would be using one eGRC platform to meet multiple financial reporting requirements, which can substantially reduce external audit and compliance costs. After this, the company might address organizational risk by using a full integrated platform.

There are many paths to take while on an eGRC journey when seeking to implement a true ERM solution. Business process management underscores a quality solution where users can identify key processes, structure the controls around the processes, and determine key risks all based on the company strategy and operational objectives, as well as financial reporting and legal compliance obligations. During the eGRC journey, business processes create the map for a seamless integration of multiple eGRC projects into one solution.

With processes integrated in one eGRC platform, the company can start balancing risks with performance which quickly supports better decision making. The final stage of a step-by-step eGRC journey yields not only improved efficiency, but a true means to continuously transform the organization. Strategy can come to life. The implementation of a smart eGRC solution begins with the decision to make a change.

Ethics and Compliance

Reading headlines from any news source clearly points out the risks of non-compliance. Fines levied on failures to meet corporate governance, regulatory, and compliance issues make for major stories on a daily basis. The board of directors must ensure an effective structure is in place to address these issues on a proactive basis and ensure controls are in place to address anomalies that may arise. In addition, it sets the tone in support of a culture of transparency and individual commitment.

CODE OF ETHICS AND RELATED POLICIES. The actions of every employee contribute to the company's reputation and the business depends on the confidence it instills in investors, regulators, and stakeholders. Good governance calls for a written company code of ethics, a training program explaining how to comply, as well as the value it represents to the company. There is likely a team

of senior leaders overseeing the policy creation and its implementation and management. In these times of potential issues, the board needs to provide regular review and oversight to ensure these processes are working flawlessly.

Participation in the annual code of ethics survey can often be perceived as a tedious, eye-rolling topic. The time it requires and the repetition of questions for multiple regulations fosters this negative perception, and typically there isn't a way to make it more palatable. Considering an eGRC software platform can streamline the process and time requirements, as well as coordinate and streamline the reporting. Sharing the various survey results with employees is vital to making compliance efforts more impactful for employees. Quite often companies make the mistake of not sharing these results with employees. By sharing the results, management can satisfactorily answer and motivate employees. It provides an opportunity for more frequent communication about ethical practices. Companies that publish results and explain meanings and consequences, benefit with improved GRC practices, transparency, and overall performance.

SUSTAINABILITY. The term “sustainability” refers to an organizational effort across multiple areas of expertise, including ethics, governance, resource management, real estate, materials, supply chain, education, philanthropy, etc. Other terms used interchangeably are corporate social responsibility (CSR) and environment, social, and governance. Over the last decade, sustainability management and reporting is no longer an exception; it has become an integral part of daily operations in successful companies. The importance of managing sustainability performance has increased due to strict legislation and increased pressure from various stakeholders to deliver transparent, comparable, and reliable sustainability performance information.

At NASDAQ OMX, we have always been a believer in the virtues of sustainability. We were practicing *corporate sustainability*—in many different places and in many different ways—long before the term became so prevalent. Our key goals—to expose operational inefficiencies, provide future growth opportunities, and significantly reduce risk and exposure—remain steadfast. These efforts come at a price, but we believe they are a vital investment in our company and our society. Sustainability issues and performance metrics are board-level concerns in this company and we believe need to be considered in every company. For example, measures we've taken in the past year transitioned many of our facilities toward more rigorous space, material, water, and energy usage standards. Several U.S. locations have achieved leadership and energy in environmental design (LEED) certifications or met other environmental standards. Our Helsinki office was the first exchange to receive a World Wildlife Fund Green Office certification. We published our first sustainability report, added a sustainability disclosure to our proxy statement, and added a more detailed one to our 2012 annual report. In addition, we have committed to the Global Reporting Initiative and the U.N. Global Compact, and will improve the data already sent to the Carbon Disclosure Project.

In terms of helping to frame the global dialogue around sustainability, we have been working through the World Federation of Exchanges to understand the need for sustainability reporting and collaborate with other stock markets and exchanges to make this part of our regular business practice. NASDAQ OMX regularly assists our listed companies in various ways, helping them

to better handle this aspect of their own operation. We have also forged relationships in the last year with several partners—advocacy groups, NGOs, and economists—to better understand the interplay of sustainability metrics and market dynamics. Last but not least, we hosted the U.S. launch of the Consultation Draft of the International Integrated Reporting Framework released on Apr. 16, 2013, by the International Integrated Reporting Council (IIRC). The IIRC is accelerating the market-led evolution in corporate reporting by producing the framework as a tool for businesses to create their integrated report. To date, the IIRC Pilot Program, with more than 85 world-renowned businesses and 30 investors, has been driving forward the development of the framework by feeding back their experiences to the IIRC while on the road to integrated reporting.

While we are in a unique position as an exchange, at NASDAQ OMX we practice the sustainability guidelines we are helping to frame and earnestly believe sustainability is an urgent issue for all companies. The importance of sustainability goes beyond the boardroom; it is imperative to determine how the sustainability requirements impact every business decision, as well as wherever it aligns to “the triple bottom line—people, planet, and profits.”

Succession Planning

Making certain the right skills are on the board and the executive management team for the future is critical to the stability of the corporation—and it takes careful planning.

BOARD SKILLS AND SUCCESSION PLANNING. Today the role is no longer an honorary appointment for retired CEOs. While there is some prestige and many perks that come with the role, directors also assume significant legal, financial, and personal exposure for their actions as a board member. Developing a pool of director candidates with appropriate talents must be an ongoing exercise.

First and foremost, the candidate needs to understand the time commitment. Of course, a good candidate would already have extensive experience as an executive, perhaps even in the same sector, and be able to contribute to at least one of the core board committees for audit, compensation, or nominating/governance. In addition, initially the candidate also would need to invest time in a director orientation program and by delving into understanding the company by spending time with various leaders and with internal and external auditors. Continuing the education process is also essential. The board candidate needs to understand the time commitment that will be required to maintain an ongoing and up-to-the-moment grasp on critical corporate issues via risk reporting dashboards, media intelligence feeds, and peer analysis. Add full board and committee meeting time, and it is a significant responsibility.

In addition, if one factors in making certain the company has a deep and robust pool of candidates with a variety of skills, diversity, independence, and experience with governance, then it is evident that developing the director pipeline requires constant attention from the current board.

EXECUTIVE TEAM SKILLS AND SUCCESSION PLANNING. Much like director recruiting, management team development and succession planning also require regular attention from the current board. Candidates need many of the same skills as directors but the board’s role is to regularly address and be encouraging the senior management team to be thinking about how to replace senior leadership

positions, as well as key leaders down the line. What are the skills, talents, and experiences that will enable the candidate to step into the position? And, is replacing one leader with someone similar the best option or perhaps it is time for a different style and skill set better suited to the company's needs and challenges ahead? An effective board will address these issues frequently.

Over the next several years, corporate directors must diligently address these pressing issues. It is likely trends toward more litigation, regulation, and complex corporate structures will continue to increase. Strong oversight from the boardroom will provide for appropriate review, capable management, and responsive corrections if necessary, to help companies steer through these challenges.

PAYING EXECUTIVES FOR DRIVING LONG-TERM SUCCESS

By Pearl Meyer & Partners

Now that executive pay is irrevocably a public issue, there's no shortage of advice and information available to compensation committees about how to improve the relationship between pay programs and shareholder returns. The advent of required say-on-pay votes three years ago has upped the stakes for boards, providing added impetus to directors to improve their understanding and oversight of all executive compensation programs, but especially performance-based incentives.

That's to the good. The problem is that so much guidance of late is predicated on classifications of "best" and "problematic" pay practices. Not surprisingly, the result has been widespread adoption of seemingly safe, one-size-fits-all pay structures demonstrated by formulaic analyses and check-the-box lists that have the desired optics to gain proxy advisory firm approval and result in successful say-on-pay votes. It's generally assumed that deviating from those standards—such as exercising discretion to allow a bonus payout although performance fell short—is most likely a symptom of poor pay governance.

But sometimes, going outside the bounds of what is defined in the marketplace today as good practice is *precisely* the right thing to do. In doing so, however, committee members can expect to face deep skepticism from outside observers that can only be allayed by making the strongest possible case for how their decisions specifically support the types and levels of performance needed to drive the company's long-term success. They must convince shareholders that over the long run, executives will be rewarded fairly and proportionately to what they achieve.

How? The often-overlooked key factor in effective pay for performance is context. The linkage of executive pay and shareholder value is not a one-shot accomplishment that is easily identified by a litmus test. Rather, it's an overreaching philosophy that should be baked into all three elements of compensation decision making: diagnosing the problems to be solved; designing programs and processes; and delivering the desired results, including communicating them to concerned parties. Adopting a more holistic approach to creating responsible and responsive executive pay programs puts compensation committees in a better position to tailor practices to their organizations' particular culture, strategy, and business model. Equally important, it builds in flexibility to deviate if appropriate from popular standards and even their own program metrics to accommodate new strategies or unexpected circumstances.

Diagnosis

The diagnosis challenges faced by the committee fall into two categories. One is how much and what forms of pay opportunity are required to attract and retain the talent needed to achieve the company's objectives. The other, equally important need is choosing what performance metrics should be the basis for establishing actual payout opportunities. Both require analysis of internal and external sources of information that can yield unexpected and even counterintuitive results.

The amounts of and vehicles for compensation opportunities are determined based on competitive market practice and what the company can afford. The committee should understand key internal considerations, including turnover; leadership talent needed to address current needs and meet future objectives; business and investment cycles in key businesses; and key features of the company's culture (especially as they relate to decision making, risk taking, rewards distribution, and various aspects of team versus individual behaviors).

When we turn to the external dimension, we immediately encounter the concept of peer group selection—a time-consuming and controversial topic that gets far more external attention than it deserves. (Absolute pay levels generally get the most public scrutiny, even though the relationship of pay delivery to company performance should be paramount.) The purpose of the peer group is to provide the committee a basis for establishing target levels of pay and testing the reasonableness of potential pay opportunities relative to different levels of performance. They also provide much-needed information on what competitive pay program structures look like, in terms of both how pay is earned and distributed over time, and how opportunity is apportioned across different vehicles (e.g., annual bonus, stock option award, and/or retirement income).

In assembling a peer group, the committee should focus on choosing relevant companies with a reasonably clear similarity in terms of revenue, market capitalization, organization, structure, the complexity of technologies used, financial structure, and business cycles. A critical caveat, however, in the committee's reliance on data based on a peer group—or from any other company—is that all compensation is ultimately contextual. That is, executive pay is just one of several interacting operational and reward systems that companies should use to drive results. Changes made to the workings of a compensation program can easily and unexpectedly affect another company system.

For that reason, it's critical that the committee consider internal and external sources of information in addition to just the peer group when establishing performance metrics and setting goals. These might include the company's strategic plans, budgets, and/or annual operating plans. External analyses of peer performance over time generally will yield good data on what financial and operating measures are associated with various levels of total shareholder returns (TSRs) over time. The incentive compensation plan features, including performance measures of peers are useful to know, but the statistical tests of pay-for-performance relationships over time will be more useful and reliable than market prevalence. Most traded companies are covered by investment analysts, who are very open about what measures they use to predict future success in the race for strong shareholder returns.

Design

In approaching the design of executive compensation programs, compensation committees should keep three goals paramount: properly calibrating realizable pay with actual performance; balancing short-term performance risk with long-term retention needs; and balancing line of sight objectives with accountability for TSRs over the long run.

The first is the need to calibrate pay to performance. A lot of time is spent on setting target pay and target performance goals, but in almost all cases the results will be above or below the targets set. Pro forma realizable pay modeling can be used to predict the level of compensation that would actually be delivered to the executive for various levels of performance. That would

include a forward-looking view to what level of performance is required to max out under the plan, or the value to the executive, for example, for hitting a particular level of performance in year three. A realizable pay analysis also can reveal whether a performance-based plan is appropriately symmetrical (i.e., that it offers a significant downside, as well as a big upside, in design and in practice). Additionally, it can illustrate whether the rewards for incremental levels of success are fairly apportioned between management and shareholders.

There is a natural tension faced by committees in program design: balancing external pressures to tie virtually all of executive pay to short-term and intermediate performance, as measured by shareholder returns, with the need to grow and retain leadership talent over the long term. While a significant portion of those long-term pay opportunities can have some associated risk, companies have to retain talent through down periods in the business cycle and through trying periods of organizational change. Time-based equity and even retirement plans can play a role, but are likely to attract criticism that they insulate executives from the consequences of lagging current performance.

There is also a major philosophical issue in performance-based programs design: balancing line of sight with shareholder accountability. Most shareholders are impatient for current returns, trading in and out of specific equities in order to maximize their total portfolio returns. Directors are obligated to be more patient and focused on the long term, since they cannot trade in and out of executive talent at will. For many shareholders, company success is defined almost exclusively by TSR results. The most successful incentive plans, however, are often those that measure and reward performance against the underlying company strategies that create shareholder value. Committees must decide to what extent executives' incentive payouts should be determined by an executive's success in meeting goals within their control, versus rewards that directly reflect short and intermediate gains for shareholders.

Boards can meet these competing needs by blending the use of pay vehicles that recognize different dimensions and time frames of performance. For example, the value of time-based restricted stock and stock option awards aren't necessarily a function of individual performance and, for better or worse, may be influenced by market trends not directly related to the company's performance. Yet, shareholders like equity-based pay, it creates a direct linkage of executive and shareholder interests. Alternatively, basing payouts on performance relative to peers, or basing payouts on metrics other than share price, such as meeting key business plan objectives, can help retain and motivate highly valued executives during times when the stock market doesn't necessarily reward their efforts. These non-equity incentives can really focus the management team's priorities and drive performance, but the committee needs to be able to explain to shareholders how paying for these "interim" goals will ultimately create value for them as well.

Generally, it is more feasible for the committee to strictly observe the parameters of a performance plan in making payouts when a company's leadership consists primarily of long-serving, career-oriented managers willing to ride out the highs and lows of the business cycle. But top managers who are mostly outside hires are likely to lose patience in the face of multiple years of below-target payouts. If the board determines that retaining executives who made a best effort is a priority, it may need to allow for incentive payouts or retention awards outside the performance plan.

Delivery

The first rule of effective delivery is to follow the rules of the plans in place. Shareholders object to awards made in excess of those earned under plan rules, such as when discretion is used to reward executives when goals are not met. Participants object when they believe earned awards are not forthcoming because the committee got cold feet. Fair and consistent treatment on both the upside and downside is paramount in establishing continuing plan credibility.

Nevertheless, the effectiveness of even the best designed and administered short- and long-term incentive programs is easily undermined by poor communication to the board's two major constituencies: shareholders and participants.

Many directors and service providers continue to argue that compensation is an ordinary course of business decision that shouldn't need to be defended to shareholders, which clearly is not the current reality. Yet we regularly see proxies and other disclosures that still rely on generalized boilerplate language or, at the other extreme, overly technical plan descriptions that are difficult to penetrate. Neither approach provides what shareholders need: a detailed but clear, direct, and persuasive account by directors of the underlying rationale for specific program choices.

The compensation committee must demonstrate that executive pay is meaningfully aligned with investor gains over the long term—even if in the short run or in a given year, executives may appear to have gained at shareholder's expense. Even the most cynical observers can be persuaded if what companies are saying is credible. Having said that, there is no question that directors should pick their battles: there is no justification for continuing to use highly controversial practices (such as gross ups for change-in-control excise taxes) that are of no practical value to the company and only infuriate shareholders.

Similarly, the effectiveness and internal credibility of incentive plans depends upon every participant being aware of exactly what level of performance is required of him or her for each level of reward. For years, companies have operated under the assumption that plan participants understand what they need to do to maximize results under the plans in which they participate. We find in talking to many plan participants that this is not the case. While this issue isn't technically the board's responsibility, members should question key managers about whether plan objectives and the paths to success are clearly understood.

Managing executive compensation in today's intensely competitive and public environment is challenging for both the board and management. Their goal should be to correctly diagnose the needs to be met by the program, ensure the resulting program properly balances competing objectives, and both delivers and effectively communicates the results. Such an approach will best position compensation committees to meet their fiduciary duty to provide rigorous oversight of pay programs that are effective over the long term and ultimately serve the best interests of shareholders.

WHAT BOARDS SHOULD FOCUS ON IN 2013

By Weil, Gotshal & Manges

With increases in shareholder influence and activism, and unprecedented federal regulation of corporate governance, pressures on boards continue to expand. Yet, the capacity of boards to meet rising expectations remains constrained by the part-time nature of board service and the independent outsider status of the vast majority of directors. The time required for outside directors to prepare for and attend board and committee meetings and to stay up to date about the company is a valuable and limited resource. In addition, outside directors must rely on others for the information necessary to fulfill their responsibilities.

Even with the broadening of corporate governance regulations over the past decade, the fundamental legal responsibilities of the board, which are imposed by state corporate law, have not changed. The board is charged with managing and directing the affairs of the company. State law does not specify how the board should carry out this mandate, but rather imposes fiduciary duties on individual directors. This allows a degree of board self-determination within the flexible fiduciary framework of prudence, good faith, and loyalty.

Nevertheless, more is expected from boards than ever before, especially in the areas of compliance, risk management, and disclosure. Boards need to meet the expanding expectations of regulators, shareholders, and the public, while maintaining focus on key board responsibilities. Given the inherent tensions in this dynamic, boards should focus on those areas where they can provide the most value to the company. An annual review of the board agenda (including committee work) can help align the board's efforts with the company's needs and priorities, consistent with the legal framework that defines the board's responsibilities.

Company Strategy and Management Performance

In managing and directing company affairs, boards must encourage entrepreneurial risk taking by management, consistent with an agreed-upon strategy, while also actively overseeing management performance. The board is responsible for:

- Approving major corporate plans, strategies, and objectives.
- Evaluating and approving major transactions.
- Monitoring the company's performance in light of those plans, strategies, and objectives.

It is critical for boards to achieve the right balance between guiding and supporting management, deferring to management on day-to-day operations, and holding management accountable for results. The appropriate balance changes with the circumstances.

The primary challenges boards face in overseeing strategy and performance include:

- Managing the board's agenda to reserve the majority of board time for strategy- and performance-related matters.
- Helping management anticipate both abrupt and long-term changes in the company's economic, political, and social environment.

- Prodding and testing key management assumptions, including those concerning risk.
- Taking an active role in strategic planning while maintaining objectivity.
- Supporting appropriate long-term investment and prudent risk taking versus short-term pressures for immediate returns.
- Determining and applying performance benchmarks.

Boards need to be especially sensitive to the interests of activist shareholders, who will likely express different views as to what constitutes the appropriate strategic direction for the company and may press for changes to suit particular short-term goals that may not be in the company's long-term interests. Successfully withstanding these pressures largely depends on the board's ability to effectively communicate its long-term approach to core strategy and performance issues, including through periodic filings and proxy statements and targeted shareholder outreach efforts.

CEO Selection, Compensation, and Succession

Boards typically delegate significant authority to the CEO to run the company and to define and develop company strategy. Boards, however, must:

- Select the CEO.
- Set goals for the CEO and other senior executives and compare company performance with those goals.
- Establish CEO compensation.
- Plan for CEO succession.
- Make changes when appropriate.

Key challenges for boards related to CEO selection, compensation, and succession include:

- Providing appropriate support, guidance, and deference to the CEO while maintaining objectivity about his performance.
- Resisting the tendency to become complacent about CEO and senior management performance when the company is doing well.
- Designing compensation to attract and retain talent while aligning it with performance (easier in good times than in bad).
- Understanding and addressing shareholder viewpoints about executive compensation, without substituting shareholder views for fiduciary judgment.
- Considering the CEO's contributions in the context of those made by the broader team.
- Discussing succession planning on a regular basis, even when the CEO is still relatively young, new, or high performing.
- Ensuring that company disclosures adequately communicate to shareholders the board's views on and activities regarding compensation and succession planning.

Boards should overcome the natural discomfort with raising succession issues and be prepared to make succession decisions when the need arises, in line with the company's long-term plans and

in an efficient manner. This requires spending adequate time—despite other, pressing demands for their attention—developing and assessing internal candidates, as well as searching for sources of potential external candidates.

Internal Controls, Risk Oversight, and Compliance

CONTROLS AND RISK. Over the past decade, significant regulatory and judicial attention has been given to board responsibilities for internal controls, risk oversight, and compliance. Challenges that boards face relating to internal controls, risk oversight, and compliance include:

- Ensuring that time is devoted to these important issues without allowing them to overtake the board agenda.
- Using board committees to efficiently address these critical issues while keeping the entire board informed and involved.
- Understanding the board's role in risk oversight and in management's risk monitoring information, reporting, compliance, and control systems.
- Remaining vigilant in looking for red flags.
- Attending to the ethical culture of the company and creating incentives for management to establish and maintain it.
- Ensuring the adoption of appropriate standards of CSR.
- Monitoring compliance with legal and ethical standards.

ETHICAL CULTURE. Intertwined with the oversight of risk management and compliance are ethical culture and CSR issues. Given the centrality of an appropriate ethical culture to effective governance, risk management, and compliance, board and management attention to corporate culture is time well spent. Boards should:

- Review company policies and controls on unethical and illegal conduct, confidentiality, and communications.
- Identify and periodically review significant risks to business operations, financial condition, and reputation.
- Monitor ongoing litigation and patterns of litigation risk.
- Emphasize to management the importance of integrity and ethics in all areas of the company's business and in all disclosure and dealings with regulators.
- Assess the board's confidence that management will bring to its attention ethical dilemmas relating to operations, strategy, or transactions.
- Evaluate the corporate culture and consider ways to improve it.
- Consider CSR issues in relation to risk and corporate culture.

Boards should continue to monitor and assess corporate culture and the effectiveness of compliance systems closely in 2013 and, as they do so, face two main challenges:

- Establishing a corporate culture that adequately encourages internal reporting of concerns.

- Supporting an effective internal compliance system that does not discourage employees from reporting directly to the Securities and Exchange Commission (SEC).

Boards should work with management to ensure, through messaging and communication, that the corporate culture is one that, among other things, encourages employees to come forward with concerns and that internal reporting is expected, valued, and critical to the company's success. This is particularly important in light of the whistleblowing incentives offered by the SEC for the provision of original information on violations of federal securities laws, including the Foreign Corrupt Practices Act.

Constituent Relations

The primary challenge for boards in 2013 will be to act as prudent fiduciaries, applying independent and objective judgment in the face of shareholder pressure. At the same time, boards must reach out to shareholders and other key constituents to understand their views and explain board decisions.

BOARD FIDUCIARY DUTIES. Directors should bear in mind when communicating with shareholders that the board has a fiduciary duty to act in the best interests of the company and the shareholders as a whole. Director duties may not be abdicated or delegated to shareholders if an issue is one that is reserved by law for the board, even when a majority of shareholders have a clear preference on the issue. Of course, shareholder views are important and should be considered by the board. They, however, cannot replace board judgment on managing and directing the affairs of the company, including matters such as:

- Strategic direction.
- Executive selection, compensation, and succession.
- Risk oversight.
- CSR.
- Dividend policy.

With greater influence and an increasing number of issues on which to vote, shareholders are finding it difficult to evaluate issues on a company-specific basis. The traditional approach of voting with board and management recommendations (except in cases of poor performance or unusual circumstances) is no longer followed by many shareholders. Instead, shareholders are relying more on voting guidelines based on governance policies recommended broadly by proxy advisors (see Preserving Balance box on page 28). Institutional investors with portfolios of hundreds or even thousands of companies and an active investment strategy often outsource voting decisions to these proxy advisors, further separating ownership interests and voting power.

To counter these trends, boards and management should:

- Spend more energy on communicating decision rationales in the context of company-specific circumstances.

- Understand what the company's large, long-term shareholders care about, given their expanding powers.
- Engage with shareholders prior to the proxy season to understand shareholder concerns on executive compensation and other shareholder proposal topics to offset and rationalize shareholder pressures.

Boards need to understand and be responsive to shareholder concerns while individual directors act as prudent fiduciaries applying their own independent judgment. Shareholder pressure for greater rights and influence through say-on-pay votes, shareholder proposals, and director elections are expected to continue in the 2013 proxy season.

SHAREHOLDER ENGAGEMENT. Boards need to identify the company's key shareholders and the issues about which they care most. Together with management, the board should make extra efforts to engage with these shareholders. Effective engagement often requires moving beyond management's typical investor relations focus. Dealing with proxy advisors is necessary but not sufficient. While engaging with buy-side analysts and proxy advisors is important, it should not be confused with getting to know the company's large institutional shareholders and, in particular, the persons responsible for voting proxies and setting the governance policies that often drive voting decisions.

Boards should reassess their approaches to shareholder relations and strive to improve communications with shareholders. Specifically, boards should seek to enhance communications relating to:

- Board composition, executive compensation, board leadership, and other key governance practices.
- Significant substantive matters, such as company strategy and risk management.

Enhanced shareholder communications should be designed to:

- Provide the board with an early warning about perceived vulnerabilities and shareholder concerns.
- Encourage investors to make company-specific voting decisions.

Board Governance Structures and Processes

In 2013, boards should focus on board governance structures and processes, including by:

- Establishing the board's own governance principles, leadership, and committee structures and charters.
- Nominating directors who can satisfy the need for diverse skills, experiences, and backgrounds for independence.
- Evaluating the performance of the board and its committees and members in an effort to improve it.
- Overseeing the company's relations with key constituents.

Board composition should relate to the company's strategic needs, which change as the company and its business environment evolve. In addition, shareholders and key constituents are interested in the value that diverse perspectives bring, including those related to gender and racial diversity.

Boards should assure that their culture and processes provide sufficiently for change. They should evaluate board composition as the company's strategic direction evolves and assess individual director capacity and contributions annually using appropriate criteria. Undue reliance on term and age limits, for example, may lead to the premature termination of high-performing directors, while also setting an expectation that all directors will serve until the limit regardless of their contributions.

Board self-determination begins with an understanding and discussion of the board's role, and can enhance board cohesiveness and credibility with shareholders.

PRESERVING BALANCE IN CORPORATE GOVERNANCE

Board and shareholders need to work to restore trust in our system of corporate governance generally and in relations between boards of directors and shareholders specifically.

Directors need to remain mindful that shareholders have legitimate interests in the governance of the company and that this includes communicating their concerns to the board, whether via shareholder proposal or some other method of engagement. At the same time, the board needs to know who the company's shareholders are and whether a vocal shareholder seeks to promote interests that are broadly in keeping with the company's long-term interests and the interests of other shareholders. Are they long-term shareholders or short-term traders, for example? This information is critical not only in engaging shareholders but also in exploring how to better communicate corporate strategies to attract the type of long-term shareholders that most companies want.

Shareholders, for their part, need to appreciate that while their views are important and valuable—and should be taken into account in board decision making—companies cannot be managed efficiently by shareholder referendum. Precatory or advisory votes are important in giving shareholders a voice with respect to subjects on which they have legitimate interests but generally lack decision rights, such as executive compensation. The nonbinding nature of votes on precatory proposals underscores that boards should consider the vote outcome but not be bound to take the advised action if directors believe that an alternate course is in the best interests of the company. Shareholders should be especially wary of proxy advisor policies that threaten to make precatory proposals that receive a majority of votes cast effectively compulsory, thereby shifting decision-making power from boards to shareholders. The rapid rise of powerful proxy advisors is the unforeseen—and yet-to-be-addressed (by the SEC)—accelerant in the increasing tensions between boards and shareholders. The coordinating impact and rigid influence of the proxy advisory firms risk upsetting the delicate balance between board and shareholder responsibilities—and may undermine the ability of boards to govern effectively.

APPENDIX: STRATEGIC PARTNER DESCRIPTIONS

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