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Eleanor Bloxham, Editor-in-Chief

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In the News

By Eleanor Bloxham

Worth reading:

- SEC Commissioner Luis Aguilar has suggestions for boards on proxy disclosure this season including important comments on compensation and risk: read it here
- Investors will be using a new guide called Investing the Rights Way to help gauge human rights at companies. Look at the questions for companies (Appendix 1) and information on reporting: read it here
- The SEC will be rolling out an automated means to catch accounting fraud: read about it here

Lessons for boards from the London Whale

By Eleanor Bloxham

All board members (not just bank directors) will gain insights on risk oversight from the Senate's bipartisan report (and related exhibits) on the JP Morgan London whale: get the documents here.

The last fifty pages of the report address failures to disclose, which should be of interest to all audit committee members. The report also provides insights on what is required in overseeing CEOs. JP Morgan emailed me that "While we have repeatedly acknowledged mistakes, our senior management acted in good faith and never had any intent to mislead anyone."

To understand why the London Whale might concern a non-bank board, below are edited snippets and summaries based on the report's 900 pages:

Jan. 16-20, 2012: [Synthetic credit portfolio] trading causes a **four-day breach** in bank wide [value at risk]; breach **reported to [CEO] Jamie Dimon**. (Mr. Dimon's testimony to Congress on June 13, 2012 did not disclose this.)

Jan. 23, 2012: **Dimon and Chief Risk Officer John Hogan approve** a temporary bank wide [value at risk] **limit increase to end the breach**; [Dimon and Hogan are] told **a new …model will reduce [reported value at risk] by 44%.**

Jan. 27, 2012*:* New … model approval is rushed through and **drops [reported value at risk] overnight by 50%. Hogan emails Dimon** on Jan. 28, 2012 to let him know that "This should be the last day of firmwide [value at risk] breach… model change is planned to go in this week-end." (In testimony on June 13, 2012, Dimon says," the new model [allowed] more risk and it contributed to what happened.")

Late Jan. 2012: [Synthetic credit portfolio] losses escalate. **Mr. Dimon orders bank to stop giving [investment office profit and loss] data to OCC** [i.e. bank regulator]; OCC objects; Chief Financial Officer Doug Braunstein restores data, **angering Mr. Dimon**.

April 5, 2012: [In advance of news stories set to appear], Joe Evangelisti, managing director and head of worldwide corporate communications and media relations, [sent emails with talking points -- and revised talking points.] Mr. Dimon responded to Mr. Evangelisti's proposed talking points with "Ok."

The Evangelisti email and talking points indicate that, **from the beginning** of the bank's public discussion of the [synthetic credit portfolio] in April 2012, **JPMorgan Chase planned to describe the portfolio as a risk-reducing hedge that was transparent to the bank's regulators, even though neither characterization was accurate.**

Apr. 6, 2012: Bloomberg and Wall Street Journal report whale trades. [Read the articles: JPMorgan Trader's Positions Said to Distort Credit Indexes and 'London Whale' Rattles Debt Market]

The Bloomberg article said: "A JPMorgan Chase & Co. (JPM) trader of derivatives linked to the financial health of corporations has amassed **positions so large that he's driving price moves in the $10 trillion market**, traders outside the firm said."

April 10, 2012: **Email from Ina Drew to Mr. Dimon** and others: The [mark to market] **loss is 412 [million] today**.

The cumulative year-to-date **losses then jumped to $1.2 billion**, the first time the cumulative … losses had crossed the $1 billion threshold. Due to the media attention and escalating losses in the synthetic credit book, **Ina Drew, CIO, set up daily conference calls for the next two days (leading up to the quarterly earnings call) with Jamie Dimon** [and others].

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April 11, 2012: [Mr. Dimon reviewed information that showed the synthetic credit portfolio was not a hedge.]

Apr. 13, 2012: [Synthetic credit portfolio] reports **$1.2 billion loss**. Bank files 8-K form previewing first quarter earnings and holds earnings call. 8-K filing discloses [value at risk] **results, but not the January change … [to the] model.**

Bank CEO Jamie Dimon calls whale trade stories "a complete tempest in a teapot."

The evidence … indicates that, **when he made that statement, Mr. Dimon was already in possession** of information about the[synthetic credit portfolio's] complex and sizeable portfolio, its sustained losses for three straight months, the exponential increase in those losses during March, and the difficulty of exiting the … positions.

In describing the [synthetic credit portfolio] on the earnings call, both Mr. Dimon and Mr. Braunstein **omitted mention of a number of key facts**. … compared to the prior quarter, the [synthetic credit portfolio] **had tripled in size from about $51 billion to $157 billion** …the portfolio's largest position **would take 10-15 days of selling at 100% trading volume to exit**, … and had switched its overall position from short to long a direction **inconsistent with its purported hedging purpose**.

Apr. 19, 2012: OCC inquires for first time about …breaches, including [one] **breach of over 1,000% for 71 days**.

[In a] May 2012 internal email …, one OCC examiner referred to the [synthetic credit portfolio] as a "make believe voodoo magic 'composite hedge."

May 10, 2012: Despite the bank's increasing grasp of the [synthetic credit portfolio's] concentrated complex, and deteriorating positions, after the April 13 earnings call the **bank did not publicly discuss** [the portfolio]again **until nearly a month later**, on May 10, 2012, when the bank filed its 10-Q form with the SEC finalizing its first quarter financial results.

[The bank] held a "business update" call and [**Mr. Dimon calls** the synthetic credit portfolio] **a hedge [multiple] times**.

[For the first time,] Mr. Dimon described the change in the [value at risk models]. [**Mr. Dimon** said the bank] made "constant changes and updates to models, always trying to get them better," but **did not disclose** that the bank had reinstated the old … model because the "update[d]" [one] had **understated risk by a factor of two**, was **error prone**, and suffered from operational problems.

The lO-Q filing does not clearly disclose that [the model had changed].

[On the call, **Mr. Dimon discloses** that the synthetic credit portfolio is] in much worse shape [than] disclosed a month earlier… **lost $2 billion in second quarter**.

(Internally, losses [were] reported as $2.8 billion.)

During the May 10 call **[Dimon]stated that he was "not going to make calls every time the number moves around, by $0.5 billion"**, and, in fact, **he did not disclose publicly the next day's loss**, even though it increased the … reported losses after a single day by **another 25%.** (In **July 2012, JPMorgan Chase restated the… first quarter losses, pushing the $660 million in losses** that would have been reported in the second quarter **back to the first quarter instead**.)

July 13 ,2012**: Bank restates** first quarter profits, disclosing **additional losses of $660 million** [in synthetic credit portfolio].

These snippets provoke the following questions for all kinds of boards:

1. Does your board have protocols to receive notification when the company breaches control limits or the CEO decides to change those limits or the models that underlie reporting of risks?
2. How does your board oversee regulatory relations?
3. What standards has the audit committee conveyed related to transparency and accuracy of reporting?
4. Do board members independently keep up with news on the company to monitor risks?
5. How do you get good performance information with which to evaluate the CEO?

Let's Integrate Compensation with Risk

By Tama Copeman, Chair of the Board of Mid Atlantic Diamond Ventures,
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Corporations face never-ending threats to their established businesses.

At nearly 2/3 of all corporations, the full board has the primary responsibility for risk oversight (with delegation to its committees), according to a Spencer Stuart 2012 survey. These board risk discussions cover financial, IT, reputational, and regulatory risks, among others.

But a subject receiving less attention in boardrooms is the organization's ability to adapt to disruptive threats in the competitive landscape -- and the impact of corporate compensation packages on the organization's ability to adapt.

Most corporations easily grasp the standard dynamics of rivalry among existing industry competitors for market share and profitability And directors are aware that competition can come from suppliers and customers also. (If the company's position is weak, suppliers and customers may work into your space and cut you out too.)

Business and operational management (including, sales, marketing, manufacturing, purchasing) seek to address these well-recognized threats. And most often, executives in these functions have performance objectives, and corresponding incentive pay, linked to straightforward factors, like improvements in revenue, profitability, reliability, and safety, of existing product lines.

But companies today increasingly face bigger perils that change the game. The risks of substitute products or services or of new entrants into the industry represent potentially disruptive and non-linear threats. Technology and new-business-development managers generally concentrate on these concerns. And their performance objectives, and associated incentive pay, focus on

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introduction of next-generation and step-out products. These step-outs frequently require the establishment of new business models and markets as well as changes in manufacturing and supply-chain sourcing, as examples.

But despite the growing relevance of the non-linear risks, boards and senior teams too often focus their primary attention on keeping the existing business running. In fact, step outs are often viewed as a distraction.

As a result, too often, corporations are slow on the draw. In fact, the case for substantial change has to be compelling for companies to drive a potentially disruptive product into the market or respond to new forces. Examples abound, including letting niche and inferior products establish a foothold in the low end of the market and grow. (Think, Clayton Christensen, The Innovator's Dilemma.) Now cloud computing, social media, big data, new materials, and diagnostic tools, among others, are part of the fast-paced change.

Delays from organizational misalignment can be damaging. And the disparity in objectives and incentives come to a head in the C-suite, ultimately residing with the CEO.

Boards can help solve this conundrum by establishing a dialogue that includes not only current competitive dynamics but also potential disruptive threats. Within that broader conversation, boards should ask the CEO to set cross-functional performance objectives, that address routine as well as non-linear threats – and ensure pay is aligned with these objectives. While this may sound difficult, the way many large industrial companies, like DuPont and Chevron, have implemented effective cross-functional safety programs can serve as a model for what boards need to do.

Part of the board's oversight role is to understand how the organization's compensation packages align with the broad competitive landscape. In doing so, the board needs to ensure the organization takes all appropriate threats seriously, and balances those objectives, while not undermining the existing businesses.

What Boards Need to Know About Political Accountability

By Sol Kwon, Associate Director,
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Board oversight of political spending is essential to ensure that spending decisions are made in the best interests of the company and its shareholders; protect companies from reputational, legal or business risks; and do not represent a use of company funds to foster executives' own political agendas. The issue is one shareholders care about and many companies will be seeing shareholder proxy proposals on this issue this year.

Voluntary reporting of corporate political spending has become a mainstream practice for U.S. companies. The *CPA-Zicklin Index of Corporate Political Accountability and Disclosure* demonstrates how well the top 200 companies in the S&P 500 have performed on a set of 24 indicators that cover the companies' disclosures, policies and oversight of political expenditures. The Index then ranks the companies on their performance.

Merck and Microsoft were the highest scoring companies in the 2012 Index, receiving 97 and 94 respectively on a 100 point scale. Fourteen companies received scores of over 80 in the 2012 Index. In the second-tier were 46 companies that scored between 60 and 79; and 34 companies scored between 40 and 59, putting them in the third-tier. (See Page 30 of the 2012 CPA-Zicklin Index for the complete ranking.)

From March to May of this year, the Center for Political Accountability will be constructing the *2013 CPA-Zicklin Index* using publicly available information on corporate political spending from company websites. The Center then gives each company an opportunity to review the resulting information and make any corrections or changes, in July. Last year, almost half of the 200 companies included in the Index provided feedback to CPA during the review period, making the report more accurate and inclusive. CPA expects to publish its 2013 findings in the early fall.

The 24 indicators used in the Index include three main categories: "Disclosure" indicators measure the actual spending information the company reports voluntarily, including recipients and amounts; "Policy" indicators capture descriptions of how the company manages political spending; and "Oversight" indicators review how the board and the company supervise political spending.

While most of the Index's indicators receive a score of two points each, a few are weighed more heavily and known as key performance indicators (or KPIs). Four-point KPIs include company disclosures of contributions to candidates, parties, committees, 527 organizations including super PACs, and ballot measures, as well as whether the company has a detailed policy on corporate political spending. Six-point KPIs include disclosures of indirect political spending through trade associations and other tax-exempt organizations such as the 501(c)(4) groups.

The 501(c)(4) groups, dubbed "social welfare organizations," gained importance after the Supreme Court's Citizens United decision because these groups do not have to reveal the sources of their funds as other political organizations do. While many traditional 501(c)(4) groups do not engage in political activities, a good number of them – such as Crossroads GPS, American Action Network and Priorities USA – specifically focus on political activities and raise money from anonymous sources. The Center for Political Accountability warned about the risks posed by such groups in "Dangerous Terrain," an article published in the Winter 2012 issue of *The Conference Board Review*.

As seen in the 2012 cycle, election spending by outside groups has broken records, heightening the need for corporate political accountability and disclosure. A post-election analysis of the Federal Election Commission (FEC) data found that at least $1.3 billion in outside money was spent, including more than $600.7 million spent by super PACs, about 11 percent of which were reportedly funded by companies.

In addition, $289.9 million – about a quarter of all outside spending – was

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spent by unknown sources, presumably by groups such as the 501(c)(4)s, according to the analysis. Trade associations reportedly spent more than $36.7 million in the 2012 elections.

Companies should adopt sound and intentional processes that allow them to clearly articulate their spending decisions and protect themselves. For directors, this means ensuring that their company has in place and, as importantly, adheres to good governance policies that promote responsible and transparent political spending in the best interests of the company and its shareholders. This includes providing a check on how much the company is giving from its treasury funds to whom, directly and indirectly, including spending through third-party organizations such as trade associations and 501(c)(4) groups, if any.

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