THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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In The News

by Eleanor Bloxham

(Please click on the links to access relevant articles.)

Proxy Access: Contrary to some fears, the sky did not fall this proxy season. Nabors received the first yes vote on a shareholder proxy access proposal this year, Bredan Reddall reported. And Chesapeake received the second, Russell Gold and Daniel Gilbert reported. Both have received low marks for good governance, though some changes are afoot.

Here is a useful chart of 2012 proxy access outcomes from James Morphy. Now that shareholders know how to word proxy access proposals so the SEC will accept them, companies that managed to exclude proposals this year are likely candidates for proposals next year. Unless they make in-roads with concerned shareholders, the excluders who may see proposals next year include Bank of America, Chiquita, Dell, Goldman Sachs, Medtronic, MEMC Electronics, Staples and Textron.

Longer term strategy?: AOL fended off an attempt by Starboard investments to put three directors on the board, according to a report from Hibah Yousuf. Starboard had issues with AOL's strategy, including the use of more professional paid staff to produce content. The Florida state pension fund, among others, supported Starboard's dissident slate.

Simon Says: Shareholders said no to the second largest pay package (next to Apple's) at Simon Property Group. Shareholders have not been fans of one-time and retention type schemes unless the company has produced seriously outsized returns for them (ala Apple). Citigroup lost its pay vote for similar reasons. Here's a wrap-up on pay votes this season from Nathaniel Popper.

Market Manipulations: Outspoken Barclays' CEO Bob Diamond stepped down amid a LIBOR rate fixing scandal that could engulf many more banks according to reports by Maureen Farrell and by Sara Schaeffer Munoz, Max Colchester, Jason Douglas, and Ainsley Tomson. According to a comment from Michael Kraten on this article by Mark Scott, Kraten and his colleagues had been publicizing the rate problem for four years.

In separate news, J.P. Morgan not only has its trading debacle to contend with. The bank is under investigation for manipulating energy markets, Katarzyna Klimasinska and Dawn Kopecki reported.

Pension funds: Vipal Monga reports that private pension funds face shortfalls as low interest rates have not translated into robust equity markets. Mary Williams Walsh reports on ways corporations may revise their pension plan contributions (to the benefit of government!). Here's a read on the public pension front from Julie Creswell who has been covering the move to higher risk investments to garner returns.

A Conversation with John Whitehead

by Eleanor Bloxham

In light of the Facebook IPO and the activity by companies to access public markets without public accountability, I spoke recently with John Whitehead, retired Co-Chair of Goldman Sachs.

EB: I know that you and I talked a few years back about the issue of one shareholder, one vote and how important it is.

JW: I am a strong believer in one share one vote. It's a psychologically important part of the free enterprise system. If you take away the vote from shareholders, they no longer have a fair way to throw out management. It is an important [check and balance on the system]…

Some managements do a good job. But those who do a good job don't need special voting arrangements. And those who do a bad job need active voting to keep them in check. There is no argument to be made for special voting in the case of Google or anywhere else…

Once you go public and have the advantage of public capital, you have a responsibility for sharing the control with your new stockholders. You need to represent those stockholders the best way you can. Investments banks shouldn't underwrite these stocks …

EB: What about fiduciaries who invest other people's money? I don't believe they should invest in the stock of companies that don't provide

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accountability mechanisms, like equal voting rights.

JW: I agree with that. Those mechanisms are important and fiduciaries should not invest in companies that don't provide them.

EB: When we talked several years ago, you were concerned about executive pay. What are your views now?

JW: Executive pay has been out of order and out of line. With effective shareholder rights, if executives are overpaid, shareholders can write letters and vote on that issue in favor of limits on top executive pay. We have seen what can happen when shareholders exercise their rights.

EB: What about boards today?

JW: Boards need to be more active. Directors need to play a bigger role in companies. They go along with management too often and don't play a great enough role. In too many cases, companies have problems and the boards don't do anything. That's why I prefer separation of the CEO and Chair over the lead director concept…

CEOs of public companies fear losing face in public but they can become isolated from what others think. I think most CEOs like to have a Chair they can talk to.

EB Postscript: All companies have a stake in the capital markets eco-system and can impact it. Just as companies take responsibility for their part in physical sustainability, they can take responsibility for their part in the capital-raising environment too. Here are other articles on fiduciary duty.

Boards and Leadership

By Paul Otte, Board Member, State Auto Mutual, Cooper State Bank and RC Olmstead Company, *otte@franklin.edu*

As a former accountant, I no longer bristle when I hear someone refer to leading people as a "soft skill". Why? We now have "hard data" to show a direct link between how employees feel and an organization's level of productivity, customer satisfaction, and employee retention.

The new term is engagement and it is estimated that around 30% of the workforce is engaged (consistently willing to provide discretionary effort), 50% is disengaged (generally doing enough to get by), and 20% is actively disengaged (may actually be working against their employers). To find out more go to: http://www.gallup.com/poll/150383/majority-american-workers-not-engaged-jobs.aspx

Further, the hard data shows:

- Unlike 30 years ago, the employer and employee bond has been broken. People now quit, but stay to collect a paycheck.
- There is a problem in *every* organization.
- Many factors contribute to an individual's level of engagement/disengagement. The most significant are: feeling supported, fairly evaluated, properly rewarded, recognized, trusted, respected, needed, cared about, and valued, along with being provided opportunities for career development.
- Disengaged people can become engaged. And engaged people can become disengaged. Engaging people requires a continuous, never ending effort.

Because, "the tone starts at the top," here are some suggestions for Boards.

1. Invest in your people (at all levels, not just the C-level). Organizations say "people are our most important asset," but typically treat them as a cost, not an investment. What do you know about your organization's investment in training and leadership development, tuition reimbursement, mentoring/coaching opportunities?
2. Intuitively we know people who view what they do as a "job" become less engaged than those who see themselves as pursuing a "career." Is your company helping people develop their careers?
3. Focus your organization's HR efforts on people, not processes. In too many organizations today the HR departments have become focused on legal, not people, issues. It might be time to consider a Chief People Officer and provide him, or her, a "seat at the table."
4. Recruit board members who understand engagement, its implications and how to raise the level of engaged employees. Provide a seat at your table for a "people person."
5. Decide for yourself the level of engagement in the organizations you serve (don't just rely on the surveys). Are people at all levels feeling supported, fairly evaluated, properly rewarded, recognized, trusted, respected, needed, cared about, and valued? Are all members of the board engaged? What about all the C-level people? Those (at any level) who aren't fully engaged themselves can not engage those below them.
6. Expect more from people. A Marine Corps recruiting poster says "All we ask of you is everything you've got. And we will let you know when you've given it." Are the people in your organization giving everything they've got? Are the C-Level people? The CEO? The Board? People know when you're not (and will not give all they've got in return).
7. Invest in your own leadership skills. Practice doesn't make perfect, but it does make better leaders. For more information: http://www.franklinleadershipcenter.com/leadership-practice

Effective Board Risk Oversight

By Tim Leech, Managing Director Global Services, Risk Oversight, *tim.leech@riskoversight.ca*

Risk Governance: Balancing Risk and Rewards , a 2009 National Association of Corporate Directors Blue Ribbon Commission Report which I highly recommend, describes six key elements (quoted below), which boards need to address to ensure effective risk oversight.

Boards need to address:

1. Whether "the risk appetite implicit in the company's business model, strategy, and execution is appropriate."

To address the company's current risk appetite, there are several practical steps boards can take.

Ask management to take a look at annual and medium term objectives and identify which have the highest level of residual risk or, stated another way, the highest level of uncertainty the objective will be achieved given the risks. Conduct the same review for annual and medium term targets (i.e. metrics). Ask for their perspectives on the specific risks in achieving each objective and target. Ask for their views on what is creating the uncertainty of achieving the objectives and targets. What do they see as the likelihood of those drivers? What are their views on the consequences of failing to achieve the objectives and targets?

Hold a candid discussion and analysis of the ability of the organization to cope if the risks identified materialize.

Schedule time to discuss what the organization's "risk appetite" actually is based on prior decision making. For example, what decisions have been made to accept risk that could result in working capital erosion? What, if any, decisions have been made where the negative consequence could be regulator infractions (e.g. FCPA, stock option backdating, environmental violations) financial statement restatements, or aggressive tax planning/execution strategies?

2. That "expected risks are commensurate with the expected rewards."

   Management generally does a good job describing "expected rewards". Many organizations lack rigorous processes to identify "expected risks". The risk that the U.S. real estate market was due for a major correction leading up to 2008 was very plausible. Clearly, many boards did not receive rigorous analysis of that risk and the impact on the companies with exposure to that risk.

   At a minimum boards should ask to see documented risk assessments of the company's foundation objectives (for example, obeying the law) as well as risk assessments of the company's key strategic business objectives. These risk assessments should identify both expected and plausible risks.

3. That "management has implemented a system to manage, monitor, and mitigate risk, and that system is appropriate given the company's business model and strategy."

   Boards need to gain a solid understanding of what varying levels of risk management sophistication look like. A simple "Risk Fitness" tool I developed can be downloaded here http://bit.ly/H88pXe. The goal should not be to have a high score. High risk management sophistication is expensive. The goal is to match the level of risk management process sophistication and maturity to the environment the organization operates in and management's strategies that expose the organization to risk. Organizations that are in a simple and stable industry don't need highly sophisticated risk management processes. The more dynamic, complex the business environment and financial instruments management uses, the more sophisticated the company's risk management processes should be.

4. That "the risk management system informs the board of the major risks facing the company."

   Because of Sarbanes-Oxley, many boards are used to receiving subjective opinions on "control effectiveness". Boards, however, need to demand that they receive regular risk ratings of core business objectives. A simple 10 level residual risk rating system with a 0 for Fully Acceptable (No changes to risk strategy required) and a 10 for Terminal (The current risk status is having material, disastrous impact and immediate top priority action is required from the board and senior management to prevent the demise of the entity) can focus attention where it is needed most.

5. That "an appropriate culture of risk-awareness exists throughout the organization."

   Risk-awareness needs to start at the board level and extend all the way down to the shop floor. Generally this awareness requires the implementation of some form of "enterprise risk management," ("ERM"), in which the company adopts common terminology to discuss and report on risk, defining specific accountabilities, providing adequate training, and adopting appropriate risk assessment and reporting tools.

6. That "there is recognition that management of risk is essential to the successful execution of the company's strategy."

   Board members generally recognize that managing risks is a key element of success – but are now recognizing that managing risk intuitively, without disciplined processes and framework, is insufficient today. Increasingly, rigor is required as a condition of doing business by regulators, credit rating agencies, institutional investors, customers, and emerging civil due diligence expectations.

More information can be found here. http://bit.ly/H0MGVw

Valuation and Performance Metrics Part Two

By Eleanor Bloxham

(This is the second in our ongoing series on Valuation and Performance metrics. See the January Digest for background.),

- Corporate boards must get metrics right if they hope to sit atop successful firms with great strategies and skillful execution.
- Board selection of the right metrics can be nearly as important as selecting the right CEO – and taking the time to determine the right metrics can help boards hire better CEOs.
- Boards need to act with some urgency. Metrics are poised to be even more in the spotlight next proxy season.

Discovering the right metrics to use in any given circumstance can be challenging. Companies that run on the wrong metrics -- and copycat ones at that -- may achieve what they set out to achieve. But what use is it, if they are chasing the wrong goals?

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Good Ol' Enron

Enron was a great example. Jeff Skilling campaigned for Enron's presidency publicly saying he could deliver earnings that didn't require capital, by taking Enron into the trading business. The board gave the nod to Skilling, but contrary to Skilling's campaign, the trading operations he sought to build (because of their inherent riskiness) actually required lots of capital. Without the right metrics (i.e. more nuanced measures of earnings based on the capital required for the risks taken on), the trading strategy he proposed did not receive the proper assessment -- and the risks of that strategy, including ethical risks, went unaccounted for.

Heating Up This Proxy Season From Unlikely Sources?

Some shareholders addressed metrics head on this year.

For example, Wal-Mart. Wal-Mart is not only in hot water for alleged FCPA (foreign corrupt practices act) violations. Even before those revelations hit, its board was under fire for the elimination of same store sales as a measure (and the use of other measures with easy to hit hurdles), James Covert reported.

In the case of Wal-Mart, a proposal from employees (who are also shareholders), won over 20% of the vote from shareholders who are not directors and officers. The proposal asked "that the Committee … annually analyze and report to shareholders on whether incentive compensation arrangements encourage investments that result in declining returns on investment, taking into account specified factors."

Metrics were also a part of the reason for the stunning no say on pay for Citi's board, according to reports by Donal Griffin and Bradley Keoun and by Palavi Gogoi.. The company took fire related to the pretax net income hurdles. And proxy advisor ISS raised other metrics objections as well.

Boards need to get out front on performance measures, as shareholders' attention to this area grows and actions ripple across the system.

The Myth of Alignment

Many shareholders continue to push the stock and stock option "myth of alignment" which has been debunked in recent years. Although payouts usually entail a "keeping up with the Jones" (aka peer) review and a few metrics hurdles, restricted stock and stock options aren't just a form of pay. They are a metric in themselves.

Individuals who receive restricted stock and stock options will be motivated to increase the volatility of the stock price, a December NY Fed staff report shows. While shareholders seem to like managers to focus on share price movements, it's not what CEOs should focus on. Why would a board knowingly defocus the CEO in this way?

But it's worse than that. CEOs paid in restricted stock and stock options take on excessive risks (although we don't see much disclosure on this). In addition, the NY Fed research determined that both these forms of payouts cause CEOs to take actions detrimental to the company. Multiplied across the system, these kinds of payouts increase economic instability, the NY Fed analysis says.

A Critical Job

Constructing the metrics for pay is more important than many recognize. Metrics define how the company behaves: what strategies CEOs propose and how they choose to execute them. In June, the United Nations issued a paper on integrating environmental, social and governance factors into executive pay. The report is here. Integrated reporting is also starting to gain momentum.

What should boards do? Define the attributes of a great company that creates sustainable value for all shareholders and stakeholders. Identify the best measures of those attributes and within those, the measures managers can control. (Personally, I like to look at the value created *for* each and *by* each stakeholder, as I outline in my book.) Then, evaluate the use of those measures in strategic and operational decision-making as well as compensation. Don't take a cookie cutter approach or follow others' leads. The discovery process is as important as the result.

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