Introduction

The Challenges in Corporate Governance project is one of the activities of the Governance Program at the Institute for Corporate Responsibility (ICR) at the George Washington University School of Business. The program, which began in 2010, examines the issue of what policies are associated with good corporate governance and promotes a dialogue on how those policies are translated into practice. The project is co-directed by John Forrer, Director of the ICR Governance Program and Dr. Cynthia A. Glassman, an ICR Senior Research Scholar. The programs are sponsored jointly with C-LEAF, the Center for Law, Economics, & Finance at GW Law School.

The panel discussions are conducted in the context of the role of the Board of Directors of public companies. In brief, in a public company, owned by a large and diverse set of shareholders, the role of the Board of Directors is to oversee management in order to protect the company and interests of the shareholders. The Board is elected by the shareholders and has a fiduciary duty to them. Their key duties are:

- A duty of care – which means they are expected to get sufficient information and fully deliberate on Board decisions
- They also have a duty of loyalty, which means they must act in the best interests of the shareholders and the company
- They must act in good faith
- And they must maintain confidentiality of any information that has not been disclosed to the public.

The roles of the Directors include:

- Review of corporate strategy
- Developing a plan for CEO succession
- Setting appropriate tone at the top
- Setting CEO and other senior executive compensation
- Overseeing compliance, risk management, and financial reporting

The panels have addressed the following subjects:

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1. The Case of Conflict Free Minerals

On December 2, 2010, the ICR conducted its first program on Challenges in Corporate Governance. The purpose of the panel was to explain the role of public company board directors from a practical perspective using the new conflict minerals requirement of the Dodd-Frank Act (2010) as a discussion catalyst.

Background

The panel discussion was opened and moderated by Catherine Dixon of Weil, Gotshal & Manges LLP, who provided an overview of the roles of Boards as well as an overview of the conflict minerals provision. Catherine is a partner in Weil’s Washington, D.C. office and a recognized authority on the federal securities laws. Her practice encompasses public and private company disclosure advice, capital markets transactions (including public and private offerings), mergers and acquisitions, corporate governance and compliance-related matters. Ms. Dixon is a member of Weil’s Public Company Advisory Group. Prior to joining Weil, Ms. Dixon was Chief Counsel of the Division of Corporation Finance at the U.S. Securities and Exchange Commission (SEC). She previously served as Chief of that Division’s Offices of Mergers & Acquisitions and Disclosure Policy (rulemaking), respectively, and as Counsel to SEC Commissioner Steven M.H. Wallman.

The panelists were the following:

**George Munoz** is a well-known international business and finance person. He is a co-founder of Muñoz Investment Banking Group, which is focused in the global emerging markets. He sits on a couple of prominent public companies including Marriott International and the Altria Group. He is also on the Board of National Geographic Society, and a Member of the Financial Accounting Standards Advisory Council. He has served in senior positions in the United States Government as an Assistant Secretary of the U.S. Treasury and as the President and CEO of the Overseas Private Investment Corporation, or OPIC, and he was named by President Obama to the President’s Commission on White House Fellows.

**Donald Nicolaiesen** currently serves on the Board of Directors of Morgan Stanley, MGIC Investment Corporation, Verizon Communications Inc. and Zurich Financial Services. Mr. Nicolaiesen also serves in a variety of advisory capacities to other companies. At the request of Henry M. Paulson, Jr., in 2008 Mr. Nicolaiesen co-chaired the US Treasury Advisory Committee on the Audit Profession. In 2009, Mr. Nicolaiesen was inducted into the Hall of Fame of the Financial Executives Institute. In addition, Mr. Nicolaiesen serves on the Board of Advisors for the University of Southern California, Leventhal School of Accounting.
Karen Hastie Williams is a retired partner at Crowell & Moring where her law practices focused on public contract law, legislation, and strategic diversity counseling for corporate clients. She was a law clerk to Supreme Court Justice Thurgood Marshall of the United States Court of Appeals for the District of Columbia Circuit. She also served as Chief Counsel to the United States Senate Committee on the Budget, and as Administrator of the Office of Federal Procurement Policy in the Office of Management and Budget. She currently is a member of the Boards of Directors of the Chubb Corporation, Continental Airlines, Inc., Gannett Company, Inc., Washington Gas Holdings Company, SunTrust Bank, and the Federal National Mortgage Association Foundation.

The Hon. Cynthia A. Glassman is Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary's designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which became law in July of 2010, contains a provision regulating the American procurement of so-called “conflict minerals.” The bill imposes a new disclosure requirement on companies using such minerals in their production processes. In particular, companies will be required to disclose whether such minerals are procured from conflict areas located in the Democratic Republic of Congo and its neighboring nations. Corporations obtaining these specified minerals have to secure external audits on the minerals’ origins and report the findings on their websites. The specific rules regarding the disclosures are to be promulgated by the Securities and Exchange Commission to go into effect in April 2011.

The amendment attached to the Dodd-Frank Act specifically mentions the minerals coltan, cassiterite, wolframite and gold—and derivatives of these minerals. All three – tantalum, tin, tungsten - plus gold, provide substantial revenue for Congolese rebel groups. They are important in the production of popular consumer goods such as cell phones and portable music players and are important in industries such as automobile manufacturing.

Discussion

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The requirement poses a new challenge for Boards of Directors of companies who use, or may use, such minerals. The new conflict minerals provision will affect the monitoring and oversight role of the Board. The Board must make sure that the implementation of the new disclosure requirements is done accurately, appropriately and timely, but must rely on management to get it done. Businesses would already have in place mechanisms for other compliance issues. However, this new requirement calls for the development of information that companies do not typically track now, that is very difficult to track, and that can create significant reputation risk. It is not the usual type of investor protection SEC disclosure.

- **Coltan is the ore mined to obtain the element tantalum.**
- **Cassiterite is the ore which is refined to produce tin.**
- **Wolframite is an abundant source of tungsten.**

The panelists agreed that the conflict minerals problem is a horrendous situation that is difficult to solve. It is similar to the “Blood Diamonds” issue that has been intractable for decades. The point was made that Boards should challenge management regarding whether they really need to use these minerals and whether there are alternative sources. A strong stand in this regard by US companies might shrink the market for these “conflict minerals” and help solve the problem.

There was agreement among the panelists that Boards will take this new requirement seriously. In Boardroom discussions, Directors will not debate whether the rule is good or bad, but will live up to their fiduciary duty to be in compliance with this requirement as well as the thousands of other rules and regulations with which public companies must comply. In this case, Boards will examine the issue to make sure the business has an appropriate process in place that could include:

- Figuring out if this applies to their company and, if so,
- Identifying the source of the designated minerals
- Monitoring the sourcing
- Testing the compliance through internal and external auditing of the process
- Timely documentation and reporting of findings
- Involvement of the legal, risk management, and compliance groups
- Management accountability for appropriate disclosures

The panel pointed out the operational difficulty in collecting the needed information and ongoing monitoring; this is not a simple task. There was discussion of the possibility that distributor/aggregators might come forward who can attest to the sourcing of the four materials. There was a question as to whether this is an appropriate corporate governance role or whether there is a more cost-effective way to deal with the issue. The point was made, however, that the visibility resulting from the disclosure requirement might help solve the problem. A final suggestion was made that the effectiveness of the disclosures in solving the problem be reviewed in a few years to determine whether this should be rethought.

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Conclusion

The conflict minerals provisions of the Dodd-Frank Act were intended to compel businesses to take the issue more seriously by locating responsibility for its execution with the Board of Directors. On one hand, the panel agreed that the issue would be considered as important and would be addressed. At the same time, most Board members will have little experience addressing such social and political issues.

In sum, while there are a number of questions regarding the specifics of the rule, the effectiveness of this requirement in solving the problem, and the difficulty of obtaining - initially and on an ongoing basis - the information needed, there was no question that Boards will make their best efforts to meet their fiduciary duties in complying with this rule.
2. The Case of Diversity on Boards

On March 31, 2011, the ICR conducted its second program on Challenges in Corporate Governance. The purpose of the panel was to explain what is meant by diversity on Boards; what it is in theory and in practice; whether and why it matters; and, how best to achieve it.

Background

At present, Directors of public companies are nominated by a committee of the Board, the Nominating Committee, that is made up of independent Directors; that is, the Directors are not part of management and do not have a significant business relationship with the company, or any relationship that might cause a conflict-of-interest. That has not always been the case. In the past, it was not unusual for the Chairman/CEO of the Board to nominate the Directors, and it was not unusual for the Board to be made up of friends and business acquaintances.

However, the process has changed as a result of the public reaction to the corporate scandals in the last 10 to 15 years, new legislation and regulation by the SEC and the stock exchanges, and increased shareholder and public scrutiny. Now, the Nominating Committee typically does a search for new Directors, often using an executive search firm, to find Directors that meet their requirements. These typically include making sure a new Director rounds out the Board with certain attributes. The professional attributes can include understanding the business, financial expertise, marketing experience, risk management knowledge, human resources experience, regulatory background, and the like. Additional attributes relate to diversity, including gender, race, ethnicity, geography, and possibly age.

Currently, Boards of Directors of large companies typically have 10-11 members. It is not uncommon that all Directors, except the Chairman/CEO, are independent. Of the S&P 500 companies, 10% have no women Directors and 11% have no minorities. Women account for only 16% of all Directors of these companies, and minorities (African Americans, Hispanics, and Asians) only 15%.1

With that brief overview, the guest panel of Board members discussed Board diversity, what it means, whether and why it matters, and how a Board achieves it. All of them have hands on experience as Board Directors and each brought a different perspective to today’s discussion.

The Hon. Cynthia Glassman moderated the panel. She is, Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was

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appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary's designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The panelists were the following:

**Alan Beller** is a Partner with Cleary Gottlieb Steen & Hamilton LLP. Mr. Beller advises senior officials of U.S. and non-U.S. entities on a wide variety of complex securities, corporate governance and corporate matters. As the SEC’s Director of the Division of Corporation Finance and as Senior Counselor to the Commission (January 2002 - February 2006), he led the Division in producing the most far-reaching corporate governance, financial disclosure and securities offering reforms in Commission history, including the implementation of the Sarbanes-Oxley Act’s corporate provisions, adoption of corporate governance standards for listed companies and successful completion of comprehensive securities offering reforms. Mr. Beller is a member of the Board of Directors of The Travelers Companies, Inc. and a member of the Board of Overseers of the University of Pennsylvania Law School.

**The Hon. Cari Dominguez** is a Corporate Director with Manpower, Inc. and the Calvert SAGE Fund, and former Chair of the Equal Employment Opportunity Commission (EEOC). She has also served in the U.S. Department of Labor in roles including Assistant Secretary of Labor for Employment Standards and Director of the Office of Federal Contract Compliance Programs. Her corporate experience includes various senior human resources positions at Bank of America, including Director of Executive Programs. She was also a partner and Director at two globally recognized executive search firms, serving in their financial services, human resources, and corporate Boards practices. Ms. Dominguez is also a trustee of Loma Linda Medical Center and Loma Linda University. She has served on numerous nonprofit Boards, including the Leadership Foundation of the International Women’s Forum, and the Human Resources Planning Society.

**Julian Ha** is a member of Heidrick & Struggles, the global Executive Search firm. Julian spearheads the firm’s Government Affairs practice and places senior-level executives and Board members into public and private companies across all industries. Julian is a member of the Board of Directors of China Recycling Energy Corporation (CREG), a NASDAQ-listed, clean tech company. He Chairs CREG’s Compensation Committee and is a member of its Audit Committee. Julian also serves on the International Boards of London Business School and the University of London’s School of Oriental and African Studies. Julian is a Member of the National Committee on US-China Relations and is Treasurer of CALPAC, a Political Action Committee.
Donald Peterson is the former Chairman and CEO of Avaya Inc. and former CFO of Lucent Technologies Inc. He is a member of the Board of Directors of the Teachers Insurance and Annuity Company (TIAA of TIAA-CREF), the Sanford C. Bernstein Fund, Committee for Economic Development, Worcester Polytechnic Institute and sits on the Boards of several small companies.

Discussion

The panel discussed what diversity means and why it matters. There was general agreement that diversity means having sufficient viewpoints and expertise to provide effective oversight and direction to the company. Further, social, political, gender, and ethnic diversity contribute to a diversity of viewpoints and a different perspective. Diversity can be reflected in different points of view or individuals’ traits. The panel emphasized that two important traits for Boards are doggedness and skepticism.

The type of skill sets and experiences needed by Board members varies by company. The specific value gained from Board diversity depends on the particular situation of each firm. For example, different skills and expertise are needed for mature versus new companies, for companies that are growing and expanding, and for companies entering new markets or adopting new business strategies. Ethnic, race and gender diversity also helps companies better understand diversity in their workforce and customer base. For example, minorities on the Board may be more sensitive to the mentoring and promotion of other minorities in management.

The discussion then turned to how Boards take diversity into account when evaluating existing and new Directors. Given the typical size of Boards and the variety of requirements -- financial experts, compensation expertise, understanding of the business strategy and markets, regulatory knowledge, etc. along with diversity by gender, race, ethnicity, geography -- how do Boards prioritize these needs?

The point was made that, as a practical matter, changing the composition of the Board is a slow process. Board seats do not turn over very frequently. However, when Board seats are open, Nominating Committees are increasingly focusing on what characteristics are needed to fill in the “expertise” gaps of their existing Board. The panel agreed that it is incumbent on Nominating Committees to push the diversity factors in Board searches. While in the past there may have been constraints resulting from a limited pool of qualified women and minorities that is no longer the case. Tone at the top is very important in this regard.

Nevertheless, getting qualified candidates that add real diversity on the radar screen of Nominating Committees is still a challenge. In addition to having the right credentials, the
potential Board member needs to have the right references, networks, and chemistry to be seriously considered for a Board membership. These are very subjective components that influence the selection process.

Given that challenge, the panel discussed whether quotas are appropriate. Several European and other countries have, or are considering legislating, a minimum number of women on public company Boards. While the panel generally believed that affirmative actions by Boards and Nominating Committees are needed to increase Board diversity, they did not necessarily believe that quotas should be imposed.

**Conclusion**

The overall theme of the panel was that gender/ethnic/race diversity is an appropriate goal for Boards. Diversity can be justified for moral reason, i.e., a basic fairness of opportunity for all types of people. However, even more important, are the business reasons: a diverse Board will make better decisions. Boards have a common objective of strong performance for their company, and they have chemistry in how they work together. Adding someone new will always alter that chemistry, and greater diversity will make that challenge even greater. However, a healthy tension is an important condition if Boards are to be productive and add value. A diverse Board could mean that the management team could be challenged more often, or in different ways, but a good CEO would see the benefit of such challenges.

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3. Directors Responsibility for Risk Management after Dodd-Frank

On November 3, 2011, the ICR conducted its third program on Challenges in Corporate Governance: Directors responsibility for Risk Management after Dodd-Frank.

Background

The focus of Boards on risk management has been growing in the past decade, especially after the accounting scandals at companies such as Enron and WorldCom. That growth was boosted after the recent financial crisis and the resulting enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. Dodd-Frank requires certain large financial institutions to have a designated Risk Committee of the Board. In the context of Boards’ enhanced focus on risk oversight, the program focused on both the external expectations regarding Directors’ role in risk management as well the practical aspects of what actually happens in the Boardroom.

The program had two consecutive panels. The first panel covered the perspective from outside the Boardroom, and addressed the role of Directors in risk management from the viewpoint of a regulator, an attorney, and a researcher. The second panel addressed the Directors’ role from inside the Boardroom, including two Board Directors, an auditor, and a Chief Risk Officer.

The panelists were the following:

John Buchman is Vice President, General Counsel and Corporate Secretary of E*TRADE Bank. Prior to joining the Bank in November 2000, John spent his entire legal career working as a banking attorney in Washington, DC both in private practice and with the government. John has been a member of the adjunct faculty of The George Washington University Law School and has taught banking law and financial regulatory reform classes there since 1991. Last year, John was named Chair, of the Advisory Board of the law school’s Center for Law, Economics & Finance. He is an active member of the American Bar Association’s Banking Law and Consumer Financial Services Committees, currently serving as Chair of the Banking Law Committee’s In- House Counsel Subcommittee, and he also serves a director of Congressional Bank in Bethesda, MD.

Patrick M. Parkinson is Director at the Federal Reserve Board’s Division of Banking Supervision and Regulation since October 2009. The division develops regulatory policy and oversees the supervision of state member banks, bank and financial holding companies, and U.S. branches and agencies of foreign banks. During the first half of 2009, Mr. Parkinson served as Counselor to Treasury Secretary Geithner and played a leading role in development of the Administration’s proposals for reforming financial institutions and markets. Previously

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Mr. Parkinson was Deputy Director of the Board’s Division of Research and Statistics, with responsibility for oversight of the micro-financial functions of the Division. In addition, from 1993 until 2009 he was the principal staff advisor to the Board’s Chairman on issues considered by the President’s Working Group on Financial Markets.

Stasia D. Kelly is a Partner at DLA Piper and former Vice Chairman and General Counsel of AIG, MCI/WorldCom, Sears and Fannie Mae. She is the former Vice Chairman of American International Group (AIG), a role she held until the end of 2009. In this role, she was responsible for the global legal, compliance and regulatory functions, government relations, communications, corporate affairs and human resources. She serves as a director of Owens-Illinois, the world’s largest manufacturer of glass packaging, and Huntington Ingalls Industries, builder of more ships in more ship classes than any other U.S. naval shipbuilder. She also serves as a Trustee of the Carey School of Business at John Hopkins University. Ms. Kelly is on the Advisory Board of the Rock Center for Corporate Governance at Stanford University.

Thomas H. Stanton is an Adjunct Professor at Johns Hopkins University Center for Advanced Governmental Studies. Mr. Stanton is a Fellow of the National Academy of Public Administration and a former member of the federal Senior Executive Service. He recently served on the staff of the Financial Crisis Inquiry Commission where he was a lead staffer on governance and risk management. He reviewed financial firms including four that had withstood the crisis and eight that had not, including interviews with CEOs, risk officers, mortgage executives, traders, and others. Mr. Stanton is author of a forthcoming book, Why Some Firms Thrive While Others Fail: Governance, Management, and the Financial Crisis (Oxford University Press, forthcoming, 2012). His publications on government and the financial markets include two books on Government-Sponsored Enterprises.

The second panel was the following:

The Hon. Cynthia A. Glassman is Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary’s designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The Hon. Mary Bush is Founder and President of Bush International. Ms. Bush currently serves on the boards of Discover Financial Services, ManTech International, Marriott

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International, Inc. and The Pioneer Family of Mutual Funds. She has served three U.S. Presidents as the U.S. Government’s representative on the International Monetary Fund Board during the Latin Debt Crisis; head of the Federal Home Loan Bank System during the Savings & Loan cleanup; and, board member of Sallie Mae. She is a member of a Kennedy Center Community Advisory Board and serves on the Board of Governors of the Investment Company Institute and the Governing Council of the Independent Directors Council for mutual funds nationwide. Her Board Committee work includes chairing or serving on audit, Finance, Governance and Compensation Committees.

**Mike Mancuso** is Corporate Vice President and Chief Financial Officer for CSC. Mr. Mancuso is responsible for CSC’s financial operations, including the offices of Controller, Treasury, Internal Audit, Investor Relations, Tax, Corporate Shared Services and Supply Chain Management. He previously served as Senior Vice President and CFO of General Dynamics Corporation; as Vice President and CFO of the commercial jet engine business at Pratt & Whitney Group, United Technologies Corporation; and in various senior financial management positions with the General Electric Company. He currently serves as a Director of two NYSE listed companies, SHAW and SPX, and chairs the audit committees of both.

**Gregory G. Weaver** is Vice Chairman of Deloitte LLP. Mr. Weaver serves as Advisory Partner for a number of significant clients and most recently, he served as Global Lead Client Service Partner for Morgan Stanley & Co, Inc. He is a member if the Board of Directors at Deloitte LLP and member of the Governance Committee, Partner Earning and Benefits Committee, and Elected Leaders Succession Committee (chairman). He serves as Advisory Partner for a number of significant clients, including International Paper, KKR, Parker-Hannifin, Procter & Gamble, and Pepsi Bottling Company. Mr. Weaver served as National Managing Partner for Deloitte’s largest business, Audit and Enterprise Risk Services (AERS) and has significant experience in mergers, acquisition, and dispositions and the attendant operational control, and reporting challenges.

**Andrew Kuritzkes** is Executive Vice President and Chief Risk Officer for State Street Corporation. Mr. Kuritzkes is responsible for leading the company’s risk management function globally. Prior to joining State Street in 2010, Mr. Kuritzkes was a partner of Oliver Wyman and led the firm’s Public Policy practice in North America. Formerly, in his role at Oliver, Wyman & Company, he worked extensively with organizations, at the board and senior executive levels, on developments in finance and risk management. He is also a member of the Financial Advisory Roundtable of the Federal Reserve Bank of New York.

**Discussion**

The program started with an overview of the Federal Reserve’s expectations regarding risk management as well as lessons learned from the financial crisis, changes resulting from the
Dodd-Frank Act, and what the Fed plans to do going forward. Overall, the Fed expects Boards of financial institutions, along with management, to set the tone at the top and establish a firm-wide culture. The Board is expected to express its tolerance for risk. To be effective in its risk management oversight role, the Board as a whole should have sufficient knowledge to understand the information provided concerning the institution’s risk and how it is being managed. One of the lessons learned from the financial crisis was that, in some cases, the directors did not have a good understanding of the risks of the business – or even a good understanding of the business.

As a result of Dodd-Frank, certain large financial institutions must now have a Board Risk Committee. There is also an increased focus on the role of risk in incentive compensation. The Fed is more focused than in the past on business strategies and the risks in the business. “Following the money” enables a better understanding of the risks of the business and how they are managed. Stress testing has become an important tool in helping the Fed evaluate institutions’ capital plans. Examiners are increasing their engagement with Boards, including with independent directors. The Fed can and does look across firms to gain an understanding of effective risk management practices.

The discussion then turned to lessons learned from the accounting scandals and recent financial crisis. Over the past 15 years or so, Corporate Governance has received increasing attention, and is now seen as the framework of principles by which companies will live. This framework has to be implemented by people – “human beings.” The general view was that the tone at the top set by Boards and senior management is critical to effective risk management at companies. Key points made were:

- Financial companies that weathered the financial crisis were those with strong governance, good management, good systems, and successful strategies.
- To be effective in their risk oversight role, Boards need both knowledge of the business and an understanding of risk. Expertise of Board members is particularly important at large complex organizations. Countervailing points of view and constructive dialogue between Boards and management are important in making major decisions.
- Boards are accountable for the way senior executives are compensated. In that regard, Boards should be clear on what behavior they are trying to incent.
- Board members should have access to senior management to get the information they need to effectively carry out their role. A CEO who does not want independent directors to have such access – or is overbearing or distracted - is a red flag.
- Companies should be transparent with their regulators in order to be credible.
- A key challenge for Boards and management is the “herd mentality.” It is hard to do something different when everyone else is apparently successful, or when the firm itself is doing well, or appears to be doing well.

The program then shifted to a discussion of the practical aspects of risk management by the
two directors, the audit partner, and the Chief Risk Officer. Several of the key themes raised by the first panel were reiterated by this panel.

The first topic was how Boards are organized to manage risk. While there are various structures depending on the size and nature of the company, for example, a combined audit and risk committee of the Board, a separate risk committee, or a robust enterprise risk management system overseen by the Board; the important point is to make sure that all risks are covered and that the Board understands how risks are being addressed within the company.

The biggest change in recent years is the increased focus on and discussion of all risks at the Board and Committee level. The range of risks discussed includes financial, liquidity, operational, reputation, strategic, etc. Following the money and understanding how people are incentivized is important to understanding the risks.

The difference between financial companies and others was raised. In particular, risk was seen as the “cost of good sold” at financial companies, where the risk/return tradeoff is the key to profits. In other companies, the tradeoff is between risk and the cost of controlling it. As a result, Boards of financial firms need special attributes.

It was also noted that risks in financial companies are more quantifiable, for example, by setting tolerance levels for credit risk or though stress testing. While other companies have to focus on obtaining necessary financing, that is typically not their biggest risk. For example, the biggest risks for an airline are safety and the cost of fuel.

The discussion then turned to the information a Director needs to be comfortable that risk is being managed appropriately and aligned with the Board’s risk management appetite. The panelists agreed that there has been an evolution, or even a revolution, in Boardroom practices in the last 10 to 15 years. While previously Boards tended to be passive, “old boy” networks, that has changed. Now, expectations for Directors have increased. As a result, potential Directors should do significantly more due diligence before they join a Board. A dominating or controlling CEO is a red flag. Directors should have sufficient background in business or technical expertise to enable them to be perceptive enough to understand whether they are getting shallow information. Auditors should be aware as well. Separate executive sessions in the Audit Committee with the external auditor, the internal auditor, the chief risk officer, and the chief financial officer should help the Directors discern if there is a problem. Simply put, as long as Board members have the strength of character and the will, they can get the information they need. Being timid or hesitant is too much of a risk for Board members.

The type of information that Boards receive has been changing as well. Anticipating “tail risk,” or what happens when the impossible becomes possible, is being discussed more by
Boards. Further, too much information is almost as bad as too little. The Board needs to focus on what really matters, for example, the 10-12 key risk sensitivities, stress testing, “what-if” scenarios, and “following the money.” Nevertheless, there is a limit to how deep the Board should go, given its oversight role, and can go, given that Boards only meet a few times a year.

It was pointed out that no matter how well risk is managed by the company or overseen by the Board, a “disaster” can happen. When that happens, the Board should step back and take an independent look at what caused the failure: Was the risk assessment incorrect? Was this risk not considered? Were the processes and controls ineffective? Were people not executing or informing appropriately? Once the problem is diagnosed, the Board should make sure that processes, procedures, and controls are appropriately remediated.

Finally, there was a discussion about the incentives Boards have to oversee risk effectively. The positive incentives are Directors’ fiduciary responsibility to shareholders and their own reputations. The negative incentives are the impact of a significant negative event or scandal as evidenced by the aftermath of events at companies such as Enron, WorldCom, Lehman, and most recently MF Global. The threat of lawsuits and regulatory action, time spent in depositions and potentially in court, financial impacts, and the taint associated with being on the Board changes the lifestyles and reputations of those Directors for a very long time.
4. The Role of Corporate Directors in Executive Compensation

On April 11, 2012, the ICR conducted its fourth program on Challenges in Corporate Governance. In this continuing series, our distinguished panel focused on the role of Corporate Directors in setting executive compensation.

**Background**

**Lisa Fairfax**, the Leroy Sorenson Merrifield Research Professor of Law at GW, moderated the panel. Professor Fairfax's scholarly interests include corporate governance matters, shareholder activism, fiduciary obligations, Board diversity, and securities fraud. Professor Fairfax has authored a book entitled, *Shareholder Democracy: A Primer on Shareholder Activism and Participation*, and is a contributing author on a book focusing on the legal, social, and ethical implications of the Martha Stewart case.

The panelists were the following:

**Veronica Biggins** is Managing Director of Diversified Search and leads the Board Practice for Diversified Search and is an active member of the Financial Services Industry and Education/Not-for-Profit practices. Veronica served as Assistant to the President of the United States and Director of Presidential Personnel under William Jefferson Clinton. She was responsible for selecting and hiring all political appointees within the federal government.

**Mark Carey** is Senior Advisor of the Division of International Finance at the Federal Reserve Board is also co-director of the National Bureau of Economic Research’s Risks of Financial Institutions Working Group, which is a mixed group of academics and financial professionals that focuses on risk management at financial firms. Much of Dr. Carey’s recent work has been on risk-taking incentives associated with employee compensation practices in the financial services industry and on issues related to systemic risk.

**The Hon. Harvey Pitt** is the Chief Executive Officer of Kalorama Partners and previously served as the twenty-sixth Chairman of the United States Securities and Exchange Commission. In that role, from 2001 until 2003, Mr. Pitt was responsible, among other things, for overseeing the SEC’s response to the market disruptions resulting from the terrorist attacks of 9/11, for creating the SEC’s “real time enforcement” program, and for leading the Commission’s adoption of dozens of rules in response to the corporate and accounting crises generated by the excesses of the 1990s.
The Hon. Gail Wilensky is an Economist and Senior Fellow at Project HOPE, directed the Medicare and Medicaid programs and served in the White House as a senior adviser on health and welfare issues to President George HW Bush. She also served as the first chair of the Medicare Payment Advisory Commission. Her expertise is on strategies to reform health care, with particular emphasis on Medicare, comparative effectiveness research and military health care.

The topic was chosen in light of the recent financial crisis and the issues about executive compensation that arose in the aftermath. However, concerns regarding corporate directors’ role in determining executive compensation date back to at least the 1930s, and more recently to the public outrage over payments to Michael Ovitz when he was fired after his short tenure as President of Disney in 1997.

Current concerns about executive compensation revolve around the absolute level of compensation as well as the widening gap between CEO compensation and average workers’ salaries. These concerns were heightened during the financial crisis, especially with respect to the apparent disconnect between compensation and performance at some large financial institutions.

Because of these concerns, there has been a movement to assure that Corporate Directors set executive compensation at appropriate levels without undue risk and without negative unintended consequences. Regulatory initiatives to deal with the issue include:

- Provisions in the Troubled Asset Relief Program (TARP) to set the compensation for senior management levels at companies receiving TARP funds.
- SEC rules requiring public companies to disclose top management compensation and to give shareholders an advisory vote on ‘Say on pay’.
- Dodd-Frank requirements that members of Board Compensation Committees be independent directors, i.e. not management.
- Federal Reserve initiatives to encourage major financial institutions to take into account risk-taking incentives and opportunities in establishing compensation at all levels in their organization.

Boards of Directors must act in their fiduciary capacity on behalf of shareholders in setting compensation for senior executives. These Board responsibilities are set by the states, not the federal government, and include:

- The duty of care, which means the directors must have a process that provides them with sufficient information to make a fully informed decision and a decision that does not waste corporate assets; as well as,
• A duty of loyalty, which means the directors must act in the best interest of the corporation, not their own self-interest. For that reason, it is important that the compensation process be overseen by independent directors.

Discussion

With this background, the discussion turned to the challenges Board Members, and especially Compensation Committee members, face in establishing executive compensation.

A major challenge is that a Board member’s role is not full-time and is not management. As hardworking and well-informed as they may be, Board Members do not and cannot know everything management knows. To overcome this challenge, Board’s need to be clear on what they expect executives to do and how to judge fairly compensation in return:

• What does the job entail? What are the components of the job?
• What are various components worth?
• What are agreed upon standards on which performance can be measured?
• How to develop measurements – both quantitative and qualitative - that are not susceptible to manipulation by management?
• Under what circumstances will “clawbacks” of compensation be expected, e.g., material restatements?

In addition to the internal analysis, an understanding what peers are paying provides important context. In this regard, compensation consultants can help the Board choose appropriate peers for comparison and keep the Board apprised of trends in compensation practices. It is critical, however, that the consultant be chosen by the Board and beholden to the Board, not to management.

Another challenge is the structure of the compensation package. The structure covers both the type of compensation and the time period. Forms of compensation are cash salary and bonus, pension contributions, stock grants, restricted stock grants, performance stock units, stock options and possible severance or change in control payments. The time frames include short, intermediate, and longer-term performance periods. The nature and timing of the package affects incentives. Further, it can result in misleading optics. For example, companies must disclose the current expected value of stock options that cannot be exercised for several years and, in fact, may never be worth anything. In addition, bonuses paid this year for good performance in earlier years, may seem inappropriate if this year’s performance is weak.

Determining an appropriate “clawback” policy is a new challenge. Clawbacks are a recoupment of certain incentive compensation. The Dodd-Frank Act expanded the limited clawbacks legislated under the Sarbanes-Oxley Act. Now, listed companies must develop and disclose

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
policies to clawback incentive based compensation from current and former executive officers if the company has a restatement resulting from erroneous financial reporting under the securities laws. The law has a three-year look back period for determining the amount of the payments to be recouped.

Probably the most difficult challenge is how to make compensation for performance operational. While “pay for performance” sounds terrific in principle, implementing it is difficult in practice. Typical packages have a moderate cash salary with a bonus target based on the expected performance (e.g., revenue growth, earnings per share, etc.), a higher bonus if a “stretch” goal is reached, and no bonus unless a minimum threshold is reached. Usually, there is a mix of objective and subjective factors that are targeted for bonus purposes. One difficulty is choosing the factors that will align the executives’ compensation with the intent of shareholders over the short and longer terms. Another difficulty is knowing if the expected level, the stretch level, and the threshold level are realistic, or understated in a way that gives management an advantage. For example, if the target is shareholder return: is absolute return appropriate even if the whole stock market rises, or is return relative to peer companies a more appropriate target? In this regard, Boards must have a constructive relationship with management, and the audit, risk and compensation committees should work in partnership to make sure the compensation targets and levels are appropriate.

**Conclusion**

In general, the panel felt that Boards seem to be moving in the right direction. While there will always be ‘bad actors,’ Boards and management appear to be more sensitive to the optics on compensation and are trying to do the right thing. Board service requires serious time, effort and availability, and Board directors, for the most part, take their fiduciary duties to shareholders very seriously.
5. The Role of Corporate Directors in CEO Succession

On November 28, 2012, the ICR conducted its fifth program on Challenges in Corporate Governance. In this program in ICR’s continuing series, our distinguished panel focused on the role of Corporate Directors in planning for CEO Succession. One of the most important responsibilities of a Corporate Board is developing a succession plan for the CEO, both for the long-term and for emergencies. The panel discussed how Boards carry out the role in practice, what they consider, and how they organize to have an effective process and outcome.

Background

The Hon. Cynthia Glassman moderated the panel. She is, Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary’s designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The panelists were the following:

Julie Howard became CEO of Navigant Consulting in March 2012 and is a member of Navigant’s Board of Directors. She previously served as President beginning in 2006 and Chief Operating Officer beginning in 2003. Ms. Howard is a member of the Board of Directors for Kemper Corporation and a member of the Foundation Board for Children’s Memorial Hospital. She formerly served on the Board of Directors for the Association of Management Consulting Firms, the Dean’s Advisory Board of the Business School at the University of Wisconsin-Madison, and the Board of Governors for the Metropolitan Planning Council in Chicago. Ms. Howard is a champion of women’s leadership development and is a founding member of the Women’s Leadership and Mentoring Alliance (WLMA).

Nels Olson joined Korn/Ferry in 1993 after a successful career in public relations and government service. Prior to joining the Firm, he was with the public relations firm Fleishman-Hillard, Inc. Previously, Mr. Olson gained experience in executive search when he was on the staff of the White House in the Office of Presidential Personnel. Mr. Olson is a board member of the Meridian International Center and the Wolf Trap Foundation for the Performing Arts, a
Trustee for the Committee for Economic Development and a member of the Federal City Council and The Economic Club of Washington, D.C.

Anthony Santomero is a former President of the Federal Reserve Bank of Philadelphia. He holds the title of Richard K. Mellon Professor Emeritus of Finance at the Wharton School of the University of Pennsylvania. Dr. Santomero serves on the Boards of Citigroup, Renaissance Reinsurance Company Ltd, the Penn Mutual Life Insurance Company, and the Columbia Funds mutual fund family. At Citi, he is chair of the lead bank subsidiary, Citibank NA, and the Risk Management and Finance Committee and is a member of the Audit and Executive Committees. At Penn Mutual, he serves on the Executive and Nominating Committees. At RenRe, he is chair of the Investments and Risk Management Committee.

In recent years, we have seen increasing scrutiny by the media, shareholders, and other stakeholders of the Board’s role in CEO succession. For example, there have been numerous articles over the past few months about Hewlett Packard’s CEO turnover; HP has had four CEO’s since 2005. In addition, a recent Wall Street Journal article reported that Groupon’s Directors were going to meet that week to discuss whether to begin a search for a new CEO. Such a story is surprising, since these deliberations are meant to be confidential. Further, the accounting scandals of ten years ago, including those at Enron and Tyco, resulted in much concern about so-called “Imperial CEO’s,” who kept their Boards in the dark about potential risks and red flags.

Clearly, getting the right CEO takes time, effort, and focus, but with so many other issues on Directors’ plates, making CEO Succession planning a priority is challenging.

Discussion

The panel first addressed how CEO succession planning is organized by Boards. Typically, either the Compensation Committee or the Nominating and Governance Committee of the Board plays a role, but ultimately, the full Board is responsible for the CEO succession plan. CEO succession is viewed as part of an entire Human Resources process by the Board, which includes review of compensation for key personnel, “depth of bench” and identification of future leaders.

There are two distinct questions to be addressed in the CEO succession planning process. One is whom will the Board choose in an emergency situation, the scenario in which the current CEO gets hit by the proverbial truck. In this case, the Board may have an internal CEO successor in mind or may plan on an interim solution, such as putting the Executive Chairman or Lead Director in the role temporarily until a new CEO is identified.
The other question is the longer-term plan for replacing the current CEO in an orderly transition at the appropriate time. While this is one of the most important responsibilities of the Board, it often gets pushed aside as the Board needs to address other, more pressing, issues. Nevertheless, best practice suggests that the CEO succession planning process should begin as soon as a new CEO comes on board.

The Board’s role should be ongoing, with Directors having the opportunity to meet senior management several levels down and to understand how the company is developing leadership. This includes both formal and informal settings, such as having senior management give presentations to the Board as well as, for example, including them at Board dinners. However, these interactions are typically limited to the five or six times a year that the Board meets in person. At least once a year, the Board should have a formal succession review on its agenda to assess likely CEO candidates as well as succession plans for other key management personnel in the context of the firm’s strategy.

In addition to limited time, there are other impediments to developing an effective succession plan. In reality, the current CEO may be reluctant to develop his or her own successors. Further, the Board may not want to deal with the internal competition that is likely to result if the Board sets up a “horse race” among two or more internal candidates. Even when successors are identified, the process may not be orderly. The chosen successor may leave or the firm’s situation may change. As a result, while most new CEOs are drawn from inside the firm, when the time actually comes to replace a CEO, the Board may have to, or choose to, look for an external candidate. A key question is what the Board is looking for in a CEO given its current situation and strategy. The directors may determine that they are looking for someone with attributes similar to the CEO who is leaving, or they may prefer someone with a different vision and experience.

When the decision is made to look externally, the Board must then decide whether to identify candidates through their own network or retain the services of an Executive Search firm. There was general consensus on the panel that using an executive search firm expands the pool of potential candidates and facilitates the process. Candidates identified by Board members can be funneled into the process.

Typically, the Board sets up a search committee of three or four directors to undertake the review of the identified candidates and develop a short list. Ultimately, all Board members would meet with the likely candidate or candidates. The process requires discretion. Normally, candidates do not want the fact that they are being considered for another position to be public knowledge; they do not want to be perceived as “in play.” Nor do current CEOs want their planned departure known until formally decided upon. In that regard, the panel had a discussion regarding the article, mentioned above, about Groupon. The view was that that

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
someone was trying to “stir something up,” and that it was inappropriate to have made public the fact of the pending Board discussion. However, the panel also acknowledged that the “GE model” -- in which the company has a visible process in which certain business leaders are in a “horse race” for the CEO position -- has proved effective for GE.

In response to a question regarding how the Board balances the various skills of a new CEO, for example, the ability to communicate well with external stakeholders versus the hands on ability to run the company, the general view was that the Board has to consider the whole management team and make sure the new CEO has good support from others with complementary skills on the team. Further, the “onboarding” process is critical to making sure the CEO gets off to a successful start. The Board’s expectations for the new CEO must be clear, and there must be continuing dialogue between the Board and CEO to be sure expectations are being met. As the panel agreed, the new CEO does not want to fail and the Board does not want to repeat the process for the foreseeable future. All of their reputations are at stake.
6. The Role of Corporate Directors in Setting the Tone at the Top

On April 15, 2013, ICR conducted its sixth program focusing on the role of Corporate Directors in setting the tone at the top of their companies.

Background

The Hon. Cynthia Glassman moderated the panel. She is, Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary’s designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The panelists were the following:

Cindy Fornelli is Executive Director of the Center for Audit Quality (CAQ), a position she has held since the CAQ was established in 2007. She currently serves on the Financial Accounting Standards Board’s Financial Accounting Standards Advisory Council and the Securities and Exchange Commission Historical Society’s Board of Trustees, Class of 2014. She previously served on the National Association of Corporate Directors’ 2010 Blue Ribbon Commission on the Audit Committee and 2009 Blue Ribbon Commission on Risk Governance. Prior to joining the CAQ, Ms. Fornelli was the Regulatory and Conflicts Management Executive at Bank of America and the Deputy Director, Division of Investment Management of the U.S. Securities and Exchange Commission.

Robert Kueppers is Managing Partner for Deloitte LLP’s Center for Corporate Governance. Mr. Kueppers leads the Center’s efforts to support Boards of directors and audit committees on a variety of governance and risk matters. Mr. Kueppers also serves as Senior Partner, Global Regulatory and Public Policy for Deloitte LLP. Mr. Kueppers is chairman of the Board of Directors of United Way of New York City; chair of the University of Minnesota’s Carlson School of Management Board of Overseers; a Board member of American Corporate Partners, a nationwide mentoring organization for United States veterans; a founding trustee and president of the SEC Historical Society; and a trustee of the Committee for Economic Development. He also helped create the Center for Audit Quality and since its inception in 2002
has chaired many committees and task forces with his peers and professional practice leaders from other national accounting firms.

**The Hon. Susan Phillips** joined The George Washington University School of Business as Dean and Professor of Finance in July 1998. On June 30, 2010, she stepped down as Dean of the School and from the faculty the following year. Previously, she was a member of the Board of Governors of the Federal Reserve System from December 1991 through June 1998. Before her Federal Reserve appointment, Dr. Phillips served at the University of Iowa as Vice President for Finance and University Services and Professor of Finance in The College of Business Administration (1987 to 1991) and as Commissioner (1981 to 1983) and then Chairman (1983 to 1987) of the Commodity Futures Trading Commission. She also serves on the Boards of Directors of the Kroger Company, the Chicago Board Options Exchange, and the National Futures Association as well as the Board of trustees of Agnes Scott College. She currently serves on the CFTC-SEC Joint Advisory Committee on Emerging Market Issues and on an Advisory Committee to the Comptroller General.

The tone at the top refers to the corporate culture. While the concept is not new, it became particularly important for corporate Boards after the accounting scandals in the early 2000’s and the more recent financial crisis.

The accounting scandals that occurred a decade ago have become shorthand for what companies should not do. While the facts of each case are different, the themes are similar. Enron, WorldCom, Tyco, Adelphia, and others manipulated earnings, misled and deceived investors, ignored or disdained critics -- leading to their own demise or diminution and to the implosion of one of the largest audit firms, Arthur Anderson.

The more recent financial crisis raised questions about the ethics, improper financial incentives, and reckless risk taking in the financial services industry.

As a result of the accounting scandals and the financial crisis, there has been a concern that fraudulent financial reporting practices and other potentially deceitful activities are associated with lack of integrity at senior levels of companies. Laws were enacted to prevent such activities – for example, certifications by the CEO and CFO regarding the integrity of financial controls were required by the Sarbanes Oxley Act (SOX). SOX also created the PCAOB – the Public Company Accounting Oversight Board, to improve auditor oversight. The more recent Dodd-Frank Act added whistleblower protections to the mix.

It is clear that from the perspective of a company’s Board of Directors, its auditors and its legal counsel, an ethical culture set by the Board and senior management is an important component of a successful company. Getting the right tone is not easy, but with a firm’s reputation on the
line, effective Boards must take up the challenge. The panelists brought a range of corporate director, regulatory, audit, and legal expertise to the discussion.

Discussion

The panel started with a discussion of the role Boards play in making sure their company has an ethical culture. Although Boards approach this in different ways, and there is no “one size fits all” solution, several themes emerged. One is that it is important to be clear about what a company stands for, what its advertising and brand say about a company, whether it deals head-on in a crisis situation or attempts to cover it up.

To be able to understand and influence the company’s culture, the Board must be effectively engaged in discussions on the strategy of the company. Further, the Board members should have access to and meet with employees at different levels of the company. Open and honest communication is critical. It is important to create an environment throughout the entire company in which issues can be raised. An example was given of the “rebooting” of WorldCom after its accounting fraud came to light. New management instilled a “no fear” culture in which employees were encouraged to raise concerns in order to fix systems and procedures that had enabled the fraudulent reporting.

A particular challenge is to incentivize profitability without the unintended consequence of placing too much pressure on management to “make the numbers.” In this regard, the Board’s role is to make sure that incentives are in place to promote the right culture. Performance goals and compensation targets are an important tool in accomplishing this. In addition, the use of “clawback” provisions in compensation policies can create incentives that encourage managers and key employees to act in the long-term interest of the firm.

The panel pointed out that improvements in corporate governance over the past 15 years or so have resulted in significantly more time and effort required to carry out all of the Board’s responsibilities. In order to make the best use of the limited time that Boards meet, Board committees have emerged as a way to efficiently focus on the key areas of oversight. For example, Audit Committees focus on the systems and practices in place to ensure accurate financial reporting. They hire the external auditor and expect the auditor to challenge management and raise concerns when warranted. Risk Committees, which are becoming more prevalent as Boards are becoming more focused on the risks inherent in the business, oversee the company’s approach to risk management, the extent of its “risk appetite,” and concerns raised by whistleblowers. Compensation committees oversee the setting of executive pay to make sure the right incentives, hiring practices, and training are in place to encourage performance that produces value for shareholders. Nominating and Governance Committees establish governance parameters for the Board and senior management and vet potential new
Board members.

Further, in the U.S., Board membership has been moving toward more independent directors - i.e. those with no financial or other relationship with the company or management other than their Board role - and fewer inside directors. The independent directors bring a more diverse set of skills and perspectives to the Board and, especially, an independent perspective on oversight of management. The tradeoff is that Boards are moving away from directors with specific knowledge of the company and its industry. Therefore, it is incumbent on directors to learn the business and understand the factors that are important to its success. This becomes even more important as companies become more complex. Various ways of accomplishing this were mentioned, including reading the Board materials in advance and asking probing questions at the Board meetings, visiting locations other than headquarters, meeting with staff below senior management, and reading outside reports about the company and the industry.

There were a number of questions from the audience.

One participant asked about whether the role of Chairman and CEO should be separated. The panelists’ view was that, again, there is no “one size fits all, and it depended on the specific Board.

Another question was the right size of Boards to be effective. There was general agreement that too large a Board is unwieldy, less candid and less effective, and too small a Board does not have sufficient bandwidth to deal sufficiently with all of the Board’s business. The general view of the panel was that around 8 to 12 members is an appropriate size.

Another question was how Board members can deal with the challenges involved in establishing a unified culture within a company that operates in different countries or different lines of business, especially when there are different cultural norms. The panelists agreed that one cannot overstate the challenges this situation presents. The key is to get the message out regarding expectations and requirements, from top to bottom and horizontally. Vigilance by the general counsel, compliance officers, internal auditors and the business line managers themselves is important. If someone steps out of line, there must be swift, strong, and clear consequences. In addition, rewarding doing the right thing and making that known is important as well. An emerging best practice of sending “ethical ambassadors,” to various regions and offices was described.

The concluding discussion was in response to a question about how a Board identifies and deals with bad behavior by the CEO. The view was that if the Board has been pressing management to do something, but management is not responding, the Board would begin to question managements’ willingness or capability to respond to the Board’s direction. The independent
directors would begin considering whether to replace the CEO or others in management. Their action would depend on the nature of the problem – something illegal would require quicker and stronger action than if the issue is a question of business judgment. Ultimately, the Board hires and fires the CEO. They may use outside consultants or a special committee to get to a resolution, but the Board’s reputation is on the line. Finally, if the issue was a difference between the Board and management on the appropriate tone at the top, the panelists all thought that the Board would prevail. However, they all thought that 15 years ago, their answer might have been different.
7. The Role of Corporate Directors in Dealing with Corporate Crises

On October 21, 2013, this continuing series, focused on the role of Corporate Directors in a Corporate Crisis.

Background

The Hon. Cynthia Glassman moderated the panel. She is Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary's designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The panelists were the following:

Alan Beller is the executive director, Cleary Gottlieb Steen & Hamilton. His practice focuses on a wide variety of complex securities, corporate governance and corporate matters. Mr. Beller advises regularly senior officials of both U.S. and non-U.S. entities on these subjects, including in connection with SEC filings, corporate transactions and other corporate matters and public and private offerings of securities. Mr. Beller served as the Director of the Division of Corporation Finance of the U.S. Securities and Exchange Commission and as Senior Counselor to the Commission from January 2002 until February 2006. Among his accomplishments were the implementation of the corporate provisions of the Sarbanes-Oxley Act of 2002, the adoption of corporate governance standards for listed companies and the successful completion of comprehensive securities offering reforms. He is a member of the Board of Directors of The Travelers Companies, Inc. and a member of the Board of Overseers of the University of Pennsylvania Law School.

John Olson is a founding partner of the Washington office of Gibson, Dunn & Crutcher. He represents business organizations in corporate governance, corporate securities, corporate finance and merger and acquisition matters. He has acted as special counsel for boards of directors and board committees on governance issues and in assessing shareholder litigation, responding to business combination proposals and conducting internal investigations. He has represented corporations, broker-dealer firms and individuals in Securities and Exchange

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
Commission and other federal agency investigations and regulatory matters. Mr. Olson is a member of the American Bar Association (ABA) Standing Committee on Government Affairs. Mr. Olson served (2000 – 2005) as Chairman of the ABA Business Law Section's Committee on Corporate Governance. Previously, he was Chairman of the ABA’s Committee on Federal Regulation of Securities (1991-1995). He is a member of the Executive Council of the Securities Committee of the Federal Bar Association. He serves on the Board of Directors of the Frederick B. Abramson Memorial Foundation, a not-for-profit charitable organization that provides scholarships for disadvantaged high school graduates going on to college, and is an honorary board member of the Washington Performing Arts Society.

**Lawrence Trautman** is an entrepreneur and professional corporate director, having held numerous corporate directorships in publicly traded and privately owned corporations engaged in such diverse industries as dairy processing, financial services, franchising and fast food, mortgage banking, publishing, software and information technology, oil & gas, social media, and others. He served as chairman of the committee of independent directors in the sale of Orange Julius, Inc. to International Dairy Queen. His other transaction experience includes: venture capital, real estate, public finance, and private debt and equity placement.

**The Hon. Laura Unger** is a special adviser with Promontory Consulting. She provides clients with strategic advice about matters relating to the SEC, regulatory and legislative process. A former SEC Commissioner (and Acting Chairman) and Senate Banking Committee Counsel, Laura has unique insight into a wide range of challenges faced by clients. She currently serves as an independent director of two public companies: CA Technologies Inc. (since 2004, Chair, Risk and Compliance Committee) and CIT Group (since 2010, Chair, Governance Committee). She is a former director of Ambac Financial, MBNA, IQ Funds, Medical Office Properties (REIT) and Borland Software.

Corporate Boards typically have several standing committees to deal with their responsibility to oversee the financial reporting, risk management, CEO succession, CEO and senior management compensation, and corporate governance. Further, the Board as a whole typically addresses corporate strategy issues.

Corporate crises come in many varieties. Some have internal causes; some result from external events. There are examples of these crises in the newspaper almost daily. However, when a crisis hits, the Board cannot rely on routine processes. Rather, the Board needs a more time sensitive and intense approach in order to react quickly and appropriately to the immediate issue.

Internally generated crises include financial issues, such as a significant loss or a potential or actual bankruptcy, for example, Lehman Brothers. Other internal issues are people related – a
CEO health or ethics issue, for instance – such as Apple or HP experienced, or a rogue trader like the one that brought down Barings. Crises can also result from possible illegal activities including fraud; Enron is a poster child for this. Antitrust issues such as the one that held up the merger of USAIR and American Airlines or a Foreign Corrupt Practices Act violation, for example at Siemens, are other possible causes of a crisis to be addressed by the Board.

External events or pressures can cause a crisis as well. Potential or actual cyber-attacks can seriously disrupt or harm a business. A weather event, such as hurricane Sandy can cause acute unexpected problems. A significant shareholder activist, hostile takeover, or proxy fight could be seen as a crisis as well.

**Discussion**

Whatever the cause, the Board is expected to act quickly and effectively to mitigate the damage to the company. The panel discussion focused on how boards accomplish this. The panel discussed three hypothetical crises and addressed:

- how Boards proactively plan to prevent or deal with a crisis,
- how the Board learns about the crisis,
- how they respond to the crisis – both with internal and external resources,
- what pitfalls the Board may encounter in dealing with the crisis,
- how they determine what and when to disclose and communicate,
- how they resolve the crisis, and,
- what is the follow-up after the crisis is resolved.

Any resemblance to a real event was pure coincidence. The discussion was not meant to be about any particular company.

The first hypothetical was an issue concerning the CEO, e.g., a significant health problem or an ethical issue. The panelists noted a key distinction between the health issue versus the ethics issue. In the former, the CEO may participate in the planning for the solution. In the latter, however, the CEO would be sidelined from the discussions.

The panel laid out certain steps that should be taken before a crisis hits. The Board should have resources identified in advance to deal with possible issues. Also, the Board should have a short term and long term plan for CEO succession. Once the Board becomes aware of the crisis, the first step is to find out the facts. The Board will likely need outside expertise to investigate and evaluate the issue. Outside counsel, a public relations firm, and medical expertise in the case of a health issue, were all mentioned as resources the Board might need.
Once the facts are established, the Board must then address the timing of any actions. In a medical problem, the decisions depend on the nature of the problem – whether the CEO can continue to perform effectively for some amount of time or whether the situation is acute and a replacement is needed immediately. If a significant ethical lapse has occurred, the CEO would likely be replaced quickly.

After the decision is made regarding what will happen to the CEO, the next question is what to disclose and when to disclose it. The discussion made clear that the answer to these questions is not always obvious. A number of issues arose. Privacy concerns were raised, not just for the CEO, but also for his or her family. If the CEO could continue to perform for some time, would it be in the best interest of the company or not to disclose to the public? If the CEO was replaced, did the public need to know why if the CEO was no longer there? Would the story leak if the company did not disclose it? There was agreement that the Board cannot mislead the public, so once the Board decided to disclose, the information had to be complete and accurate and kept current. Overall, there was a sense that corporate integrity, tone at the top, corporate culture and protecting the company’s reputation all point in the direction of disclosure, especially in the post Sarbanes-Oxley environment, in which standards and expectations of corporate boards have become much more rigorous over the past 10 years.

The second hypothetical was a company facing a possible enforcement action. The panel focused on a Foreign Corrupt Practices Act (FCPA) violation. The law essentially prohibits payments to a foreign official to generate business. Although the law is decades old, enforcement focus has picked up significantly in recent years.

The panel highlighted a variety of ways in which the company could learn that it had violated the FCPA: a whistleblower complaint to the audit committee, a press article, a competitor losing a contract, or a disgruntled employee. However, the company learns about an alleged FCPA violation, the Chair of the Audit Committee, as well as the General Counsel should be informed immediately. They, in turn, would determine next steps. Large, multinational companies typically have an internal group to review and investigate such allegations. However, for both large and small companies, if the alleged violation appears to be significant or if someone in senior management may be involved, it is important to undertake an independent investigation. In addition, the outside auditor and outside counsel need to be informed quickly.

While this is typically not a life or death situation, timeliness is important. Unless a regularly scheduled Board meeting is imminent, the Audit Committee Chair should inform the Committee members within a few days, and the Committee would likely want to have a special meeting of the Board, typically by phone, to inform the Directors and discuss options, including self-reporting to the enforcement authorities. Since self-reporting is looked upon positively, at
least in the U.S., the company would likely want to report to the enforcement authorities within two to three weeks of the Board discussion.

There was general agreement among the panelists that Board members should be informed in a timely manner so as not to be surprised by a press article or an enforcement action. Their reputation and the reputation of the company are at risk, and Directors would take an alleged FCPA violation very seriously.

The third hypothetical was a suspected fraud. The panel focused their discussion on an ongoing, material financial fraud by someone in senior management. In this situation, the panelists agreed that action needed to be taken quickly. Delay was not an option. The Audit Committee Chair and the lead independent director would need to be notified right away, and an investigation would be started quickly. If a fraud had been committed, it would need to be reported and stopped.

To be prepared for such an event, the independent directors should insist that the General Counsel have identified outside legal expertise that can be brought in immediately. Similarly, the CFO should have identified potential audit resources other than the firm’s external auditor. If a fraud were suspected, the independent directors would need to bring in such outside expertise to conduct the investigation.

One of the first decisions is what to do about the perpetrator of the alleged fraud. The individual would likely not admit to the fraud, at least initially, but rather would have a story to explain the action. Whether to bench or “ring-fence” the executive would depend on how strong the allegations were. However, the executive should not be left in place without constraints on his or her activities.

The panel emphasized that for his or her own continued career, it was important for the executive to cooperate with the investigation. In this regard, the panel agreed that the company should provide excellent legal counsel for the person to make sure that the legal advice given is constructive.

The question was raised regarding when to go to the SEC. If a quick investigation did not corroborate the fraud, the company could continue to monitor the situation without reporting anything unless and until a full investigation revealed a fraud. Alternatively, the company could report to the SEC early in its review, but would risk losing control of its investigation if the SEC starts its own investigation. If a material financial fraud were determined, however, both the company and its auditors would have to file with the SEC within four days if it is determined by
the company and its auditors that the company’s previously published financial statements cannot be relied upon.

The panel agreed that of the three scenarios, this situation would likely be the most time sensitive and time intensive for Board members, and could require daily Board calls until the situation was resolved. Overall, the discussion highlighted the importance of Board focus and timely action when faced with a crisis.
8. The Role of Corporate Directors in Overseeing Financial Reporting

On March 31, 2014, this continuing series focused on the role of corporate directors in overseeing financial reporting.

Background

The Hon. Cynthia Glassman moderated the panel. She is Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary’s designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The panelists were the following:

Candace Duncan is the former Managing Partner of the Washington Metro Area of KPMG and has worked with numerous public company Audit Committees. She was the first woman to be admitted into the KPMG partnership in Virginia and has served in a variety of leadership roles, including the first woman to become managing partner of the Washington Metro Area offices. Prior to this role, Ms. Duncan served as the Midatlantic Area managing partner for Audit and as the Audit partner in charge of the firm’s Virginia business unit. Candy also served as a member of KPMG’s Board of Directors and as chair of the firm’s Nominating Committee and Partnership and Employer of Choice Committee.

Daniel Goelzer is currently a partner at the law firm of Baker & McKenzie and was a founding member of the Public Company Accounting Oversight Board (PCAOB), where he served from 2002 to 2012, including serving as Acting Chair from August of 2009 through January of 2011. Mr. Goelzer specializes in matters involving the Securities and Exchange Commission (SEC) and the PCAOB. His practice areas include corporate governance; compliance with SEC disclosure and financial reporting requirements; the auditor/public company relationship; and financial institution regulatory issues, with a focus on global asset custody. From 1983 to 1990, Mr. Goelzer served as General Counsel of the Securities and Exchange Commission.

Roger Millay is currently Vice President and Chief Financial Officer of Towers Watson and has 12 years’ experience as a public company CFO. Before the firm’s merger with Towers Perrin in
2010, he held the same position at Watson Wyatt. Roger, a certified public accountant, has more than 30 years of finance and accounting business experience. Earlier experience includes roles with Arthur Young & Company, GE Capital, Airgas, Inc., and Discovery Communications. Roger is a member of the Board of Governors of the Folger Shakespeare Library and a Trustee and Chair of the Audit Committee of the College Foundation of the University of Virginia.

**Follin Smith** is the Chair of the Audit and Risk Committee of Discover Financial Services and is a member of the Boards of Directors of Kraft Foods, Ryder Systems, Inc. and Discover Financial Services. She is a member of the Davidson College Board of Trustees and of the CenterStage Board of Trustees. Until May 2007, Ms. Smith was Executive Vice President and Chief Financial and Chief Administrative Officer of Constellation Energy Group. With $19 billion 2006 revenues and $15 billion in equity market capitalization, Constellation Energy is the nation’s largest competitive supplier of power and one of the largest nuclear generators in the country.

For context in addressing the Board’s role in overseeing financial reporting, the panel began with a short history, beginning with the Securities Act of 1933, which was passed in reaction to the stock market crash in 1929. The Act required an independent public or certified accountant to attest to the accuracy of financial statements of public companies. These accountants were then liable for misleading statements or omissions of fact. In 1934, the newly formed Securities and Exchange Commission created Form 10, later known as form 10-K, for permanent registration of existing securities. It included both financial and non-financial data about public companies.

However, it wasn’t until the 1970s that Audit Committees of the Board became prevalent. That was likely in reaction to public statements by the NYSE and the SEC. In 1972, the SEC endorsed the establishment of Audit Committees composed of independent directors for all publicly held companies and a few years later asked the NYSE to add the requirement to its listing standards. The apparent goal was to bolster the independence of the auditor, since that independence was fundamental to the concept of reliable external audits. Having an independent auditor also provided a communications channel - separate from management - for Audit Committees to receive information about the company. According to the Conference Board, only 24% of their members had an Audit Committee in 1967. By 1977, that percentage had risen to 90%. The internal audit function arose in the late 1970s, after the Foreign Corrupt Practices Act (FCPA) of 1977 required public companies to have systems of internal control over their accounting procedures.

Fast-forwarding to the accounting frauds at the beginning of this century -- Enron, Worldcom, Adelphia, and Tyco, among others, --Congress passed the Sarbanes-Oxley Act, or SOX, in 2002.

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2 Various documents from the SEC Historical Society website provided background for the historical overview

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx

http://business.gwu.edu/icr
Among its many provisions, SOX provided that stock exchanges could not list companies unless the company met certain requirements, including:

- The audit committee members had to be independent
- The audit committee was responsible for the appointment, compensation, retention, and oversight of any registered public accounting firm issuing an audit report or providing other audit or attest services for the company.
- The registered public accounting firm had to report directly to the audit committee.
- The audit committee had to have procedures for handling complaints regarding questionable accounting or auditing matters,
- The audit committee had to have the authority to hire independent counsel or other advisors and be provided with appropriate funding.

SOX also created the Public Company Accounting Oversight Board, the PCAOB, whose mission includes the responsibility “to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.” In carrying out its mission, the PCAOB registers public accounting firms, regulates and inspects them, and sets auditing standards for the profession.

Finally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) passed in 2010 in reaction to the financial crisis and “Great Recession” has expanded the scope of issues that Audit Committees must address, especially those of financial services companies.

**Discussion**

With that overview, our panel began the discussion of how Audit Committees meet the challenge of overseeing the accuracy and integrity of a public company’s financial reporting, especially the annual 10-K, which has evolved substantially from its origins in the 1930s. The panelists represented the range of key participants involved in ensuring the integrity of financial reporting at public companies and included a CFO, an external auditor, an Audit Committee Chair, and a former member of the PCAOB.

The discussion highlighted the relationships among the different roles represented and the importance of communication, integrity and trust.

The principal responsibility for developing well-controlled financial statements that comply with laws and regulations lies with company management. It is management’s role to identify and manage key risks. The actual gathering of the financial information is conducted by the CFO and his/her staff. SOX requires that the CFO, along with the CEO, must certify -- subject to civil and potentially criminal penalties - that the 10-K is accurate and complete and that they have established adequate internal controls over public disclosure. To sign that certification, CFO

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
needs to be confident in the capabilities and commitment of the people and processes involved in the development of the annual and quarterly financial reports. For most public companies, especially with diverse lines of business or geographic locations, the issues are broad and complex, and can create challenges.

The CFO typically works with a team to consolidate the financial reporting, tax requirements and accounting issues that that roll up from the various parts of the organization. The CFO’s role is to make sure that the proper management systems and organizational structure are in place with the appropriate people involved to effectively govern the process needed to accomplish the reporting objective within the tight timeframe of filing deadlines. The CFO’s role includes probing at all levels to identify and resolve issues that arise as well communicating information as appropriate to others in senior management, the Audit Committee, the full Board, and shareholders. A strong culture of accountability, integrity, and tone at the top is key to creating the right environment for the CFO to effectively perform his/her duties.

The role of the external auditor is to determine if the financial statements are “fairly stated” and give a true picture of the financial health of the company. The auditor is responsible to the capital markets and is hired by, and reports to, the Audit Committee of the Board. The auditor reviews the information provided by the CFO’s team and works through any differences of opinion regarding accounting treatment to secure an agreed upon decision. The auditor signs off on year-end numbers and also performs reviews of the quarterly financial statements.

The auditor typically meets with the Audit Committee at least once a quarter, at which time they describe the work they have undertaken and any unusual issues that have arisen. The auditor also spends a lot of time in discussions with management. Again, integrity is critical to the process. One reason auditors have refused to work with a firm or would resign from an engagement is that management does not provide accurate and truthful information.

The Audit Committee Chair and Committee members, on behalf of the full Board, oversee how management develops and prepares the financial statements. Members of the Audit Committee are typically expected to be financially literate, and the company must disclose whether or not - and if not, why not - the Audit Committee has at least one member who is a “qualified financial expert,” as defined by the SEC. The Audit Committee typically meets in person or by conference call 10 or more times a year, and they review all public financial filings to make sure they are appropriate and in good order. Their goal is to help make sure there is a well-controlled process that prevents problems from arising in the company’s financial reporting, compliance with laws and regulations, and risk taking and, ultimately, to avoid surprises. In that role, they receive input from various executives who are each responsible for building a culture of doing the right thing within the company.

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
The greatest share of the Audit Committee’s time is spent with the CFO and the controller or chief accounting officer to discuss such topics as emerging business risk, significant accounting estimates where judgment is involved, and accounting for unusual transactions. The Audit Committee also meets with the General Counsel and Chief Compliance Officer to understand all of the laws and rules with which the company must comply and make sure there are checks and balances to insure compliance. The Chief Risk Officer provides input on risks facing the company, especially focused on quantifiable risks. The Chief Information or Technology Officer provides information on such issues as cyber security or a major technology system change. The Internal Auditor objectively reviews and tests the effectiveness of controls, independent of the management that creates them, and is a powerful safeguard for the company. As employees of the company, the internal audit group may face tensions as they evaluate and suggest improvements in the control environment of others in the company. To protect the independence of the head of internal audit, the Audit Committee typically is involved in the performance review and pay decisions for that officer.

Finally, as an independent third party, the external auditor is the last check for feedback on any difficult issues or judgments in the financial reports. The external auditor also helps the committee members understand best practices, alerts them to any unusual accounting practices, and highlights evolving issues under consideration by, for example, the SEC, FASB (Financial Accounting Standards Board) or the PCAOB.

Typically, the Audit Committee will also meet in Executive sessions (i.e., with no other members of management present) with each of the senior management individuals noted above, as well as the external auditor, which enables candid discussion of any concerns or discomfort the individual may have regarding the firm’s financial reporting, controls and processes, or risk taking.

The PCAOB, created with the passage of SOX in 2002, oversees the audits of public companies by setting and enforcing audit standards. While the PCAOB does not directly oversee or regulate Audit Committees, it wants to make sure that Audit Committees have the information they need to carry out their duties. To that end, the PCAOB has set standards for the information to be provided by the external auditor to the Audit Committee. These information standards include, for example, the audit strategy, any special factors that were considered, significant or unusual transactions, and difficult or contentious issues that arose during the audit. In recent years, expected communications from the auditor to the Audit Committee have increased significantly. In evaluating the auditor, the Audit Committee should evaluate whether the auditor has met the communication standards.

As part of its inspection function, the PCAOB reviews how the audit firm performs its engagements. Red flags for the PCAOB include unusual accounting treatment, issues regarding
the firm’s ability to continue as a going concern, and questionable judgments or assumptions. In rare instances, the PCAOB review may identify an issue that was not raised in the company’s audit. Also, the PCAOB may interview Audit Committee Chairs to elicit feedback on the external auditor.

Another important issue discussed was how a concern or problem gets conveyed to the CEO and the full Board. Generally, the view was that open communications, trust, and transparency are critical to be able to deal with such issues or problems quickly and effectively. Specifically for example, if the problem is a material accounting issue, the CFO would be expected to raise it with the CEO as soon as the matter surfaced, followed by a call to the Audit Committee Chair. Then, as the nature of the problem became clearer, it would be brought to the attention of the full Audit Committee, and then to the Board by email or a conference call.

The panel then addressed the question of the role of the Audit Committee in overseeing risk management at a public company. The oversight of risk management has become particularly important in the aftermath of the financial crisis and the “Great recession.” Many financial institutions, in particular, have created a separate Risk Committee of the Board. Some nonfinancial companies have also instituted a Risk Committee of the Board. The Risk Committee focuses on nonfinancial risks. It is a challenge, however, to designate what is covered by the Risk Committee and what remains under the purview of the Audit Committee. To some extent, the determination depends on the industry and the specific expertise of Board members. Nevertheless, there may be some unavoidable overlap and tensions between the roles of the two committees.

Finally, the panel discussed the changes that have taken place in financial reporting oversight in the last 10 to 15 years. Simply put, the panel agreed that the frequency of Audit Committee meetings and the length of time of those meetings have increased enormously over this period, due to increased business complexity, more stringent regulatory requirements, accounting changes and documentation expectations. Internal audit and compliance staff has grown substantially, and the cost of external audits has increased as well. It is not possible to oversee effectively the financial reporting without the increased time, effort, and expense. Examples of issues demanding additional attention include compliance with FCPA, anti-money-laundering, supply chain issues such as conflicts minerals disclosures, and labor practices. Further, expectations for oversight of vendors used for outsourcing have grown substantially.

The panel also agreed that in the post-Enron, post-SOX environment, Corporate Directors are much more inclined to ask probing questions and push back against management if appropriate answers are not forthcoming. The importance of the Audit Committee executive sessions was also noted as an important factor in the changing culture at public companies. Further,
Incentives to manage short-term earnings have been limited by longer-term incentive plans for compensation of senior management.

While the panel agreed that, over time, the processes used to generate financial reports have been improved, there was discussion regarding whether the benefits outweigh the costs. In particular, to the extent that the Board’s time is absorbed by focusing on details, they may be missing the bigger picture and shortchanging the time spent on significant strategic issues.
9. The Role of Directors when Dealing with Activist Investors

On **November 4, 2014**, this continuing series focused on the role of Corporate Directors in dealing with activist shareholders.

**Background**

**The Hon. Cynthia Glassman** moderated the panel. Dr. Glassman is an ICR senior research scholar. She served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she chairs the Audit Committee, and Navigant Consulting, where she serves on the nominating and governance and on the compensation committees. She is a former Trustee of the SEC Historical Society and a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues.

The panelists discussing this Board challenge were Board Directors who face this actual or potential challenge on an ongoing basis, and consultants who advise Boards on how to prepare for or deal with activist shareholders.

The panelists were the following:

**Ken Bertsch** is a partner at CamberView Partners, LLC. He has spent over 30 years in leadership roles in corporate governance and has been named one of the 100 most influential leaders in corporate governance by the National Association of Corporate Directors. Previously, Mr. Bertsch led corporate governance teams at Morgan Stanley Investment Management, Moody’s Investors Service Corporate Governance Ratings, and served as Director of Corporate Governance at TIAA-CREF. He most recently served as CEO and President of the Society of Corporate Secretaries and Governance Professionals. Mr. Bertsch currently serves as a director on the board of the Investor Responsibility Research Center Institute.

**Joe Rigby** is Chairman, President, and CEO of Pepco Holdings, Inc., a regional energy holding company that provides utility services to about 2 million customers. He serves on a number of Boards of local and national associations and is a member of the Rutgers-Camden School of Business Executive Advisory Board. Mr. Rigby is immediate past chair of the United Way of the National Capital Area. He is a member of the senior council of the Greater Washington Board of Trade, having served as its chairman. He also serves on the boards of the U.S. Chamber of Commerce, the Edison Electric Institute, the Federal City Council, the Greater Washington Initiative, and the Economic Club of Washington.

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
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Kathryn Turner is the founder, Chairman and CEO of Standard Technology, Inc., a management consulting firm focused on health information management for the Department of Defense. Currently, she serves on the Boards of Directors for Carpenter Technology Corporation, the National Association of Corporate Directors (NACD) National Capitol Area Chapter, and the Smithsonian Institute Library Advisory Board. She has also served previously on the Boards of Directors for ConocoPhillips, Schering-Plough, The Tribune Company and COMSAT and the BB&T Montgomery County Advisory Board, as well as the National Capital Area Chapter of the Boy Scouts, the Northern Virginia Urban League, and Children’s Hospice International.

Susan Ellen Wolf is the founder and CEO of Global Governance Consulting, LLC. Ms. Wolf is a member of the Advisory Board for C-LEAF. Over a 25-year career as an in-house lawyer (with extensive experience in securities law, M&A and governance), Ms. Wolf’s positions included Corporate Secretary, Chief Governance Officer and Associate General Counsel of Schering-Plough Corporation (now Merck), as well as securities law and governance positions with The Coca-Cola Company, Delta Air Lines, Baltimore Gas and Electric Company (now Exelon) and ConTel (now Verizon).

This panel addressed an issue that relates to the Board’s duty of loyalty to act in the best interest of the company’s shareholders, that is, how the Board deals with activist shareholders.

In addressing shareholder activism, it is important to keep in mind that a company’s shareholders are a diverse group of individuals and institutions that may, or may not, have the same views regarding how the company should operate. That fact alone makes protecting the interests of shareholders a challenging prospect, especially when an investor is pushing for significant change. The challenge for Boards is that what activist investors want may not always align with what is best overall for the company’s shareholders.

What activists may want covers a broad range of issues. Some shareholders have very specific agendas regarding, for example, social, environmental, or governance issues. Others, more generally, want to see improved performance. Some want improved performance through such actions as strategy change, management change, board change, or financial engineering.

The term shareholder activist covers a range of shareholders who are actively trying to effect change at the target company. Activists can be individual shareholders or groups who attend annual meetings or submit shareholder proposals to advance their agenda. At the other extreme are large institutional investors, who in recent years have become more aggressive and successful in pushing for change at public companies.

The type of investor who has become an activist has broadened. In the past, activists tended to be small “gadfly” shareholders or aggressive corporate raiders. Now, hedge funds, mutual
funds, and pension funds are more actively engaging with company management and Boards. Even traditionally passive investors may coordinate with activist investors in encouraging change.

Some activist shareholders act very publicly; others work behind the scenes. However, even when starting behind the scenes, investors may become more public if the Board and management are not engaging and responding to the activist’s satisfaction.

A few very recent examples of shareholder actions are:
- CalPERS and CalSTRS and the New York City pension funds criticizing Bank of America’s decision to combine the Chairman and CEO positions.
- Starboard Value LP getting shareholders to vote to completely replace Darden’s Board with its own slate.
- Carl Icahn pushing Apple to buy back more of its shares.

**Discussion**

The panel discussed what Boards should do to protect themselves from becoming a target of an activist as well as how to respond to an approach by an activist. There was general agreement that preemptioning activist interests requires good communication with shareholders in order to understand their concerns as well as to convey clearly the company’s plans. It was also noted that activists are usually less concerned about a company if its share price is performing well.

However, the company’s plans and what the activist wants the company to do are not always aligned. In that case, steps those companies can take to deal effectively with activist approaches include:
- Having an ongoing investor engagement program in which an executive in the company – for example, Investor Relations Officer, Corporate Secretary, or Chief Governance Officer – is designated to take the investor calls and to brief the Board on what is on the investors’ minds.
- Conducting assessments, for example, by investment bankers, to identify potential vulnerabilities.
- Undertaking periodic practice drills regarding what the Board and management will do if they get a specific request.
- Identifying a team in advance, including appropriate counsel and consultants, so that any response can be consistent and timely.
- Making sure the Board has the leadership, organization, and understanding of their plan to speak with one voice.
- Having appropriate resources to deal with this issue (and any other significant disruption or risk that may arise.)
• Treating investors with respect, especially regarding listening to and understanding their concerns.

An actual example of the process that Schering Plough went through in addressing the concerns of activist Ralph Whitworth of Relational Investors, LLC. was described. Susan Wolf and Kathryn Turner spoke of an engagement between Schering-Plough (where Ms. Wolf was Chief Governance Officer and Ms. Turner was a Director and Chair of the Board’s Nominating & Governance Committee) and Relational Investors, an investment firm that at the time was led by the activist Ralph Whitworth. Relational had taken a stake in Schering and asked for a meeting with management and a member of the board. Certain outside advisors counseled against the meeting, based on a recent, well-publicized and somewhat adversarial interaction between Relational and Home Depot. But Schering’s CEO believed in listening to, and learning from, investors and other key stakeholders. Ms. Wolf and the Investor Relations executive had met Ralph Whitworth and others from his team at Council of Institutional Investors meetings and other governance forums. They both supported the meeting.

After consideration, a meeting was held and it went very well. The CFO, Investor Relations executive and Governance Officer met with Relational executives for a half day. The Chairman of the Board and CEO attended for an hour. Only public information was discussed. The meeting allowed Relational Investors to get a sense of the senior team’s commitment to driving a corporate transformation forward. Relational Investors did not ask for further involvement with the board or management or for any changes (operational or governance) at the company. Ms. Wolf noted that many companies engage in successful shareholder interactions of this type, which get no notice from the media as there is no controversy involved.

In response to a question on why Boards do not just say yes to an activist shareholder, the panel made several points. One was that the Board needs to understand the motivation behind the request and determine whether it is consistent with the company’s own strategy, especially for the long-term. Often, activists have a shorter-term focus than the company does, and want the company to take actions, such as cutting costs, that could negatively impact long term viability. In this regard, it is important that the Board understands and believes in the company’s plan, that they have confidence in the management team, and that they have a long-term view of the company and the industry. Further, other shareholders may have different interests. Some may prefer steady dividends, while others may want share buybacks. Index funds may take a longer view than certain hedge funds. The Board and management have to take all of these perspectives into account when determining their response to a specific shareholder request.

The panel then addressed concerns about whether independent directors should engage directly with the activist shareholder. The concern is that although most directors have a good
understanding of the company, they are not as deeply involved in or knowledgeable about the operations as is senior management. The panel suggested that the Board have a process in place for such engagements, and that the initial contact be made by management in order to understand the issue at hand. Follow-up meetings could involve independent directors with the appropriate expertise. That could be the Lead Director or Non-Executive Chair, the Chair of the Compensation Committee (if the issue is about compensation), or the Chair of the Nominating/Governance Committee (if the issue is about governance). Such engagement provides the company the chance to show the activist that its Board members are knowledgeable and engaged in the discussion.

The panel had similar suggestions for dealing with proxy advisors when they make recommendations on how shareholders should vote their proxy that conflict with the company’s recommendations. While the Board needs to be aware of and understand the concerns of the proxy advisors, it is management’s role to engage initially in the discussions with the proxy advisor. However, follow up discussions that include an appropriate independent director may help resolve the issues.

Finally, the panel addressed when and whether approaches by, and discussions with, activists should be made public. The view was that generally it is in the best interest of the company to keep the discussions private as long as possible. That enables more flexibility in such discussions. However, in certain circumstances, such as a proxy contest or an activist who goes public, it is important to have a public relations firm identified and ready to provide advice. That brought the discussion back to the earlier point of how important it is for the Board to be prepared.
10. The Role of Directors when Dealing with Cybersecurity Risks

On April 7, 2015, this panel in the continuing series addressed an issue that relates to the Board’s oversight of risk managements, that is, how the Board deals with cybersecurity issues.

Background

The Hon. Cynthia Glassman moderated the panel. She is, Senior Research Scholar at the ICR. She is a member of the Board of Discover Financial Services and serves on the audit committee. She is also on the Board of Navigant Consulting, Inc. and serves on the nominating and governance and on the compensation committees. Prior to her current roles, she was appointed by President Bush to serve as the Under Secretary for Economic Affairs at the U.S. Department of Commerce from 2006 to January 2009. In that role, she served as the principal economic advisor to the Secretary of Commerce and oversaw two major Federal statistical agencies. She was also the Secretary's designated Board Representative to the Pension Benefit Guaranty Corporation (PBGC), where she was actively involved in PBGC investment policy and corporate governance matters.

The panelists were Board Directors who actually face this actual or potential challenge on an ongoing basis as well as experts in cybersecurity issues.

The panelists were the following:

Scott Cogan is currently responsible for managing RSA’s global alliances business working closely with strategic partners to solve today’s most challenging, governance, risk, and compliance (GRC) including cyber and third-party risk issues. In this role Mr. Cogan is responsible for the business relationships and go to market strategies associated with leading Advisory firms, System Integrators, and Service Providers. Mr. Cogan has over 20 years of experience in the space and has held leadership positions in large and small firms with roles in business development, sales and consulting. During his career, Mr. Cogan has been a principal or founding member in several leading companies focused on bringing dozens of innovative consulting services, managed security services, and new product offerings to market.

J. Richard Knop is a member of the Board of Trustees of The George Washington University where he is Chairman of the Board of Directors of the GW Center for Cyber and Homeland Security. He is co-managing partner of FedCap Partners, a private equity firm focused on the government defense contracting industry. Mr. Knop is also a member of the Board of Directors for a number of federal service and technology companies. With over 25 years of investment
banking experience, Mr. Knop has closed a broad range of investment banking transactions. He has personally closed over 100 defense and government contractor mergers ranging from $10 million to $1.2 billion. In 2004, Mr. Knop was awarded the Distinguished Alumni Achievement Award from The George Washington University. He is a member of the Board of Directors of the World Affairs Council.

**Gail Lione** is a senior executive with intellectual property, business strategy and corporate governance experience. She is also an adjunct professor at Georgetown University and taught intellectual property law at Marquette University Law School. She is a Senior Fellow of the Governance Center of The Conference Board. She has been a member of the Board of Directors and Audit Committee of Sargento Foods Inc. since 2006; she is the Lead Director at Badger Meter, Inc. since February 2012 and serves on its Compensation and Corporate Governance Committees; and she was elected to the Board of The F. Dohmen Co. in March 2013 and serves on its Audit Committee. Ms. Lione formerly served as a director of Imperial Sugar Company and was the Executive Vice President, General Counsel, Secretary and Chief Compliance Officer of Harley-Davidson, Inc.

**The Hon. Ronald Spoehel** is a private investor with over 35 years of private investment, board, executive management, and investment banking experience, from Fortune 500 to technology start-ups, and served as the Presidentially-appointed Senate-confirmed Chief Financial Officer of NASA. He currently serves on the Boards of U.S. and international companies including publicly traded Profire Energy (Committees: Audit, Compensation (chair), and Nominating and Corporate Governance) and Global Defense & National Security Systems (Committees: Audit (chair), Compensation, and Nominating). Over the last 25 years, he has served in executive management with multinational companies such as ManTech, Harris and ICF Kaiser; on Boards of public and private companies in the U.S., the Americas, and Europe; and on the U.S. Air Force Audit Committee.

Cyber attacks on companies have been increasing in their number, cost, and impact on companies and their customers. Recent examples include attacks on:

- Premera Blue Cross, affecting as many as 11 million customers
- Anthem, another major health insurer, affecting tens of millions of customers and employees
- Sony Pictures, with internal data centers wiped clean, embarrassing emails leaked, personal data, stolen, and the movie The Interview cancelled, and
- Staples, in which over a million credit cards were compromised.

This new cyber environment presents a new challenge for Directors, whose role with respect to risk is oversight, not management. They are only at the company a few times a year. However, as good stewards of the company’s assets, they need to make sure that management is acting...
responsibly to minimize cybersecurity risk incidents and to mitigate the impact of breaches that occur.

Discussion

The panelists described the increasing cybersecurity risk in an environment in which the world is more digitized and wireless. In that regard, every company is – to a greater or lesser extent – a technology company. The “bad actors” are more sophisticated and more diverse, ranging from hackers to criminals to nation states. Their impact is disruptive and dangerous, affecting the culture and operations of companies. The consequences of cyber attacks include:

- theft of intellectual property and trade secrets, for example at Boeing and Sony
- theft of credit and debit card information, for example at JP Morgan Chase and Target
- wiping out computers and the ability to conduct business, for example, at Sony
- access to classified information, for example at USIS, a contractor that was barred from government work because of the stolen classified information
- potential shutdowns of critical infrastructure, for example, by a computer worm such as stuxnet
- shareholder and consumer law suits against Boards and management
- CEO and other senior management job losses, and
- loss of company reputation and brand name

In the discussion, it was pointed out that a Board’s role in overseeing cybersecurity risks is not that different from other risks that the company faces. Over time, companies have done much of the groundwork in establishing processes and procedures to manage this risk. The examination of internal controls that was enhanced by requirements of the Sarbanes-Oxley Act of 2002 has tightened restrictions on access to computers and confidential information. Potential litigation and concomitant discovery requests have meant that companies are better prepared to know where their confidential information and other important records are kept and protected. Trade secret theft is not a new issue. As a result, the elements of what management needs to do would typically be in place. The key difference in managing cybersecurity risks is the time pressure. Attacks come more often and faster; there is less time to react, and responses need to be quick and effective.

With technology everywhere and access to information pervasive within companies, it is incumbent upon Boards to make sure their companies have an effective strategy for appropriately addressing cybersecurity risks. This has required more focus by Directors on such risks. There is an increasing expectation that Boards are knowledgeable about their cybersecurity risks. In particular, Boards have had to enhance their understanding of:

- how cyber attacks can occur
- what the possible legal, financial, and reputational risks are to their company
what the company does to fend off the attackers
how well the company is positioned to mitigate quickly any attack that does occur
when and how a breach needs to be disclosed to customers and shareholders. In that regard, the Securities and Exchange Commission (SEC) is looking at the possibility of requiring companies to disclose more information about cybersecurity vulnerabilities and breaches. (It was noted that private companies have the same risks, except they face fewer disclosure requirements than public companies.)

The panel then turned to how Boards obtain the understanding and information they need to carry out their fiduciary responsibility of protecting their company’s assets – including digital assets – from cyber threats. The discussion revolved around two topics: What boards need to know and what they need to do.

The discussion turned to what boards need to know and highlighted that Boards need to have a clear understanding of their business operations. That includes where they do business and vendor supply chain relationships. They need to know what key assets of the company are vulnerable to attack. They should receive reports and briefings on management’s cybersecurity risk management plan and how it fits into management’s integrated strategic plan as well as relevant metrics that support the plan. Key information includes feedback from internal, (e.g., Chief Information Security Officer) and third party experts to understand vulnerabilities and activities regarding prevention and protection, such as:

- the extent and nature of firewalls;
- the existence of red flag alarms that identify when and where an attack has occurred;
- programs to manage effectively “identities” within the company to protect it from misuse of identities by hackers who download malware or steal information.

Boards should also be updated periodically on how management’s cybersecurity risk management program is evolving over time to address new threats and changes in the business.

The panel noted that the National Institute of Standards and Technology (NIST) has put out voluntary standards and guidelines to help manage cybersecurity risks and suggested that Boards should be aware of the NIST standards and whether management is following them or, if not, why not. They also pointed out the availability of numerous Director education programs on cybersecurity risks from, for example, NACD, and the NYSE, among others.

The panel then discussed what boards need to do. Very simply put, the panel suggested that the Board’s role is to ensure that management has in place a cybersecurity risk management program that is appropriate for the company; that the program is integrated into the
company’s enterprise risk management (ERM) program; and that information technology (IT) risk governance is an integral part of Board governance. The audit committee or a special cyber committee may monitor this more closely, and the Board may even want a Director with IT experience. However, the entire Board should understand and oversee ERM as relevant for their company.

Discussions about the program and considerations for budgets for IT, training, and education regarding cyber issues, should cover priorities in resource allocation. Tradeoffs between efficiency, growth and innovation versus managing cybersecurity risks should be considered. The Board should discuss with management how these are taken into account in day-to-day business operations and in evaluating changes such as new product lines, new business lines, or mergers and acquisitions. Along with management, the Board should consider ways to turn this risk into an opportunity.

Further, the Board should make sure that management has in place a comprehensive and customized incident response, notification and public relations plan that covers who will be involved internally, what outside experts will be engaged, what state and federal agencies need to be contacted, and what is required to comply with state and federal privacy and security laws. Disclosures should take into consideration the difference between consumer facing business versus other types of business, how to rebuild trust, whether there are good reasons to delay disclosure, and when discussions about disclosure should take place under attorney client privilege.

Finally, the panel noted the importance for the Board in understanding the coverage of cybersecurity risks in the company’s general insurance policies, coverage under Directors and Officers policies, and determining potential benefits of obtaining standalone cyber insurance.

Conclusion

In sum, the panel agreed that cybersecurity risks affect the entire company. However, not every company is the same. For example, the nature and level of cybersecurity risks differ among manufacturing versus health care versus technology services. Boards need to consider what industry their company is in and hold management accountable for cyber risk strategies that are relevant for that institution. There is no “one size fits all” solution to the cybersecurity challenge.
11. The Role of Directors in Mergers and Acquisitions

On October 1, 2015, the eleventh panel in the series on Challenges in Corporate Governance addressed an issue that relates to the Board’s oversight of corporate strategy, that is, how the Board deals with mergers and acquisitions.

Background

The Hon. Cynthia Glassman moderated the panel. Dr. Glassman is an ICR senior research scholar. She served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she chairs the Audit Committee, and Navigant Consulting, where she chairs the Nominating and Governance Committee and serves on the Compensation Committee. She is a former Trustee of the SEC Historical Society and a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues.

The panelists were the following:

Tyler Brooke is the Senior Vice President of Mergers & Acquisitions Shareholder Advisory at Goldman Sachs. His work focuses exclusively on activism and raid defense for corporate clients including with respect to proxy contests and execution of contested M&A transactions. Mr. Brooke’s background is in traditional M&A, focused on clients and transactions in the technology, media, telecommunications, and real estate industries. Prior to joining Goldman Sachs, Tyler worked in investment banking for Lehman Brothers / Barclays and received an MBA from Columbia Business School.

Robert Gervis currently serves on the board of directors of Axiall Corporation, Aspen Aerogels, and EnergySage. He previously has served on several other boards, including Tronox Incentive Targeting, ProBuild Holdings, and Crowdly. Prior to 2009, Mr. Gervis spent nearly 15 years in a variety of senior executive positions at Fidelity Investments in Boston, MA; and before that he was a partner in the New York office of Weil, Gotshal & Manges. Mr. Gervis currently serves on the advisory board for the C-LEAF at George Washington University Law School, several committees including an investment committee for Combined Jewish Philanthropies in Boston, MA, and the Budget and Finance Committee for Gann Academy in Waltham, MA.

Marilyn Mooney is a partner in the Washington, D.C. office of Norton Rose Fulbright. She heads the Mergers and Acquisitions practice and is the Partner-in-Charge of the Corporate and
Marilyn serves the Internal Audit Committee, the Audit Response Committee and Diversity and Inclusion Committee. Marilyn is known for running complex worldwide acquisitions, often in regulated industries. Her transactional practice includes mergers and acquisitions, joint ventures, tender and exchange offers, purchases and sales of assets and securities, public and private offerings of debt and equity securities, and counseling Boards of Directors and Special Committees in regard to proposed transactions. She was a member of DuPont’s acquisition team for the then largest takeover battle in US history, the acquisition of Conoco, Inc.

Susan Ellen Wolf is the founder and CEO of Global Governance Consulting, which designs governance processes to drive high-performance, including, board/committee self-assessment; board refreshment; succession planning, risk oversight and other board functions; shareholder engagement and response to activism; crisis management; customized board education; best practices for executive-board interaction. Ms. Wolf’s prior corporate experience includes Chief Governance Officer, Associate General Counsel & Corporate Secretary of Schering-Plough until it merged with Merck and securities law/governance positions at The Coca-Cola Company, Delta Air Lines and predecessors of Verizon and Exelon. Ms. Wolf is currently a member of the George Washington University Business and Finance Law Board of Advisors and a Senior Fellow at The Conference Board Governance Center.

One of the key roles of Board Directors at public companies is to set and oversee the strategic direction of the company. In discussions of strategy with senior management, the Board typically addresses issues surrounding organic growth, inorganic growth through mergers and/or acquisitions, and possible divestitures to realign the business. If the strategy discussions result in plans to merge, acquire, and/or divest in a way that is significant to the company, the Board is then involved in reviewing and evaluating potential deals and overseeing implementation. Often, the company will engage outside counsel and investment bankers to aid in the evaluation, planning and implementation process.

Consideration of mergers and acquisitions – and divestitures – has always been one of the key roles of Boards of Directors. A recent Wall Street Journal article noted that companies have announced $3.2 trillion dollars of U.S. M&A this year, according to Dealogic. 2015 may be a record setting year for M&A.

M&A present multiple challenges for Directors, including:
- Making sure that the transaction is in the best interest of the company and its shareholders
- Exercising due care and avoiding conflicts of interest
- Asking the hard questions and challenging management’s assumptions
- Avoiding actions that could result in litigation.
Discussion

The panel addressed the issue in the context of a corporate finance framework. That is, the company owns assets from which it makes money. The management team and Board determine what to do with the money that the company makes. There are several choices for what to do with the money:

- Give it to shareholders through dividends or stock buybacks,
- Change the firm’s capital structure by paying down debt and reducing leverage,
- Invest the funds back into the business to grow organically through, for example, research and development, capital expenditures, or increasing the sales force, or
- Engage in M&A activities that will supplement the strategy inorganically, often in ways that cannot be accomplished organically.

From a strategic perspective, the company engages in M&A activities to improve business performance and its share price. The purpose of M&A activity may be to increase revenues, decrease costs by making the company more efficient, or reduce risk, such as by buying a supplier or a distribution channel. Examples of M&A goals include diversifying into new products or new geographies.

It was pointed out that the role of the Directors with respect to a specific acquisition depends on the relative size and strategic fit with the company’s existing business.

- A very small and incremental transaction would typically be delegated to management, with only reporting to the Board.
- A somewhat larger and less evolutionary transaction would be brought to the Board for presumptive approval, with limited review.
- A transaction of significant size or change for the company would undergo a more thorough Board review.
- A “bet the company” or revolutionary transaction would likely entail a detailed independent assessment by the Board, with input from independent legal and financial advisors.

The panel noted that M&A activity is not always successful, and that shareholders will hold the Board and management accountable if they do not do “smart” M&A. From a legal perspective, Directors are subject to the “business judgment rule” which requires directors to act on an informed basis, in good faith, and in the best interest of the company. That means that the Board cannot just focus internally on the company, but must also anticipate the possibility of being a target of dissident shareholders or another company. In other words, the Board must take into consideration the fact that the company may be part of a third party’s M&A plan. The board must understand the company’s corporate governance, its by-laws and its vulnerabilities.
The case law in the aftermath of the surge of mega-mergers in the 1980s has made complying with the business judgment rule more complicated. If the company is defending against a takeover, the enhanced scrutiny if the matter goes to court will focus on anti-takeover moves and other defensive measures that the company may employ, before the business judgment rule comes into play.

If the Board decides it is going to sell the company, either proactively or in reaction to a takeover offer, other duties come into play. At that point, the focus moves away from the notion of protecting the corporate entity since the entity will no longer exist. Rather, the focus moves to maximizing the value of the sale for the shareholders. It was noted that the negotiations take place in the context of “dueling fiduciaries” in which all parties are attempting to do the best job for their clients or shareholders.

In that regard, a practice was described that helps position boards to make decisions about potential M&A activity. Specifically, every 12 to 18 months, the company schedules an educational session, not tied to a strategy discussion, for the Board to help the Directors be ready if a shareholder activist pressures them to make an acquisition, spin-off part of the company, or split-up. This type of session would also help Directors make decisions about organic and inorganic growth in general, and about specific deals in particular. Typically, the agenda would begin with an overview by outside investment bankers of what has been happening in the company’s industry, their view of the outlook for the industry, and an assessment of likely acquirers and acquirees. Following that discussion, a legal advisor would cover legal challenges, such as antitrust issues and regulatory considerations. In addition, other relevant advisors would be brought in as appropriate. The purpose of such a session is to give the Board a strong foundation of knowledge for when the time comes to actually make an M&A decision.

Investment bankers help Boards evaluate the company’s value and whether it is a likely acquisition target. They provide a view of the company’s intrinsic value based on a range of analyses, not just the current stock price. Their role differs somewhat when a company is in a “normal” negotiation versus a hostile takeover situation. In a normal negotiation, the parties discuss a number of factors, such as the price, location of headquarters, potential synergies, and the resulting Board and senior management of the combined company. Once a deal is agreed upon, it goes to the shareholders for a vote. In this situation, the selling company’s Directors need to be comfortable with the negotiated price. To help them do that, they look to the investment banker for a “fairness opinion.” Basically, the investment banker looks at a range of information about the company, including high and low share price, how research analysts value the company, a discounted cash flow analysis, and comparables in the market to develop a range of values for the company. Based on the range of values, the banker
The process differs in a hostile takeover bid situation. In that case, the potential acquirer sends a letter to the company’s shareholders – a tender offer – to buy their shares at a premium over the current stock price. The Board and management then must determine if they think the company is being valued appropriately. Even though the hostile bidder is offering a premium over the current stock price, the Board must evaluate the company’s growth prospects and ability to execute its strategy to determine whether the future value of the company is higher than the premium offered. If the Board decides to reject an offer, then it has to be prepared to defend its position.

The panelists agreed that in defending a turndown of a hostile bid, the Board needs to position itself as being in charge of the process. In the recent past, the issues would have been worked out within the Board. However, with the increasing pressures coming from shareholder activists, it is not uncommon for Board members to meet with shareholders. Normally, the CEO makes the initial contact with shareholders, but the Board may designate a special committee to deal with a specific matter. In particular, if the Board has turned down a hostile bid because they think the company can do better, the relevant committee may meet with shareholders to listen to their concerns. Because of regulatory constraints on what information companies can provide in a nonpublic forum, Directors rarely actually “talk” to shareholders. An exception is that, when dealing with shareholder activists, the Board may need to present their case to shareholders to explain why they do not support what the activist wants.

The discussion then turned to how Boards look at multinational deals. Simply put, international M&A is more complicated. The company has to align regulatory regimes and find the common denominator. There may be conflicting rules and requirements, conflicting antitrust issues and other complicating factors. There may be unintended consequences as well. An example was given of a merger of a US and a UK company with the combined company being headquartered in the US. An unintended result was that some UK institutional shareholders with mandates to hold only UK headquartered companies had to divest their shares. Because of such complications, international transactions require multiple advisors.

The question was raised as to how a Director gets comfortable that the transaction is in the best interest of shareholders, given all of the legal, regulatory, and cultural differences in multinational deals. One suggestion was made that the company already have an existing relationship with its advisors, so directors have built trust in their abilities and expertise. Another view was to start small when going into international deals and progress deliberately. Overall, the panelists agreed that cross-border M&A is growing significantly, so companies must be aware of the possibilities and issues.
Another question arose regarding how the Board deals with the situation in which a Director has an interest in the other party to the transaction. In such a case, the Board needs to insulate itself from that conflict by setting up a special committee of the Board that can replicate an arm’s length process. The goal is to make sure that the deal is achieved without the conflicted person(s) involved. The special committee has to be empowered to negotiate for the Board and to be able to hire its own advisors.

While most of the discussion was focused on issues for Boards in actually making an M&A deal, the concluding remarks made the point that making sure a deal is ultimately successful is less about how much the company pays and more about how well the CEO and other management can integrate the businesses, take advantage of synergies, and make the deal profitable. In that regard, the cultural fit of the companies is very important. As the integration progresses, the Board’s role is to oversee and hold management accountable for a successful outcome.

Conclusion

In sum, in engaging in M&A activities, Directors of public companies are expected to do their homework; understand their company’s business, strategy and culture; undertake due diligence regarding potential deals; and, make sure that management follows through effectively.
12. How Directors Choose Directors

On March 29, 2016, the twelfth panel in the series focused on the role of Directors in choosing new Directors.

Background

The Hon. Cynthia Glassman moderated the panel. Dr. Glassman served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she chairs the Audit Committee, and Navigant Consulting, where she chairs the Nominating and Governance Committee and serves on the Compensation Committee. She is a former Trustee of the SEC Historical Society and a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues.

The panelists were the following:

Keir Gumbs is a partner in the corporate and securities practice at Covington & Burling LLP. Keir started his career at the SEC, where he served for six years - first as a staff attorney, later as a Special Counsel in the Office of Chief Counsel in the SEC’s Division of Corporation Finance and finally as counsel to SEC Commissioner Roel Campos. Keir is recognized as a leading authority on securities regulation and corporate governance that represents a cross-section of constituencies in securities and governance matters, including companies ranging in size from Fortune 50 companies to venture-backed firms, as well as public pension funds, hedge funds, faith-based investors and trade associations.

Nels Olson is Vice Chairman and Co-Leader of the Board and CEO Services Practice of Korn Ferry, the preeminent executive search firm. His executive search and board assignments span the US, Europe, Asia and Latin America, and across multiple industries, including financial services, technology, consumer, industrial and healthcare. Recent Board assignments include American International Group, Occidental Petroleum Corp., The Carlyle Group, NewsCorp and The Travelers Companies. He has extensive experience in leading associations and non-profit organizations including: Business Roundtable and Motion Picture Association of America (MPAA). Prior to joining Korn Ferry, Nels had a successful career in public relations and government service, including serving on the staff of the White House Office of Presidential Personnel.
James Turley serves on the Boards of Citigroup, Emerson Electric Company, Intrexon Corporation, and Northrop Grumman. He is also on the Board of the Boy Scouts of America, and has served on the boards of several other organizations. He was on the board of Catalyst from 2001-2013, serving as its Chair from 2009-2013. He also chaired the Governing Board of the U.S. Center for Audit Quality from 2007-2011. Jim is the former Chairman and CEO of Ernst & Young, where he spent his entire professional career.

The Hon. Elisse Walter was appointed Commissioner of the Securities and Exchange Commission by President George W. Bush and served from July 2008 until August 2013. She was designated the 30th Chairman of the SEC by President Barack Obama, and she served as the agency’s leader from December 2012 to April 2013. She also served as Acting Chairman in January 2009, a member of the Board of Occidental Petroleum Corporation, the Sustainable Accounting Standards Board and the National Women’s Law Center, and a member Of the Board of Governors of FINRA, the Financial Industry Regulatory Authority.

Choosing new Directors has traditionally been one of the key roles of incumbent Boards of Directors. The process has evolved from shareholders voting for management’s slate in person at the annual meeting—with the possibility of nominations from the floor—to the current practice of voting the “proxy”—which is essentially a ballot—by mail, phone or online under rules promulgated by the SEC soon after it was established and updated over the years. Generally, management’s slate was not contested, and, to win their seats, directors only needed to get a plurality, as opposed to a majority, of the votes.

How the slate was chosen was often up to the CEO, under the theory that the CEO needed a group with which he or she could work effectively. In the 1970s, the SEC raised concerns about this process, and proposed instituting nominating committees. According to Conference Board Surveys, only 8% of companies had nominating committees in 1971. (Note: the source of this historical context is an article by Michael E. Murphy in the Berkeley Business Law Review in September 2008 entitled The Nominating Process for Corporate Boards of Directors, A decision Making Analysis.)

Fast forward to 2002 when the Sarbanes Oxley Act—or SOX—was enacted in reaction to accounting scandals in the early 2000’s. A key concern at the time was that Boards were not sufficiently independent from management and, thus, were not as effective as they should be in their oversight role. As a result, both the New York Stock exchange and the NASDAQ changed their rules for companies that wanted to list their shares with them, including requiring that the nominating and governance committee be composed only of independent directors. Currently, essentially all public companies in the US have nominating committees made up of independent directors.

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
That very abridged history gave some context to the panel’s discussion, which was focused on challenges relating to choosing new directors in the post-SOX environment, including how to have an effective balance of new perspectives and expertise while maintaining institutional memory and a workable-sized board.

Discussion

The panel discussion began with views on how the process for choosing new directors for the Board has changed from 15-20 years ago to what it is now in the post-SOX environment. Several themes emerged. First, the nature of Boards has changed. In the past, in the selection of Board members, who you knew was more important than what you knew. Board seats tended to be filled through “old boy networks,” of the current board members, especially the CEO. Further, being a CEO was often a key credential to being attractive as a potential Board member. Anecdotes suggested that some board members sat on a Board for decades without ever significantly contributing to the Board’s deliberations. Board meetings included such activities as golf outings as part of their activities. The time commitment needed to serve on a Board was more limited, enabling Board members to serve on 8 to 10 boards at the same time.

Now, however, the atmosphere has changed markedly. Being a director is a more demanding role. There is a significant time commitment. Skills matter more than titles or who you know. Board policies, discussions and actions are more heavily documented and procedurally precise. Background reading materials for Board meetings are extensive. Further, there are more external actors focused on what boards do and how they do it. The SEC’s rules, as well as the listing standards of the exchanges, have led to more transparency. Documents, such as proxy statements are more comprehensive and robust, and the public scrutiny and expectations of Boards have increased. Boards are expected to focus on strategy and risks, as well as the views of investors. It is now unusual for Board members to sit on more than four Boards, and the trend is for Boards to place a limit on how many other Boards its directors may serve.

As a result, the process for choosing directors has changed. In the past, Directors tended to be experts in general management, which is why CEOs were preferred Board members. “No longer are Boards looking for a group of Leonardo Da Vinci’s who can do it all.” Rather, Boards are looking for a portfolio of skills in a group that can work together to provide oversight and insight. As a result, Nominating and Governance Committees are now more likely to identify systematically key attributes that the Board needs now and in the future, identify where gaps exist, and develop a plan to recruit new directors to fill those gaps. In this process, they solicit views of other committee Chairs and Board members. Depending on the nature and the size of the business, these attributes can include expertise in finance, accounting, governance issues, risk, technology, cybersecurity, as well as international experience or other attributes specific to the firm or industry.
In addition to professional expertise, the panel discussed the importance of diversity on the Board. Diversity has a number of dimensions. In its broadest sense, from a board perspective, diversity refers to diversity of viewpoints, experiences and ways to approach problems. The point was made that the best decisions often are made by a group of people who do not all think the same way. By working together, they come up with an answer that is better than anyone could have come up with individually. Just starting with that premise would lead to searching for board members with different characteristics, such as gender, race, ethnic background, and age. It was pointed out that age is a particularly important attribute now, because people of different ages work differently, think differently, and approach problems differently. Adding minorities and women is important as well. Boards are increasingly recognizing the benefits of having members who reflect the views and values of their customers and employees.

There was a general sense among the panelists that more progress is needed on Board diversity. Research has shown that diverse Boards are highly correlated with better financial performance, a finding that has attracted the interest of shareholders. The regulatory environment, too, has added focus to the issues of diversity, resulting in disclosure requirements; private initiatives to identify and expand the pipeline for qualified, diverse candidates; and, in some countries, even quotas for women on Boards. The challenge, however, is that people tend to look for people who are like themselves. With some Boards still “pale, male, and stale,” developing a truly diverse board requires explicit focus on developing a diverse slate of qualified candidates.

Part of the process to determine the attributes that a Board wants in potential new board members includes evaluating existing members of the Board. The issue is not just about what gaps need to be filled, but also whether existing board members are no longer adding value or have an expertise that is no longer needed. That raised the delicate issue of Board self-evaluations.

While Board self-evaluations are increasingly common, how they are conducted varies. Some Boards use third parties, others rely on their own questionnaires, and still others have individual conversations with the Independent Chair, Lead Director, or Chair of the Nominating and Governance Committee. Some focus on an assessment of the Board as a whole, and some assess individual directors as well. Larger companies tend to have a more formal and robust process than smaller companies. The key is what the Board does with the information. While Board members are usually aware when one of their colleagues is no longer contributing, having the evaluation is a catalyst for taking the very difficult step of asking a Board member to move on.

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
The process of choosing new Board members, and whether or not to re-nominate existing members, also involves reevaluating policies regarding Directors’ tenure, age limits, term limits, and size of the Board. Age and term limits may be considered a proxy for the decision as to whether a Board member should leave the Board, but it is not always the right standard. Someone older or with more institutional knowledge may add more value than a younger or newer colleague. On the other hand, an age or term limit may be a crutch to keep someone on the board longer than is warranted. The size of the Board is an important factor, as well. Typically, Boards have about 11 members. When new expertise is needed, Boards can consider adding a board member, but too many members can become unwieldy. (Note: A Wall Street Journal article on March 24, 2016, entitled Investor Scrutinize Board Tenures, discussed questions regarding the tenure and age of Corporate Board members.)

When there is an open board position and the attributes for the next Board member are determined, the Nominating Committee must decide how it is going to develop a list of potential candidates. The choice is to use its own network or to engage the services of an executive search firm. While not all companies engage an executive search firm, the panel cited a number of advantages to using one. An important consideration in using a search firm is the transparency of the process. In addition, search firms have broader access to candidates. This is especially important in helping Boards find diverse candidates. They also have the ability to evaluate candidates objectively in the context of what the Board needs and who may be a good fit. They are able to evaluate whether individuals who are interested in being on a Board are actually qualified to serve. Further, they can help manage the process in a timely manner and deal with board politics should that arise. Overall, it is helpful to have a third party expert advise the Board. However, the panel noted that small companies in particular may not want to incur the expense of an executive search firm or may have a candidate in mind.

It was pointed out that Boards use executive search firms differently, ranging from:

- here are the skills we need, who do you have;
- help us refine the skills we need;
- help us assess the people we are considering.

The panel then turned to the question of how candidate names are surfaced. Simply put, the names can come from anywhere— including from the search firm, from current board members, even from the CEO and senior management. The key is individuals should be put through a process that allows them to be evaluated side-by-side. As a result, for example, if someone suggested by the CEO—or anyone else— does not measure up, they do not move forward in the process.

The discussion then turned to the role of the CEO in the process. It was pointed out that the CEO might contribute some promising candidates. Further, it is important that the CEO and
Board members are able to work together with mutual trust and respect. In theory, the CEO should not get a veto. In practice, they may not like a particular choice of the Nominating and Governance Committee. However, if that is constantly the case, it is an issue that would have to be dealt with by the Board.

Collegiality is important for the Board as a whole. Therefore, it is important that nominees meet with as many board members as possible so they can determine if they will be comfortable with each other. It is through the interview process that boards can evaluate the intangibles e.g. chemistry, collegiality, time availability. Generally, Boards are looking for people who do their homework and speak their minds—including standing up to the CEO if necessary, but will also listen to their Board colleagues’ perspectives. Once a Board consensus is developed, the Board members are expected to accept it, even if they disagree.

No discussion of how directors choose directors would be complete without covering the impact of shareholder activists. This is an increasing issue, as evidenced by the financial press coverage of activist activities. The panelists described different types of activists, including:

- investors who want to take over the company,
- Investors who want to change the direction of the company,
- Investors who want to influence the company’s policies, and
- Investors who just want to be able to speak to management or the Board.

With respect to activists, companies do not like being in the public eye, so increasingly they are willing to meet with the activist if they think it will be productive. Going into that determination is the track record of the activist and whether they should be taken seriously, taking into consideration, for example, whether the activist has been successful before or if it is an institutional investor who is a long-term shareholder.

When an activist wants to put a director on the board, there is often a give-and-take process. It was noted that some activists today are the smartest shareholders a company could have and that, in some cases, directors put on Boards by activist shareholders turn out to be among the best directors. Other times, however, they can be disruptive and intolerable.

**Conclusion**

The discussion about activist shareholders highlighted the importance of Board directors to a company’s success. Choosing directors with the right expertise, the right motivation, the willingness to provide credible challenges to management, and the ability to work together collegially is the ultimate challenge for directors in choosing new directors who will effectively carry out their fiduciary duty to shareholders.
13. Is Corporate Governance Common Sense?

On September 29, 2016, the 13th panel in the series focused on the Commonsense Principles of Corporate Governance that were issued in July 2016 by a group of prominent CEO’s and investment managers including Mary Barra of GM, Jamie Dimon of JPMorgan Chase, and Warren Buffett of Berkshire Hathaway. The Principles can be found at http://www.governanceprinciples.org/.

Background

The Hon. Cynthia Glassman moderated the panel. Dr. Glassman is an ICR senior research scholar. She served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she chairs the Audit Committee, and Navigant Consulting, where she chairs the Nominating and Governance Committee and serves on the Compensation Committee. She is a former Trustee of the SEC Historical Society and a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues.

The panelists were the following:

Stephen Cutler is Vice Chairman of JPMorgan Chase & Co. From 2007 through 2015, he was the company's General Counsel. Before joining JPMorgan Chase, Cutler was a partner at Wilmer Cutler Pickering Hale and Dorr LLP in Washington, D.C. and co-chair of the firm's Securities Department. From to 2001 to 2005, Cutler served as Director of the U.S. Securities and Exchange Commission’s Division of Enforcement, where he oversaw the Commission’s investigations of Enron and WorldCom, as well as those involving NYSE specialists, research analyst conflicts and mutual fund market timing and revenue sharing. Before joining the SEC as Deputy Director of Enforcement in 1999, Cutler was a partner at Wilmer, Cutler & Pickering in Washington, D.C. Cutler is on the boards of the Legal Action Center, the National Women's Law Center and the Metropolitan Museum of Art.

Tonya Mitchem Grindon is a shareholder in the Nashville office of Baker Donelson Bearman Caldwell & Berkowitz. She serves on her firm's Board of Directors and is chair of her firm’s Corporate Finance & Securities Group. She will assume the role of chairperson of her firm's Business Department in January 2017. She concentrates her practice in securities and corporate finance, corporate governance and business transactions.
**Linda Livingstone** serves as dean of the George Washington University School of Business, leveraging its unique location in Washington, D.C., to enhance the capacities of students, faculty, staff, alumni, and the business community to be productive and principled members of society. Previously, she served as dean of the Grazziadio School of Business and Management at Pepperdine University for 12 years, where she strengthened the school’s focus on excellence in teaching, scholarship, and Christian values. She has been published and cited in numerous academic and professional outlets for her work in creativity, leadership and business/higher education. Livingstone also serves on the board of Capital Southwest Industrials where she chairs the compensation committee and is a member of the board of Trinity Christian School in Fairfax, VA.

**Lynne Miller** has over 30 years of executive and board experience, including 19 years on an S&P 500 utility board, 10 years on a bank board and 16 years as President/CEO of a high-growth environmental firm she co-founded. Lynne is a director of Scana Corporation, a public energy-based holding company headquartered in Cayce, South Carolina with a market cap of $10 billion. Lynne has served on the board since 1997 and has been a member of all board committees: Audit, Nominating & Governance, Compensation, and Nuclear Oversight. She chaired the Nuclear Oversight Committee from 2000-2015. She currently sits on the Audit and the Nominating & Governance Committees. Lynne was a director of Adams National Bank, a DC based community bank, from 1998-2008. Adams was the first federally chartered bank in the US to be owned and managed by women. Lynne was the director representative to the bank’s IT Committee. She was on the Directors’ Loan Committee.

The Commonsense Principles cover eight categories, many of which have been discussed in the previous 12 ICR-CLEAF panels. The categories are:

1. Board of Directors composition and internal governance including independence, expertise, integrity, diversity, commitment, compensation, effectiveness, and availability.
2. Board of Directors responsibilities including, communication, setting the board’s agenda, understanding the business, overseeing the performance of the CEO and senior management, and the focus on major strategic issues and risks.
3. Shareholder rights covering proxy access and voting rights.
4. Public reporting focusing on transparency, clarity, earnings guidance and non-Gaap measures.
5. Board leadership, addressing the issue of combining the Chairman/CEO role, Lead director, and independent chair.
6. Management succession planning, covering the importance of and the process for management succession.
7. Compensation of management, addressing compensation policies and process, as well
as disclosure.
8. Asset managers’ role in Corporate Governance, focusing on the responsibilities of asset managers in voting their shares and communicating any concerns with the companies.

In releasing these principles, the group stated that they offered the principles in the hope that they will promote further conversation on Board governance. The purpose of the panel was to have such a conversation. The principles provided the context for a discussion of ‘good corporate governance’ overall and some of specific issues Boards address.

Discussion

The panel began with a discussion of the motivation for and the evolution of the Principles. It was noted that the environment in which Boards operate has changed over the last 15 to 20 years. In earlier years, Boards were generally left alone in their role of overseers of company performance. More recently, pressures to focus on short-term performance have emerged. These pressures – on maximizing year-over-year or quarter-over-quarter profits – have been detrimental to sustaining long-term investment and ultimately to the country’s economic growth. Concerns about “short-termism” have been raised by some large investment managers, and even by Vice President Joseph Biden.

What the Principles embody is a new “Board activism” where investors have decided that that the way to counter short-termism is to have directors promote a long-term outlook. It is an answer to a rise in institutional shareholder activism. In essence, the Principles are designed from the perspective of how an owner of a company would like to see it run. They were developed by executives of major corporations and asset managers as well as an activist investor. Beyond the substance of the Principles, which are not that controversial, their importance lies in the fact that the group came together and, from very different perspectives, coalesced their ideas and experiences into a coherent set of recommendations. The fact that other groups, such as the NACD, the Business Roundtable and the Conference Board, have also been focusing on governance issues highlights that that we are at an inflexion point with respect to reconsidering the role of Boards.

The discussion then turned to how boards are reacting to the Principles. There was general agreement that nothing in the Principles was ground breaking, but that they did evidence major changes in Board Governance over the last 15 to 20 years. To put that in context, it was noted that they came out on the eve of the 15th anniversary of the Enron bankruptcy, an event that contributed to the governance requirements in the Sarbanes-Oxley Act of 2002.

Since that time, Boards have become more independent and more diverse. Executive sessions of independent directors are routine, and robust board self-evaluations are more common. Board members now receive more training on their roles and responsibilities. They have access

http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/default.aspx
http://business.gwu.edu/icr
to a broad range of educational materials from outside entities including the NYSE, NACD, academic institutions, outside counsel, and consultants. As a result, Boards are much more aware of, and attuned to, corporate governance expectations. They also have more internal access outside the C-suite, including interactions with lower level management and the internal audit team. The days when Board meetings were a social activity, with golf games and fancy dinners, are over.

In that context, therefore, from the Board member perspective, the principles are viewed as a reminder to step back and reflect on their own Board’s governance practices in light of their particular circumstance. A key takeaway is that one size does not fit all.

The conversation then turned to several of the principles that were put forward without a specific recommendation.

Regarding Director tenure and retirement age, the principles said that it is essential that a company attract and retain strong, experienced, and knowledgeable board members, noted that some boards have maximum length of service and mandatory retirement age for directors with or without exceptions, and some have no such rules, and stated that the importance of fresh thinking and new perspectives should be tempered with the understanding that age and experience often bring wisdom, judgement, and knowledge.

Clearly, there are positives and negatives between having seasoned directors versus newer directors with fresh experience and insights.

With respect to age limits, the question was raised “if you could get Warren Buffett on your Board, would you?” If the answer is “yes” then a hard and fast retirement age does not make sense. Further, although some companies do have a retirement age, they make exceptions. It seems very arbitrary to say that at age 70 or 75 you no longer add value. Similar arguments could be made regarding term limits. On the other hand, having a tenure limit or retirement age makes it easier to remove a director who is not performing up to expectations. However, an effective self-evaluation process can accomplish the same objective. The general view was that you need a retirement age or term limit only if the Board is not prepared to make the hard decisions.

What appears to be happening is that while Board seats are turning over slowly, boards are evaluating themselves more robustly, including sometimes getting help from third parties to ask the hard questions. The real issue when it comes to good corporate governance is not age or tenure, but rather appointing directors who perform their duty of care, who do their homework, read the materials in advance, and ask the tough questions.
Boards also need to consider whether the composition of the board is appropriate in the current environment. If changes are needed, they have to figure out how to leverage the expertise and diversity they have currently and refresh it when necessary. For example, when a company’s business has changed direction, current members, who may have been terrific board members in the past, may be less relevant and helpful now. Boards are increasingly looking at the skills they have versus the skills they need and are considering how to fill the gaps as they refresh their boards.

Regarding Proxy access, the Board Principles suggest that many public companies and asset managers have reviewed their approach to proxy access. Others have not yet undertaken such a review or may have one underway.

The Board Nominating and Governance Committee is responsible for determining who will be on the company’s proxy. Activist investors want their nominees on the company’s proxy card, rather than going through an expensive complicated proxy fight. Whether to allow access to the proxy has been a controversial issue for a number of years. Recently, however, more companies have allowed proxy access as a result of successful shareholder proposals and in response to the growing trend, even without a formal proposal. Over 35% of S&P 500 companies now allow proxy access (e.g. typically for a group with at least 3% of shares held by no more than 20 shareholders for at least 3 years to nominate up to 20% of directors of a company), compared to virtually none five years ago. This was seen as the most rapid acceptance of shareholder proposals over the last 50 years. In addition, its impact may not be known for years.

From the Directors’ perspective, they want to be sure that the candidates put forth by the activists would serve for the right reasons over the long term. Why it matters to the Board is that it is important for directors to work well together, to be collegial. They do not necessarily, nor should they, agree all of the time, but they should share the same goals for the company. If a board member does not fit in with the culture and chemistry of the Board, that can create problems in the boardroom, which can translate into problems for the shareholders. Proxy access makes it hard to control getting the kind of directors that the Board wants and needs.

Regarding the separation of the roles of Chairman and CEO, the principles said that the board’s independent directors should decide, based on the circumstances at the time, whether it is appropriate for the company to have separate or combined chair and CEO roles. ...if the company combines the roles, it is critical that the board has in place a strong designated lead director and governance structure.

Usually, if the role of Chairman and CEO is combined, that person is the only inside director on the Board. The others are all independent. That is a very different situation than in the mid to late 20th century, when many boards were dominated by insiders.
When the role of Chairman and CEO is combined, Boards typically have a lead director, who gets input from the other independent directors, including in executive sessions. A strong lead director works closely with the Chairman/CEO, including providing input on setting the agenda for meetings and discussions.

There is no data that suggests that combining or separating the roles makes a difference in performance. The general view was that one size does not fit all, and the decision regarding combining the roles should be very specific to the company’s situation. By not taking a position on this issue, the Commonsense Principles left it to Boards to decide.

Regarding Board meetings with third parties, the principles said that robust communication of a board’s thinking to the company’s shareholders is important...Directors who communicate directly with shareholders ideally will be experienced in such matters.

With increasing shareholder activism, requests for Board meetings with third parties have become more prevalent. The general view was that such meetings are fine, with the caveat that the directors must be briefed on what they can and cannot say, especially under the SEC’s Regulation FD (Fair Disclosure) requirements, and that counsel be present. It was noted that such meetings might be helpful in giving comfort to shareholders that the Board is engaged and informed.

**Conclusion**

In the press statement on the Principles, the authors stated that these recommendations are not meant to be absolute. We know that there is significant variation among our public companies and that their approach to corporate governance will inevitably (and appropriately) reflect those differences.

The panel discussion confirmed the importance of these issues to corporate directors and that, as said often during the discussion, one size does not fit all with respect to corporate governance practices.
14. The Role of Directors in Dealing with Reputation Risk

On March 30, 2017, the 14th panel in the series focused on how Directors deal with reputation risk to the company in their oversight role.

Background:

Damage to the company’s reputation can have a negative impact on revenues, profits, growth, employee morale, share price, and even its viability. It can result in costly litigation and reduce investor and public trust in the company. Reputation risk has always been a concern of companies and their Boards. Triggers of a reputation problem can be internal or external. Some examples include:

- Johnson and Johnson, which 25 years ago set a high standard for responding to deaths from Tylenol pills, which were poisoned by a 3rd party. By quickly recalling 31 million bottles of Tylenol and developing expensive tamper proof packaging, it regained lost sales and protected its brand.
- A less successful, more recent case is Wells Fargo, whose ‘stretch goals’ for cross-selling apparently created incentives to open fake accounts in customers’ names. With a slow and seemingly mishandled response, it is still seeing negative effects on its account openings and customer trust.
- In an interesting case in 2012, resulting from a negative media description of its finely textured beef product – calling it ‘pink slime’ -- Beef Products Inc. alleged that ABC’s news coverage caused $1.9 billion in damages. The case is going to trial during the summer 2017.
- There are many other cases, e.g., Volkswagen, Toyota, BP, and many cybersecurity breaches that also make the point.

With the advent of social media, news — good and bad — travels more quickly and more broadly (and sometimes more inaccurately) than in the past. In addition, whistleblowers have been given more protections and possible awards from the SEC under the Dodd Frank Act. As a result, the role of corporate boards in overseeing reputation risk to their companies has required more intense and timely focus on risks to the company’s reputation. The challenge for Directors in this regard is to understand possible internal and external sources of reputation risk, what is being done to prevent such risks, how the company is perceived by its stakeholders, and what plans are in place to deal with reputation damage if it were to occur.

The Hon. Cynthia Glassman moderated the panel. Dr. Glassman is an ICR senior research scholar. She served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she chairs the Audit Committee, and Navigant Consulting, where she chairs the Nominating and Governance Committee and serves on the Audit Committee. She is a former Trustee of the SEC Historical
Society and a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues.

The panelists were Board directors who actually face this actual or potential challenge on an ongoing basis as well an advisor to Boards on communications.

The panelists were the following:

**Charles Bakaly** is a strategic communications counselor, with 35 years of experience, who leads Edelman’s National Litigation and DC Crisis Communications practices. At Edelman, he conceives and executes campaign strategies for organizations to promote and protect their reputations. He regularly counsels senior leadership and boards of directors on governance and reputation management issues. His prior roles include private law practice at Morgan Lewis and Bockius, federal prosecutor, and several positions in the Reagan administration. Charles has advised government and business leaders in many high-profile situations. In 2006, he directed the release of the Iraq Study Group recommendations for the co-chairmen, former Secretary of State James A. Baker III and Congressman Lee Hamilton. In 1998, Independent Counsel Kenneth W. Starr appointed him counselor and spokesperson for the Office of Independent Counsel. He also served as counsel to Judge William Webster in the investigation of the Los Angeles Police Department’s response to the civil disorder in 1992 following the verdict in the first Rodney King case.

**The Hon. William Barr** received his law degree with highest honors from George Washington University. He served as the Attorney General of the United States from 1991 to 1993 under President George H.W. Bush and prior to that as the Deputy Attorney General and as Assistant Attorney General in charge of the Office of Legal Counsel. At the end of 2008 Mr. Barr retired from Verizon Communications, after serving as General Counsel and Executive Vice President of that company since its formation in 2000. Prior to that, he served in that capacity at GTE Corporation from 1994 until that company merged with Bell Atlantic to form Verizon. He has served in the Central Intelligence Agency, clerked for Judge Malcolm Wilkey of the U.S. Court of Appeals for the District of Columbia, and served on the White House Domestic Policy Staff under President Reagan. Mr. Barr currently serves on the Boards of Time Warner Inc., Dominion Resources Inc., and Och-Ziff Capital Management.

**The Hon. Kathleen Cooper** has served in a variety of posts during her career -- Under Secretary for Economic Affairs at the U.S. Commerce Department, Chief Economist for the Exxon Mobil Corporation, Executive Vice President of Security Pacific National Bank and Dean of the College of Business at the University of North Texas. In addition to her current role as senior fellow at SMU’s John G. Tower Center for Political Studies, Dr. Cooper is the nonexecutive chair of the Williams Companies board and a director of Deutsche Bank Trust Company of the Americas. She is also the immediate past chair of the National Bureau of Economic Research and a member of
the Council on Foreign Relations. She has held positions as president of the National Association for Business Economics and the U.S. Association for Energy Economics, chair of the American Bankers Association’s Economic Advisory Committee, and founding director of Texas Security Bank. She earned a Ph.D. degree in economics from the University of Colorado.

Cynthia Hostetler is an attorney, serves on multiple public company and mutual fund boards, including as board executive committee member and finance chair for Vulcan Materials Company; board member and investment management services committee chair for Aberdeen Funds; board member and governance committee chair for TriLinc Global: and board member of Invesco Funds. She serves on the Executive Committee of the Independent Directors Governing Council, the leading professional organization for independent mutual fund directors and on the Eisenhower Foundation board of directors which supports the Presidential Library. Cynthia was board member and governance committee chair for Edgen Group and Artio Funds until their successful sales. Prior to board service, Cynthia was head of the Overseas Private Investment Corporation’s investment funds group, one of the world’s largest emerging markets private equity fund of funds. Previously, she was president of First Manhattan Bancorporation.

Discussion

The panel began with a discussion of why reputation risk is so important to Boards. It was noted that reputation risk is part of general business risk in that if products and services are not well thought of, the company could lose customers and investors. Usually, a poor reputation comes from a failure to execute business strategy and policies properly or a failure of integrity. By and large, for Directors, dealing with reputation risk is ‘blocking and tackling’ to make sure the company has a high-quality management team, that operational processes are effective, and that compliance processes are in place and followed. However, no matter how good a job the board or management does, mistakes will occur, external events will cause problems, or a rogue employee will do something illegal or unethical. When such events happen, management can be distracted from the ongoing operations of the business. An example was given of a company whose reputation problem limited its ability to innovate and develop new products, which in turn caused it to lose customers and employees, and ultimately put it in a position from which it could not rebound.

One member of the panel recalled a recent study that reported 25% of a company’s value can be attributed to its brand and reputation. It is not surprising, then, that damage to a company’s reputation can reduce its stock price and make financing more expensive. As Warren Buffet has said, “It takes 20 years to build a reputation and five minutes to ruin it.” Boards must understand that reputation risk is about who you are, not what you produce, and that the company’s values and what it stands for are critical factors in maintaining a good reputation. Therefore, from a Board perspective, it is important that directors pay attention to building up good will so the company has the capacity to weather a potential reputational storm. This can be done, for
example, by setting up foundations, supporting the community, and developing good investor relations. Further, it is important to have savvy people in place who can deal with a public affairs crisis, including internal and external counsel, and public affairs specialists who can help respond appropriately. Examples were given about lessons learned by the energy industry from the Exxon Valdez oil spill and the BP Deepwater Horizon explosion and oil spill, as well as those learned by the financial services industry after the financial crisis of 2008.

In recent years, social media has heightened the challenge companies face in protecting their reputations. In a world of 24/7 coverage of stories, repeated over and over, in which the information may be incomplete or inaccurate, Boards and management must focus attention—in a way they never have before—on how the company is being portrayed and perceived. This new reality is a game changer, in which an offhand comment by a CEO can result in social media attack against the company.

The panel then turned to how Boards are structured to oversee reputation risk. The general view was that overseeing reputation risk is the role of the full board, regardless of whether the discussion starts in a Board committee, such as the risk or audit committee.

With regard to what Boards need in order to understand perceptions and vulnerabilities of the company, there were several themes:

- First and foremost, Boards need a **CEO and management team they can trust**, that deals with them honestly, and is transparent. They need to have the opportunity to meet with people in operations. They need to candidly discuss risks with management. The Board needs to ask the hard questions and expect complete and accurate answers. They need to be able to assess whether they are being “managed” by management.

- Boards need information. They need access to materials and reports from their investor relations team. They need feedback on what shareholders and analysts are saying about the company, the questions they are asking, and concerns they have raised. They should be aware of any concerns raised by their bankers. They should also be aware of what is said in the press and social media.

- Boards need to set the appropriate **tone at the top** and an ability to assess whether employees are adhering to the company’s values. Ways that Boards can accomplish this include: reviewing communications to employees; being informed of turnover, especially among particularly valued employees; expecting punishment of bad actors and rewarding the right behavior; and monitoring trends from employee surveys, employee exit reports, hotline reports, consumer complaints, and industry surveys.

- Boards need to know whether and how the company is **prepared for a crisis** and that there exists a response plan that has been tested for worst-case scenarios.

Simply put, Boards need to understand that no matter how good they think the company is, things could “go south” quickly, so they need to be prepared for the worst. If something does go
wrong, the Board is going to be asked, from a governance perspective, why this problem was not caught sooner.

What Boards do has changed significantly since the accounting scandals earlier this century and the enactment of Sarbanes-Oxley (SOX) and later the Dodd-Frank Act. Before that time, Boards did not get as much information as they do now, and they did not delve into business risk the way they do now. Several developments were noted:

- Enterprise risk officers undertake ongoing reviews of risks, including reputational risks, by business lines, by counterparties, and with compliance reviews, among other steps. They provide risk ratings and red flags to the Board routinely.
- Internal audit departments have more robust processes to determine whether controls are appropriate and effective, and routinely provide to the Board the results of audit reviews and remediation expected and undertaken.
- Anonymous hotlines are in place to enable whistleblowers and others with complaints or concerns regarding fraud, employment issues, or other issues, to be heard. Significant issues are typically escalated to senior management and the Board.
- Boards and committees now typically have executive sessions of the independent (i.e., non-management) directors with individuals, e.g., the chief financial officer, general counsel, the head of internal audit, the chief risk officer, and others as appropriate, to provide an opportunity to discuss any concerns that they might not want to raise in a broader meeting.
- Boards are learning from other’s mistakes. When a significant reputation event happens at another company, Boards are often asking management to review their own processes in order to learn the lessons and avoid a similar problem.

In sum, more robust processes are now in place to help make sure that the types of problems that occurred in the past do not happen again.

However, as noted above, the Board cannot protect against all reputation risks. Despite its best efforts, bad things can happen. When that occurs, the Board needs to recognize and be responsible for the problem and own the solution. Sometimes, though, the Board cannot act as quickly or effectively as it would like. When an investigation is ongoing, legal impediments may prevent the company from issuing statements or responding to questions. Meanwhile, media stories may be damaging the firm’s reputation. In such cases, the company might rely on third parties to provide some generic perspective on the issue to balance the negative press. Also, the board may take actions to enhance its governance and compliance proactively to rebuild its reputation while an investigation or settlement is pending.

**Conclusion**

Overseeing reputation risk is a growing challenge for Boards of public companies. As a result, Directors must be increasingly diligent in their oversight efforts to protect the company’s reputation and to mitigate damage should the company’s reputation be sullied.