

# 2010: FIVE BIG BANGS

*A look at five explosive issues in corporate governance and what directors should watch for in 2011.*

While the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed and took center stage, other corporate governance happenings did occur in 2010, like an increase in FCPA enforcement and board members focusing more on their own performance. In this top-five roundup, *Corporate Board Member* looks back on a tumultuous year for corporate governance.

## 1 THE DODD-FRANK ACT: PAYBACK TIME IN WASHINGTON

At the Corporate Board Member Annual Boardroom Summit, former Security and Exchange Commission Chairman Harvey Pitt called the Dodd-Frank Act "a disaster." With 500 rules in the act, it certainly brings a whole new load of work to company executives and board members, what with requirements already enacted, requirements coming into play in 2011 and beyond, and studies the government is currently doing that companies need to be aware of.

The act could be renamed "The Dodd-Frank Activist Shareholder Wish List Enactment Act," suggests M&A attorney Richard Hall, because a lot of the bill is based on changes that have been sought by activists for years. It is filled with both provisions and calls for studies and reports to be conducted on possible provisions. "I think that legislation was the highlight of the year, with a lot of interesting provisions people will be contending with for a long time to come," says Mark V. Nuccio, partner, Ropes & Gray. Some of the most attention-getting areas of the bill include proxy access, say on pay, and a new whistleblower bounty program.

# IN CORPORATE GOVERNANCE

BY LAURA J. FINN

Proxy access, a longtime wish of activist investors, gives shareholders with 3% ownership for at least three years the right to nominate their own slate of directors. "Even without Dodd-Frank, the proxy access train had left the SEC station," says Hall, a partner at Cravath, Swaine & Moore. At the moment, the proxy access provision is on hold; the U.S. Chamber of Commerce and Business Roundtable filed a lawsuit alleging that the SEC does not have the authority to issue such rules. Experts agree that it is only a matter of time before proxy access is mandated. But when that happens, will proxy access actually be a board concern? Ethan A. Klingsberg, partner, Cleary Gottlieb Steen & Hamilton, suggests that proxy access is not going to be as big of an issue as it might appear.

"The shareholders that are 3% or greater owners, [management] is all over," Klingsberg says. "They are even spending time with the activist shareholders so there aren't surprises." So if boards are talking to their biggest shareholders, will they still worry about a shareholder revolt? Roger Kimmel, vice chairman of global investment bank Rothschild Inc. and a director on the boards of Endo Pharmaceuticals, gas and electric company PG&E Corp., and Schiff Nutrition International, says, "People with political and specific agendas, like share buybacks, will use proxy access and make it a political contest, a campaign."

How should boards prepare for possible proxy campaigns? "Boards will have to think about who's in their shareholder base and try to interact with them for viewpoints. Also, boards should review governance policies and charters,

identify dissident shareholders and [any] perceived performance issues, and try to address them more directly," advises Louis Lehot, partner, Sheppard, Mullin, Richter & Hampton. He foresees more proxy contests in the coming years. "I think activist investors will be emboldened by the environment to really make their voices heard."

Another can of particularly repellent worms in the Dodd-Frank Act are the whistleblower provisions. These provisions place the SEC in charge of rewarding corporate whistleblowers up to 30% of the value of the monetary sanctions arising out of a judicial action that occurs based on a whistleblower tip, if such sanctions exceed \$1 million. In setting such a bounty program, the SEC may encourage workers to ignore their companies' internal compliance programs and report a problem directly to the SEC.

"People are worried about being sandbagged by their employees. There's concern about how the SEC implements the whistleblower regime. The SEC will have unappointed watchdogs in every company," says Nuccio. The whistleblower provisions have made board members and experts uneasy. "I rate it an eight in terms of a 1-10 scale of disaster," says F. Daniel Siciliano, faculty director, Stanford Rock Center for Corporate Governance and associate dean, Stanford Law School. This is an area boards should pay attention to, as more detail on the program is provided by the SEC.

The upside to proxy access and whistleblower provisions is that these will not impact the boardroom in the very near future. However, compensation

matters like say on pay (and say on frequency and on golden parachutes) are coming and will challenge boards during the 2011 proxy season.

## WHAT TO WATCH FOR IN 2011.

James C. McGough, partner, Meridian Compensation Partners LLC, expects companies to adopt say on pay, as required by law, and navigate their way through that process. "Most will probably get yes votes," he says. As more provisions of the Dodd-Frank Act work their way from the pages of legislation into the boardroom, boards will continue to deal with new policies and move forward.

"Companies will take these regulations very seriously. Whether the exercise has a value commensurate with the cost, that is difficult to answer," says Nuccio, who co-heads the banking practice at his firm and has been answering many Dodd-Frank-related questions from clients. He adds, "The message of Dodd-Frank is to get corporate America thinking differently. I don't know if that happens as a result of legislation being passed."

Anastasia D. Kelly, partner, DLA Piper, and board member at Owens-Illinois, a glass container manufacturer, has a glimmer of optimism for Dodd-Frank: "The hope I have is that companies in the U.S. will turn the effort into a positive for corporate governance rather than get tied up in a knot over draconian regulations. We must look at what's around the corner, not what happened in the past."

Boards have dealt with huge legislative changes before and continued to conduct business successfully. "Companies are adaptable. They cope, move on, and deal with the reality of the marketplace as

they know it," says McGough. In 2011, despite all the obstacles, informed boards should be able to adapt to the changing environment and move forward.

## **2 FCPA: A WATCHFUL EYE ON GLOBAL TRANSGRESSIONS**

While the Foreign Corrupt Practices Act was enacted in 1977, in 2010 the FCPA became a much bigger threat to public companies. Between 2004 and 2007, the Department of Justice and the SEC issued less than \$350 million in FCPA-related fines, according to Bethany Hengsbach, partner, Sheppard, Mullin, Richter & Hampton. While totals for 2010 have not yet been tallied, Hengsbach says fines of nearly \$1.7 billion had been imposed as of mid-November, "more than double the amount from 2009."

In 2009 the SEC and DOJ prosecuted 42 individuals for FCPA violations, up from 16 in 2008. While year-end statistics aren't available, through the third quarter of 2010, the DOJ and SEC had already charged more than 30 individuals with violations of the FCPA, so the final number will likely be greater than the 2009 figure, predicts Hengsbach, who specializes in government contracts and FCPA matters.

In 2010 it became an obligation of the board to engage in a complete analysis of FCPA risks in a way that in previous years did not fall on its shoulders. "Any company with overseas operations, joint ventures, or sourcing, even on a project basis, needs to be vigilant in that sphere," says Siciliano of Stanford. "Managing the issue is time-consuming and expensive and especially important in the scope of M&A activity."

But as board member Kelly points out, "This is one piece of the corporate governance equation. Everyone says it's a big deal and it is, especially in China where there are many state-owned businesses, but it is only one element of corporate governance and risk and compliance and regulation." Still, FCPA is a hot topic right now, and boards need to carefully consider it.

### **WHAT TO WATCH FOR IN 2011.**

Siciliano predicts "spinoff reputational damage, especially in China." In a place

like China where there are social issues and unemployment unrest, regional areas with numerous FCPA violations will create major news headlines, perhaps drawing attention to companies that do not normally find themselves in the spotlight.

The United Kingdom's version of the FCPA, the U.K. Bribery Act, is due out in 2011. Hengsbach describes it as "stricter and broader. For any public company that has operations in the U.K. or employs U.K. nationals, you need to be aware." The rule is scheduled to take effect in April, giving boards only a short time to look at, and possibly revise, compliance programs and train employees.

## **3 SHAREHOLDER ACTIVISM: FLEXING POWERFUL MUSCLES**

Shareholder activism decreased in the early part of the economic downturn. Attorney Richard Hall offers two reasons for the decline. "First, there was a collapse in liquidity, so it was hard to leverage their positions with less firepower. Second, the collapse of the LBO market took away two things to agitate for—deployment of cash, through buybacks or special dividends, or a company sale. Very few had the courage to campaign on the CFO holding too much money."

In 2010, activists returned and were aggressive in agitating against the strategic direction of the company (think Burkle with Barnes & Noble, Icahn with Lionsgate). Still, Hall says that because the problems that led to the pullback aren't completely gone, "activists are being more thoughtful" in their approach.

2010 also saw greater shareholder outreach and interaction with both boards and company management. There was an emphasis on communicating directly with executives, in addition to the investor relations team. Executive search firm Spencer Stuart conducted a governance survey of S&P 500 general counsel/corporate secretaries and found more than 80% of respondents reported that shareholders initiated contact with their board or management in the 2010 proxy year.

"Volatility can happen if management is not managing shareholders in a very aggressive way," says Cleary Gottlieb's

Klingsberg. Boards and management took heed of shareholder empowerment in 2010 and sought out shareholders to defend their strategy or convince shareholders not to vote with proxy advisory firms' recommendations for no votes.

Board member Roger Kimmel has reached out to shareholders when appropriate. "In circumstances where proxy advisory firms may take a position we think is unreasonable, we communicate."

He also notes that dealing with shareholders isn't necessarily a negative for boards. "Boards don't view all shareholder proposals as negative—some have been very helpful." Kelly agrees. She says Owens-Illinois is having more conversations with shareholders and that shareholders have some good ideas. "Shareholders need to [be heard or] use their votes the way they are meant to be used."

### **WHAT TO WATCH FOR IN 2011.**

"There will be continued emphasis on managing shareholders and not going through ISS and Glass Lewis," predicts Klingsberg. Also watch for greater transparency on shareholder ownership through bylaws and SEC requirements.

## **4 STRATEGIC PLANNING: BOARDS TAKE A LONG, HARD LOOK AT THEMSELVES**

"I think the most interesting thing seen in several boardrooms in 2010 is the deep dive into strategic planning. Should we buy back shares, make a strategic acquisition, talk to LBO shops? This deep thinking about strategic alternatives, which is not easy, is commendable," says Klingsberg, who advises public company boards on M&A, SEC, and corporate matters.

As a result of the SEC requiring board members to explain their qualifications in the proxy, boards also spent a lot of time talking about board leadership. Julie Hembrook Daum, practice leader, Spencer Stuart, says boards asked questions like: Should we split the role of CEO/chair? What's the advantage of a lead director?

Spencer Stuart found that 40% of S&P 500 companies have split the CEO and

chairman roles, up from 29% five years ago. And 19% of companies have a truly independent chair, up from 9% five years ago. Daum says that in companies with a combined chairman/CEO role, "there's also an increase in the importance of the lead director," a change from past years

Nevertheless, McGough emphasizes how essential it is for board members, especially compensation committees, to work to tie pay with the company's performance, something he says a majority of companies do. "Most companies continue to have very substantial fractions

and say on pay. Boards are very attentive. Executive compensation is something we have spent a lot of time on this year, but this is no different than in the last few years."

## VOLATILITY CAN HAPPEN IF MANAGEMENT IS NOT MANAGING SHAREHOLDERS IN A VERY AGGRESSIVE WAY.

when boards simply rotated the role of lead director from board meeting to board meeting. With a heightened focus on board leadership and board composition, directors spent time in 2010 evaluating such issues, she says.

### WHAT TO WATCH FOR IN 2011.

"The notion of board leadership will continue in 2011," Daum believes. Stanford's Siciliano agrees. "There's been a subtle change in the past 12 months with the SEC's expectation of explaining qualifications of board members," he says. "It's not a big deal on its face but part of a trend to be picked up by institutional investors. Boards need to pay a lot more attention to performance, quality, and ongoing, continuous improvement of board members, and articulate it more." According to Spencer Stuart's research, 96% of boards undergo annual evaluations. In 2011, expect your board to spend more time evaluating itself.

### 5 EXECUTIVE COMPENSATION: A WHITE, HOT LIGHT ON PAY LEVELS

Finally, as the economic recovery remained in the doldrums throughout most of the year, executive compensation continued to receive a lot of attention from the media and shareholders alike. "Many people attributed what happened in 2008 to executive compensation practices or executive compensation design. I don't think a close review of the facts backs that up; I think that's misguided," says Meridian Compensation's McGough.

of compensation tied to performance. Many have the impression that pay has not fluctuated with performance, and this is simply not the case." While there are exceptions, most companies continually try to improve their executive compensation packages, he says.

While some companies have already enacted say on pay, which gives their shareholders a nonbinding, thumbs up or thumbs down vote on executive pay, the Dodd-Frank Act will make say on pay a reality for most public companies this proxy season. Siciliano is curious to see how say on pay will impact the corporate environment. "It's intriguing because it's not clear [say on pay] will help shareholders to have the kind of influence they meant to have. If the U.K. is any indication, say on pay will not have much impact." In the United Kingdom, shareholders have had a vote on pay every year since 2002. In that time, only a small percentage of pay packages have received no votes, according to Meridian Compensation Partners.

Catherine Bromilow, partner in PwCs' Center for Board Governance, wonders if shareholders realize how much work will be required to have a say on executive compensation. "A lot more analysis will be required by the shareholders to make decisions, particularly with say on pay. There may not be full appreciation for how much work shareholders have to do to be prepared." Board member Kimmel believes the focus on executive compensation is excessive. "I think this is a little bit overblown because most boards already focus on pay for performance

### WHAT TO WATCH FOR IN 2011.

In 2008, new executives entering companies accepted pay mostly in stock. In 2011 it will be time for those executives to cash in their restricted stock, which may cause uproar. "A whole cohort of executives came in two years ago. Next year, pay packages will be very high against a backdrop of an economy that is not great, with unemployment high. While stock price and earnings may be high, politically it doesn't look great. This will be a huge lightning rod," predicts Siciliano. Even in situations where executives did a solid job designing pay-for-performance packages, expect big blowups in 2011.

Internal CEO pay equity ratios is another emerging trend to pay attention to in the new year. This provision of the Dodd-Frank Act will require companies to disclose the median employee total compensation, divided by the CEO total compensation, to show the difference in CEO versus employee pay. While it may be a political issue—with a debatable business purpose—companies need to prepare for it to become part of proxy disclosure. The upside is that this disclosure will not be required for the 2011 proxy season. The downside is that preparing the median employee total compensation will eventually require quite a bit of time.

"Pay ratios are a waste of time and money. It's absurd, a meaningless statistic," says Kimmel. Still, internal pay equity ratios will likely stir up headlines, even for companies that aren't usually caught in the spotlight. "We're heading into a perfect storm for compensation," Siciliano forecasts. ☺