



## The Corporate Governance Alliance Digest

### 'Tis the Season to get ready for Proxy and Annual Reporting Season

By Eleanor Bloxham

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#### Shareholder Shopping Lists

Do shareholder shopping lists matter to boards?

PWC's 2010 annual survey of more than 1,000 directors who serve on the boards of the top 2,000 US publicly traded companies measured the level of influence directors feel different groups have on their board. <http://www.pwc.com/us/en/corporate-governance/assets/annual-corporate-directors-survey-2010.pdf>

Over half (50.8%) of the directors chose either shareholders (37.5%) or analysts (13.3%) as the most influential. Government regulators (23.6%) and ISS/proxy advisors (18.8%) were chosen as most influential by nearly a quarter and a fifth of respondents respectively.

So what may be on shareholders' shopping lists for the upcoming proxy and annual reporting season and how does it differ from that of issuers?

#### Most Important Governance Topics to Issuers: Risk Oversight and Board Competence

According to an ISS policy survey (ISS 2010-2011 Policy Survey Summary of Results, October 26, 2010), issuers seem to have "gotten the memo" from the financial crisis about the importance of risk oversight. [http://www.issgovernance.com/files/ISS2010-2011\\_PolicySurveyResults.pdf](http://www.issgovernance.com/files/ISS2010-2011_PolicySurveyResults.pdf),

Issuers, *in all markets*, ranked *risk oversight* as the most important governance topic and ranked *board competence* consistently near the top.

In fact, the highest ranking governance topics, to issuers in Europe, Asia-Pacific, and developing markets, were the same: Risk Oversight (1), Board competence (2) and *Audit related practices* (3).

In the US market, with the presence of the much maligned Sarbanes-Oxley and high comparative compensation, audit related practices were *not* among the top 3 highest ranked.

Instead, North American issuers' highest picks were Risk oversight (1), *Executive compensation* (2) and Board competence (3).

The PWC survey provided similar validation on US directors' views, as those surveyed thought new 2010 proxy disclosures around *risk oversight* and *board competence* provided the most value to investors. (Defining diversity was considered the least valuable – by a wide margin.)

But there were some differences between perception of *importance* and actual *actions* planned.

While, according to the PWC US survey, 56.6% plan to spend more time on risk oversight, 72.1% do *not* expect to spend additional time on *executive compensation*.

Regarding board competence, when asked if the new proxy disclosures caused them to re-think who sat on the board, over 3/4 of directors said no. Of those that said yes, only 2.9% took some immediate action as a result, while 9% said their boards had re-thought the mix -- yet *plan to take no action*.

### Most Important Governance Topics to Investors: Board Independence and Board Competence

According to the ISS policy survey, investors were unanimous in *not* selecting Risk Oversight, (the issuers' top pick) as the most important governance topic. Rather, investors in all markets ranked *board independence* as the most important topic and, like issuers, included *board competence* consistently among the top choices. (Nevertheless, in terms of proxy voting decision making, *Board Oversight of ESG Risks* was deemed either very or somewhat important to 97% of investors, as compared to only 79% of issuers.)

Both the Asia Pacific and developing markets' investors shared the same importance rankings: Board independence (1), Board competence (2),

and Shareholder rights (special meetings, written consents, amend bylaws) (3).

In North America, the investor order was Board independence (1), Executive compensation (2) and Board competence (3). And in Europe, it was Board independence on top, with Executive compensation and Board competence tied for second place.

World-wide, board competence was ranked as among the most important topics of governance by both issuers and investors. Yet, when it came to proxy voting, 84% of investors considered director competence very or somewhat important, while only 68% of issuers agreed.

Similarly, although 84% of investors considered executive compensation to be either very important or somewhat important to proxy voting, only 62% of issuers agreed.

### NYSE-sponsored Commission on Corporate Governance on Board Independence

The final report of the NYSE-sponsored Commission on Corporate Governance, which set out to “examine core governance principles that could be widely supported by issuers, investors, directors and other market participants” was issued September 23, 2010. <http://www.nyse.com/press/1285236224629.html>

With board independence consistently the top ranked investor concern worldwide, the report curiously states “While independence is an important attribute for board members, the NYSE’s Listing Standards do not limit a board to just one non-independent director and boards should seek an appropriate balance between independent and non-independent directors to ensure a proper mix of expertise, diversity and knowledge.” (Emphasis added)

Is this a good idea? Including *more* non-independent members on an issuer’s board may

be a very hard sell to investors, given the fact that *in all markets* investors rank board independence as the most important governance topic. Is adding non-independent members an irritant worth creating?

Nominating committees should think carefully about this NYSE recommendation before leaping. If a nominations committee can't find competent board members that are independent (!) and must go this route, checking-in directly to see how important board independence is to your investors could help you make a wise decision and ascertain what the backlash, if any, may be.

Of course, independent directors must be competent. An editorial in The Financial Express (India) strikes a strident tone on independence alone: "Take Air India, these independents had no clue to what was happening in the airline"... "several of Money Matters' independent directors are also claiming they knew nothing of the alleged nefarious ways in which their company operated"... "Why not just junk the fiction of independent directors and the role they play?" (Clause 49, RIP, The Financial Express, 11/29/10,

<http://www.financialexpress.com/news/fe-editorial-clause-49-rip/717316/>)

### Related Party Transactions: Are Shareholders and Related Companies on Your List?

In the ISS survey, issuers and investors overwhelmingly agreed that related party transactions involving executives and directors were of particular concern.

Of even more particular concern to investors (94%, the most concern), however, were *related party transactions involving controlling shareholders* (while controlling shareholders were only of particular concern to 71% of issuers).

Investors were also more concerned than issuers about related party transactions with sister

companies (59% versus 21%), subsidiaries that are not wholly owned (55% versus 25%) and minority shareholders (42% versus 19%).

### Separate Chair

In the US, investors and issuers continue to disagree on who should lead the board: 3/4 of investors favor separation while 3/5 of issuers favor a combined role, according to the ISS survey.

Only 1.1% of directors said their boards rethought the issue of separation, based on 2010 disclosure requirements, and plan to act in the near term, according to the PWC survey. 85.8% did not re-think their position (they were satisfied with the status quo) and 7% rethought yet *plan to take no action*.

"Based on interviews with 70 directors of large companies who have sat on 200 international boards, including 60 of the FTSE 100" MWM consulting found "success depends on having a chairman with emotional maturity. Great chief executives do not necessarily make effective chairmen because different skills are required, including less directive leadership." (*Actions count more than rules, say directors*, Brian Groom, Financial Times, 11/28/10, <http://www.ft.com/cms/s/0/f382a036-fb30-11df-b576-00144feab49a.html#ixzz16gSZ1QsW>)

### Annual Director Elections

In Europe, the ISS survey shows that, while 55% of investors support mandatory annual director elections, 81% of issuers do not.

### Stocking Stuffer: Political Spending

Political spending and board oversight of political spending may also be on your shareholders' proxy shopping list this year. Most boards don't have an oversight policy but it's worth considering now.

Please see [http://money.cnn.com/2010/10/18/news/companies/corporate\\_political\\_spending.fortune/index.htm](http://money.cnn.com/2010/10/18/news/companies/corporate_political_spending.fortune/index.htm)

## Who's Naughty and Who's Nice?

How will ISS assess who has been naughty and nice next year?

ISS has issued its policy updates applicable to shareholder meetings on or after February 1, 2011. Please see [http://www.issgovernance.com/policy/2011/policy\\_information](http://www.issgovernance.com/policy/2011/policy_information) for the details. "While, in general, country of incorporation will still be the basis for policy application, beginning with the 2011 policy update, ISS will generally apply its U.S. policies to the extent possible at issuers that file DEF 14As, 10-K annual, and 10-Q quarterly reports and are thus considered domestic issuers by the U.S. Securities and Exchange Commission (SEC)."

Some of the most important updates fall into three basic categories:

director composition/board structure, executive compensation and shareholder rights.

## Director Composition/Structure/Behavior

- US: *Disclose attendance records and enforce attendance standards*; ISS will recommend both against directors where their individual attendance record is not publicly disclosed and against directors who don't attend 75% of meetings unless there is a good excuse publicly disclosed – good excuses include medical issues and family emergencies.
- Canada: *Consider committee structure and majority independence*; ISS will recommend against inside/affiliated directors (or the entire slate proposed) at all TSX companies where the board lacks a separate nominating or compensation committee or where the board is less than majority independent.
- Europe: *Consider separate Chair*; ISS will recommend against combined CEO/Chair positions -- subject to review on a case by case basis if this is an interim arrangement (no more than two years) and other control mechanisms are in place.
- Japan: *Consider independence of board*; ISS won't recommend votes against the appointment of affiliated outsiders "if a majority of the directors on the board after the shareholder meeting are independent outsiders" but will recommend against "the top executive at listed companies that have controlling shareholders, where the board after the shareholder meeting does not include at least two independent directors."

## Compensation

- US: *Consider say on pay time period*; ISS will support *annual* (versus 2 or 3 year) say on pay
- US: *Consider golden parachute practices*; ISS will look unfavorably upon golden parachute plans up for a vote associated with M&A, that have any tie between deal consummation and golden parachute acceptance -- and that include recent amendments, tax gross ups, single trigger payments or vesting, and excessive severance.
- Europe: *Make sure saying and doing are aligned*; ISS will recommend against compensation plans where the company's actual compensation practices differ from its stated philosophy or where severance pay fails to meet local standards (with a 24 months of pay maximum cap).
- Japan: *Disclose retirement bonuses and special payments*; ISS will not recommend retirement bonuses for directors or statutory auditors - or special payments as part of abolishing such programs - if the amounts paid to individuals are not disclosed.

- Japan: ISS will support increased use of options if the vesting period is three years or more. (Memo to file: If this has not been a good idea in the US, why would we encourage it elsewhere? The myth that this creates alignment persists in the face of strong fact based evidence to the contrary.)

### Shareholder Rights

The key theme from an ISS perspective is that intentions and other safeguards matter.

- US: While generally endorsing proposals allowing shareholders to act by written consent, ISS may recommend against if shareholders already have the right to call a meeting at the 10% threshold, have a declassified board, and there is no non-shareholder approved pill.
- Canada: ISS will look unfavorably on and have a whole set of criteria for review if the poison pill/shareholder rights plan does more than give the board time to consider other value enhancing transactions and ensure the equal rights of all shareholders. Specific policies under the spotlight this year that will garner a recommend against include mechanisms that allow insiders to proceed with a takeover bid without triggering the pill and the use of derivatives in counting beneficial ownership that the party, in fact, has no right to acquire outside the rights plan.

### Wrapping the Presents

#### Involvement in the Proxy and Annual Disclosure Process

One of the issues rightly highlighted by the ISS update is that ISS will recommend against compensation plans in Europe where the company's actual compensation practices differ from its stated philosophy.

But this is not solely a European issue. In other markets, notably the US, some company proxies present compensation philosophies that differ from their compensation practice. At its core, this reflects not only a failure of process in the development of philosophy and follow-through in design but also in the failure of the disclosure process itself.

To remedy this, boards must carefully *read* the disclosures themselves. If a board member can't understand the disclosures, why would an investor, further removed from the company, be expected to?

Boards should also seriously consider the benefit of a non-attorney outside expert who can read the material in an analytical and detached fashion and provide useful commentary and questions. Voltaire's famous quote is that "the perfect is the enemy of the good". In proxy and other annual disclosure, however, too often, rushing and expediency are the enemy of the good.

Is investor relations (IR) involved? (Recent anecdotal evidence suggests too often, no.) Have you as a director read every word? (Recent anecdotal evidence suggests too often, no.) Slow down and do that. Needless work is created on the backend (mollifying investors and the press and others) when you don't.

After publication, have employees read the disclosures too. According to Leadership IQ, "only 34% of employees said they could articulate the strategic goals of their organization" and "When

we asked the 34% of employees who said they could articulate the strategic goals to actually articulate them ... 51% got it wrong"... "this leaves roughly 17% of all employees who can clearly articulate their organization's strategic goals". (*You'll be Surprised What Employees Think of Your Strategy*, Mark Murphy, Leadership IQ, 11/30/10)

If that's the figure inside the firm, what are the (mis-) perceptions outside the firm?

## Giving Good Gifts

From the surveys and the Financial Express editorial, it is clear board competence is key to better governance.

What are some perhaps less obvious areas that, as a board member, require ongoing study, even if you are a seasoned CEO or executive? Based on my experiences in the last few months, some of the key areas are:

- Understanding the capital markets: how they function and work and who the players and investors are (retail and institutional), including the shifts that have occurred over the last forty years.
- Understanding board responsibilities in a broad context, beyond one's own personal past experiences, and understanding today's requirements. This includes understanding the powerful influence the board has and the consequences of failures to: own the board process and agenda (not defer to management or the general counsel without question), take advantage of outside educational opportunities, speak up courteously, address managerial oversight, and re-evaluate performance metrics.

According to the PWC 2010 survey, 91.3% of US boards were not surprised in their review of compensation and its relation to risk this last

year. (Only 1.7% *were* surprised - more should have been.)

- Understanding valuation concepts in order to analyze business strategies and alternatives effectively. To the rescue on the valuation front is a new, just released, book by Robert Monks and Alexandra Lajoux entitled Corporate Valuation for Portfolio Investment, which provides "a detailed guide to the discipline of corporate valuation" ... taking "you through a range of approaches, including those primarily based on assets, earnings, cash flow, and securities prices, as well as hybrid techniques" ... and "offers valuation guidance based on less quantitative factors, namely management quality and factors relating to the company and the economy".  
[http://www.amazon.com/Corporate-Valuation-Portfolio-Investment-Governance/dp/1576603172/ref=sr\\_1\\_1?s=books&ie=UTF8&qid=1291060958&sr=1-1](http://www.amazon.com/Corporate-Valuation-Portfolio-Investment-Governance/dp/1576603172/ref=sr_1_1?s=books&ie=UTF8&qid=1291060958&sr=1-1)

On a personal note, in their book, I am honored that they highlight part of what I have been discussing with boards, companies and investors over the course of the last decade:

"Economic value management, developed by Eleanor Bloxham, is a valuation approach created for managers ... EVM is broader than shareholder value because it examines economic value management from the perspective of all the potential constituents of an organization and their roles. Many people have written about stakeholders, but Bloxham makes a significant contribution by analyzing them by role: she sees a central role for internal and external suppliers. Internal suppliers are board, management and employees. Externally, on the one side, we have providers of capital (equity and debt) and on the other we have consumers (customers). Other important stakeholders are citizens and regulators who represent them as well as observers (critics, the media). Bloxham sees value as a function of all these relationships...very useful for running a company or in the case of investors, evaluating how well a company is run."

In this context, for example, how important are customers to your company's business and strategy? It's interesting that the PWC survey shows that 52.6% of US directors do *not* receive general or specific information about customer satisfaction and of those that do, 21.5% don't find it to be adequate in scope and 39.6% find it inadequate in quality.

Board competence and board information clearly go hand in hand. But if you have read to this point, that's something you already know.

Footnote: Every board should be reviewing their own internal policies related to insider trading and Regulation FD and reinforcing those messages to board members, management and employees.

Please see

<http://finance.fortune.cnn.com/2010/11/29/why-the-stock-market-isnt-fair/> and

<http://finance.fortune.cnn.com/2010/12/01/why-o-is-an-insider-anyway/>

To ensure proxy votes next year are not mired in controversy, issuers should continue to apply pressure to solving the "vote count" problem.

Please see

<http://management.fortune.cnn.com/2010/12/01/why-your-shareholder-vote-may-not-count/>

## The Value Alliance and Corporate Governance Alliance

### About Eleanor Bloxham and John Nash

Both Eleanor Bloxham and John Nash are recognized internationally as authorities on board governance matters. For further information, please visit [www.thevaluealliance.com](http://www.thevaluealliance.com).



Eleanor Bloxham is Founder and CEO of The Value Alliance and Corporate Governance Alliance. She is a recognized thought leader in corporate governance and valuation who has provided information, education and advisory services to companies and their boards in the US and around the globe. She has served as a governance expert in complex litigation and her focus is on board processes and the kind of information boards, investors and other stakeholders need in their oversight and strategic responsibilities. She is the author of two books, two book chapters and over 100 published articles. She writes frequently for CNN/Fortune.



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