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BOARD AGENDA

Twelve Key Corporate Governance Issues for 2012

In her regular column on corporate governance issues, Holly Gregory explores 12 important areas requiring board attention in the year ahead.

Concerns about the responsible use of corporate power remain high in the wake of the financial crisis. Tough economic conditions, stagnant job growth and uncertainties about the future continue to fuel public distrust, as evidenced by the Occupy Wall Street movement, and weaken investor confidence. This in turn increases scrutiny of corporate actions and board decisions, and potentially impacts the regulatory environment in which companies operate. Public sentiment also affects the way in which companies compete for consumers, employees and capital.

Boards should be mindful of the broad need to restore trust and confidence in 2012, while meeting ever expanding expectations about the board's role, as well as overcoming the challenges posed by the part-time nature of director involvement in board activities and dependence on management for company-specific information. There are several important issues on which boards should focus to support board effectiveness, which is essential to restoring public trust and investor confidence.

LONG-TERM FIDUCIARY FOCUS

The primary challenge for boards in 2012 will be carrying out their fiduciary duties in the face of pressures from certain shareholders seeking to influence board decisions. Boards

must continue to exercise independent and objective judgment on issues that are reserved by law to the board's fiduciary judgment. These issues range from strategic direction and corporate social responsibility to executive compensation and dividend policy.

At the same time, boards must reach out to shareholders and other key constituents to understand their views and explain board decisions. Directors should bear in mind when communicating with shareholders that the board has a fiduciary duty to act in the best interests of the company and shareholders as a whole. Director duties may not be abdicated nor delegated to shareholders, even if a majority of shareholders have a clear preference on an issue. Of course, shareholder views are important and should be considered by the board. However, in areas where the board has legal duties, shareholder views are not determinative.

>> For more information on the fiduciary duties of the board, search [Fiduciary Duties of the Board of Directors](#) on our website.

STRATEGY, RISK AND PERFORMANCE

The primary function of the board to direct and manage the affairs of the company has not changed. Board responsibilities and activities revolve around issues related to:

- Strategic planning.
- Risk management.
- Corporate performance.
- Management development (and succession).

The majority of board time and attention should be focused on these matters.

Shareholders may have different views as to what constitutes the appropriate strategic direction for the company. For example, a shareholder may press for changes to suit its particular short-term goals that may not be in the company's long-term interests. Shareholders may also seek more direct influence on matters affecting the company's strategic direction through shareholder proposals on CEO succession, risk management and environmental and social issues.

Successfully withstanding these pressures largely depends on the board's ability to effectively communicate its long-term approach to these core issues. Boards should ensure that regular disclosures to shareholders through periodic filings and proxy statements, as well as targeted shareholder outreach efforts, effectively communicate board action and viewpoints on strategy, risk, performance and management development. (For more guidance, see *The Aspen Principles, Long-Term Value Creation: Guiding Principles for Corporations and Investors*, available at aspeninstitute.org.)

SHAREHOLDER INFLUENCE AND ENGAGEMENT

Shareholder influence will continue to grow in 2012, especially in relation to (but not limited to) proxy voting and the annual meeting. Boards and management teams will need to continue to improve their approaches to shareholder communication and engagement.

SHAREHOLDER POWER

In addition to campaigns for majority voting and proxy access (see below *Director Elections*), shareholders will continue to push for the ability to:

- Call special meetings.
- Act by written consent.
- Elect directors annually (by doing away with classified boards).

But with greater influence, and an increasing number of issues on which to vote, shareholders are finding it difficult to evaluate issues on a company-specific basis. The traditional approach of voting with board and management recommendations (except if there is poor performance or other unusual circumstances) is no longer being followed by many shareholders. Instead, shareholders are relying more on voting guidelines based on governance policies recommended broadly by proxy advisors.

The challenge of performing meaningful voting analysis is particularly pronounced for institutional investors that rely on active investment strategies. Given their portfolios of hundreds or even thousands of companies, these investors often outsource voting decisions to proxy advisors, further separating ownership interests and voting power.

Boards and management teams will need to spend more energy to counter this trend through better communication of decision rationales in the context of company-specific circumstances.

SHAREHOLDER COMMUNICATIONS

Boards need to identify the company's key shareholders and the issues about which they care most. Together with management, the board should make extra efforts to engage with these shareholders. Effective engagement often requires moving beyond management's typical investor relations focus. Further, dealing with proxy advisors such as Institutional Shareholder Services Inc. (ISS) is necessary but not sufficient. While engaging with buy-side analysts and proxy advisors is important, it should not be confused with getting to know the company's large institutional shareholders and, in particular, the persons responsible for voting proxies and setting the governance policies that often drive voting decisions.

Boards should reassess their approaches to shareholder relations and strive to improve communications with shareholders. In particular, boards should seek to enhance communications relating to:

- Board composition, executive compensation, board leadership and other key governance practices.
- Significant substantive matters, such as corporate strategy and risk management.

Enhanced shareholder communications should be designed to:

- Provide the board with an early warning about perceived vulnerabilities and shareholder concerns.
- Encourage investors to make company-specific decisions.

DIRECTOR ELECTIONS

The broad adoption of majority voting as the standard for director elections among S&P 500 companies, along with the likelihood of shareholder proposals seeking proxy access, have the potential to shift the focus of the 2012 proxy season from executive compensation to director elections.

MAJORITY VOTING

Boards should expect a concerted effort from shareholders to extend acceptance of majority voting beyond the S&P 500 to the next tier of companies in 2012. Boards at companies that have not yet adopted a majority voting standard, or a director resignation policy in the event a director fails to receive a majority of the votes, should be prepared to address this issue

with shareholders. In 2011, at least 22 companies had shareholder proposals on majority voting that received more than 50% support, and about 30 companies negotiated some form of majority voting to avoid taking the issue to a vote.

PROXY ACCESS

Boards and their advisers should keep a close watch on developments related to proxy access. 2012 is the first year in which shareholders may bring proposals seeking by-law changes to allow proxy access for shareholder nominations of director candidates in competition with the board's nominees. Public pension funds and union funds are expected to bring a relatively focused set of proposals concentrating on high-profile companies that have had significant governance, compliance or performance issues. In addition, individual shareholders may bring proxy access proposals. Notably, Ken Steiner, a shareholder activist involved in the US Proxy Exchange, had already submitted proposals to two companies (Textron and MEMC Electronic Materials) as of November 15, 2011.

“VOTE NO” CAMPAIGNS

Boards may see an uptick in the number of campaigns to vote against directors. ISS has a fairly long list of circumstances that will cause it to recommend voting against a director in an uncontested election. In addition, “vote no” campaigns may target compensation committee members at companies where shareholders and proxy advisors deem the committee and board unresponsive to the 2011 say on pay vote. Boards should review ISS's recently revised policies early to understand where there may be vulnerabilities so that they can take appropriate action, including, if necessary, targeted shareholder outreach. (For further information, see *ISS Issues Policy Updates for 2012 Proxy Season* (November 22, 2011), available at weil.com.)

BOARD COMPOSITION AND DIVERSITY

Board composition should relate to the company's strategic needs, which change as a company and its business environment evolve. In addition, shareholders and key constituents are interested in the value that diverse perspectives bring, including those related to gender and racial diversity. Yet, according to Spencer Stuart:

- 9% of S&P 500 boards have no women directors.
- 12% of S&P 500 boards have no minority directors.

Boards should be sensitive to board composition needs and diversity concerns, and consider whether board culture and processes provide sufficiently for change. Along with considering the company's strategic direction when evaluating board composition, boards should assess individual director capacity and contributions annually. Undue reliance on term and age limits may lead to the premature termination of high performing directors, while also setting an expectation that directors will serve until the limit regardless of director contributions.

EXECUTIVE COMPENSATION

The say on pay vote will still be high on the shareholder agenda in 2012. Say on pay acted as a “release valve” allowing shareholders to let off steam in 2011, resulting in fewer withhold and against campaigns targeting individual directors in elections. To bolster shareholder support in the coming year, boards and compensation committees should:

- Demonstrate restraint regarding compensation decisions, and expect pay for performance to continue as the primary measure for shareholder approval. Shareholders have shown particular sensitivity to:
 - pay levels relative to peers; and
 - pay increases out of proportion to performance trends.
- Consider the shareholder perspective on, and public perception of, the company's executive compensation program and related disclosures, including how the program matches up to current proxy advisor guidelines.
- For companies that failed to receive a majority vote in favor of executive compensation or received a high proportion of negative votes (even though they received a majority vote in favor), identify the primary shareholder concerns and determine whether changes are necessary (based on fiduciary judgment).
- Explain the company's compensation philosophy in clear and understandable proxy disclosures.
- Follow-up with key shareholders to discuss the board's approach to say on pay and explain any potential “hot button” compensation elements or decisions. In particular, make sure to communicate with shareholders about any potential perception of a misalignment between pay and performance.

BOARD LEADERSHIP STRUCTURE

Shareholder pressure to separate the chairman and CEO roles is likely to grow. In 2011, at least four companies saw majority support for shareholder proposals calling for an independent chair. According to Spencer Stuart, 41% of S&P 500 boards currently split the chairman and CEO roles, compared with 26% a decade ago, and about 21% have independent chairs.

Companies should expect to see more shareholder proposals for the board to implement a policy requiring that the chair position be held by an independent director, beginning with the next CEO succession (if not before). Given the potential for scrutiny and shareholder activity in this area, boards should ensure that they agree on the rationale for the company's leadership structure, and that the rationale is well disclosed. Boards should also be prepared to revisit leadership structure issues during times of CEO transition, when the decision about the chairman position will be closely scrutinized.

SUCCESSION PLANNING

Shareholders are showing more interest in succession planning. Over the past several years, the number of shareholder proposals seeking greater disclosure related to succession planning has increased. However, this is an area where detailed disclosure can be difficult, other than with respect to the board's overall process.

In reviewing their processes, boards should consider the central components of succession planning, such as the company's:

- Management development efforts.
- Strategic direction and future leadership needs.

Boards should be prepared to make succession decisions when the need arises in accordance with the company's long-term plans, and in an efficient manner. This requires developing and assessing internal candidates, as well as scanning for sources of potential external candidates. Boards should ensure they are spending adequate time on management development and succession planning, even though there may be more pressing and immediate demands for board attention and a natural discomfort in raising succession issues with a well-performing CEO.

CORPORATE POLITICAL CONTRIBUTIONS

Boards should expect the attention on transparency and board oversight of corporate political spending to intensify, especially given the 2012 presidential election and the US Supreme Court's January 2010 decision invalidating restrictions on certain corporate political expenditures (*Citizens United v. Federal Election Commission*).

The Center for Political Accountability (CPA), with assistance from the Wharton School's Zicklin Center for Business Ethics, recently created an index (CPA-Zicklin Index) ranking S&P 100 companies on their levels of political transparency and accountability, based on information from company websites. The CPA-Zicklin Index, available at politicalaccountability.net, will be updated annually and expanded in 2012 to cover the S&P 500. Shareholders are likely to consider these rankings in determining where to file shareholder proposals on corporate disclosure and policies related to political activities.

According to the CPA-Zicklin Index, a growing number of S&P 100 companies are developing policies that restrict political spending in some respect, and are voluntarily disclosing aspects of their political spending. For example:

- 57 of the S&P 100 disclose their direct corporate political spending and have adopted board oversight or restricted corporate political spending.
- 43 of the S&P 100 disclose information about indirect spending through trade associations or other tax-exempt groups.
- Two companies (Colgate-Palmolive and IBM) prohibit the use of corporate funds for both direct and indirect political activity.

CORPORATE RESPONSIBILITY

Shareholder focus on corporate responsibility will likely magnify in the coming year. In 2011, both the number of social and environmental proposals brought by shareholders and the support for these proposals increased. Boards should expect disclosures regarding the corporate impact on natural resources to be an important topic, with an emphasis on water and air quality and supply chain sustainability.

COMPLIANCE PROGRAM EFFECTIVENESS

Boards should work with management to ensure a corporate culture in which employees are encouraged to report compliance and ethical concerns through the company's internal channels. Boards should assess the quality of the company's messaging and communicate at every opportunity that internal reporting is expected, valued and critical to the company's success.

Encouraging employees to come forward with concerns internally may be more challenging given that employees are eligible for awards through the SEC's whistleblower program for providing original information on violations of federal securities law. This includes, for example, violations of the Foreign Corrupt Practices Act, which may attract significant fines and bounties. The challenge is to establish a culture that encourages internal reporting of concerns to support compliance system effectiveness, without discouraging employees from reporting directly to the SEC, should they choose to do so. Boards should continue to monitor and assess the corporate culture and the effectiveness of compliance systems closely in 2012.

RULES ON THE HORIZON

A number of rules mandated by the Dodd-Frank Act have yet to be finalized. Among others, these include disclosure requirements relating to:

- Executive pay ratios.
- Compensation committee and adviser independence.
- Clawback policies to recover incentive compensation.
- Conflict minerals, mine safety and resource extraction.

In addition, the Public Company Accounting Oversight Board (PCAOB) recently issued proposed amendments to its auditing standards, potentially impacting the relationships between companies and audit firms.

Boards should stay abreast of regulatory developments and devote time to preparing for new rules that may be implemented in 2012.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.