Monday, October 25
2:30pm-4:00pm

308 - Care and Feeding of a Board: Solving Difficult Liability Issues

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Managing Director, Board Advisory Services
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Session 308

Faculty Biographies

Suzanne Hopgood

Suzanne Hopgood is the managing director of board advisory services of the National Association of Corporate Directors.

Prior to founding The Hopgood Group, LLC, Ms. Hopgood was responsible for a $1 billion equity real estate portfolio for Aetna Realty Investors. She is also the president and CEO of The Hopgood Group, LLC, a workout consulting firm she founded.

Ms. Hopgood has served on the board of nine companies and as chairman of the board of two. She has also served as CEO of both public and private companies, and she is a financial expert. She has assisted a variety of companies in facing difficult business, financial and legal challenges and crises. She has served as chair of Nominating & Governance of Acadia Realty Trust, Point Blank Solutions, Inc., a global leader in the design, manufacture, and distribution of high performance body armor, chairman of the board of Del Global Technologies, Inc and chair/CEO Furr's Restaurant Group. She has twice served as a member of board slates elected in proxy contests initiated by institutional investors. She co-authored the award-winning Board Leadership for the Company in Crisis.

Paul Mamalian
HMSHost Corporation

Arden Phillips

Arden Phillips is assistant corporate secretary of WGL Holdings Inc. and its wholly-owned subsidiary, Washington Gas Light Company. He plays an integral role in coordinating the actions of directors, maintaining relations between management and the board, and addressing Sarbanes-Oxley and corporate governance questions. Mr. Phillips also has significant responsibility for preparing and filing periodic reports and disclosures required under federal securities laws.

Prior to joining WGL Holdings Inc., Mr. Phillips worked at various private law firms where he obtained experience with a wide range of corporate transactions, including the preparation and negotiation of agreements and ancillary documents for mergers, acquisitions, joint ventures and secured financing transactions. He also advised and represented issuers in private offerings of debt and equity.

Mr. Phillips was elected chair of the Corporate and Securities Law Committee of the Association of Corporate Counsel (ACC). As Chair of the Corporate and Securities Law Committee, Phillips will determine and implement several of the committee's initiatives which will focus primarily on advocacy, networking, and educational opportunities. Mr. Phillips has also been on the advisory board of the mid-Atlantic chapter of the Society of

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Corporate Secretaries and Governance Professionals Inc. (the "Society"). The Society has over 3,800 members representing approximately 2,600 companies. Its members deal with matters affecting federal securities law disclosure and corporate governance.

Mr. Phillips received his BA from Columbia University and his JD from Duke University School of Law.

James Williams

James E. Williams is the vice president, general counsel and corporate secretary of Liquidity Services Inc., a leading provider of online auction marketplaces for surplus and salvage assets, listed on the Nasdaq Stock Market and headquartered in Washington, DC. He is responsible for all legal, corporate governance, and compliance matters at Liquidity Services Inc.

Prior to joining Liquidity Services, Mr. Williams served as vice president, general counsel and secretary of Acterna Corporation, a telecommunications equipment manufacturer. Prior to Acterna, he served as Assistant General Counsel of Pathnet Telecommunications, a wholesale telecommunications provider. Mr. Williams began his career in private practice; he was a corporate associate with the law firms of Kirkland & Ellis and Wilson Sonsini, Goodrich & Rosati.

He received his BA from Brown University and his JD from the University of Chicago Law School.

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Executive Compensation and Proxy Disclosure

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Executive Compensation & Proxy Disclosure

Say on Pay Shareholder Votes

- Beginning January 21, 2011, the Dodd-Frank Act requires public companies to:
  - Hold annual, biennial or triennial non-binding shareholder advisory votes ("say on pay") to approve the compensation of Named Executive Officers ("NEOs"); and
  - Hold a separate vote at least once every six years to determine whether the say on pay votes will be held every one, two or three years
- Potential Board Action
  - Revisit how compensation programs are presented in the CD&A
  - Revisit ISS guidelines as to pay practices that will cause ISS to issue a negative vote recommendation
  - Review management's communication with the proxy voting departments at institutional investors to encourage affirmative voting for say on pay

Say on Golden Parachutes Shareholder Votes

- Dodd-Frank Act requires public companies soliciting votes (on or after January 21, 2011) in connection with a shareholder vote to approve certain change of control transactions to:
  - Disclose all compensation arrangements with NEOs relating to the transaction, including total amount; and
  - Hold separate non-binding shareholder advisory vote on these arrangements unless they already have been subject to a say on pay vote
- Potential Board Action
  - Consider establishing change-of-control compensation in advance so that it can be subject to say on pay votes rather than being separately voted on in the merger context

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Executive Compensation & Proxy Disclosure

Clawback Policies

- Dodd-Frank Act requires listed companies to adopt clawback policies:
  - To recoup from any current or former executive officers incentive compensation paid during a three-year look-back period based on erroneous data if the company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, regardless of whether the individual was involved in misconduct that led to the restatement
- No time period prescribed for SEC and stock exchanges to adopt rules to implement this provision
- Potential Board Action
  - Evaluate compensation arrangements that might be subject to the new clawback policy
  - Adopt clawback policy or review and amend existing policy to comply with new rules

Anti-Hedging Policy Disclosure

- Dodd-Frank Act requires public companies to disclose in their proxy statements whether employees or directors may purchase financial instruments designed to hedge decreases in the value of company stock held by them
- Potential Board Action
  - Consider whether to adopt an anti-hedging policy and if it will apply to all employees
  - If a policy already is in place, review to determine if any changes are advisable

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Executive Compensation & Proxy Disclosure

- Pay versus Performance Disclosure
  - Dodd-Frank Act requires public companies to disclose in their proxy statements the relationship between:
    - Executive compensation "actually paid"; and
    - The company's financial performance (taking into account stock value changes and dividends)
  - Potential Board Action
    - Analyze how compensation will compare with financial performance
    - Consider developing alternative ways to more effectively present the pay for performance relationship
- Internal Pay Ratio Disclosure
  - Dodd-Frank Act requires public companies to disclose in their SEC filings:
    - Median annual total compensation of all employees except the CEO;
    - Annual total compensation of the CEO; and
    - Ratio of these amounts
  - "Total compensation" calculated in same manner as for the Summary Compensation Table
  - Potential Board Action
    - Review factors that may contribute to any potentially large disparities in the ratio to help to explain the disparity
- SEC must adopt rules to implement anti-hedging policy, pay versus performance and internal pay ratio disclosure requirements, but no time period prescribed

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Governance Structure

- Risk Management/Risk Committee
  - Earlier bills prior to the final Dodd-Frank Act proposed a requirement requiring that all listed companies have a separate risk committee of the board
  - Dodd-Frank Act imposes a risk committee requirement only on certain large financial institutions
  - Several companies have received shareholder proposals requesting the creation of a compliance or risk committee
    - Some companies have created risk committees to separate the evaluation of risk function from the numerous tasks already required of an audit committee
    - Oversight of risk assessment and management involves more than just the evaluation of financial risks, and audit committee members may not have the experience necessary to evaluate all types of risk
  - Addressing risk through a separate risk committee or through the board as a whole makes use of all of the areas of expertise of the various members of the committee or the board
    - This can elevate the visibility of the board's oversight of risk management to the shareholders
  - Potential Board Action
    - Consider whether the members of the audit committee have the skills and experience to properly evaluate all types of risk
    - Consider whether to move the risk management function to a separate risk management committee or to the board as a whole
    - Re-evaluate how the Board monitors the company's risk management practices
- Enhanced Committee Charters
  - Proxy statements contain increased disclosure about management and board oversight of risk
    - Several companies have amended their audit committee charters in order to reflect what is disclosed in the proxy statement about risk
  - Potential Board Action
    - Consider amending the audit committee charter and/or mission statement to reflect proxy disclosure about management and oversight of risk
    - To the extent any other committees manage risk, consider similarly amending the charter and/or mission statement

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Other Governance Issues

- Compensation Committee Independence
  - Dodd-Frank Act requires SEC within 360 days to direct exchanges to enact rules regarding compensation committee independence for listed companies
  - Exchanges must consider relevant factors including sources of compensation paid to compensation committee members (e.g. consulting, advisory or other compensatory arrangements) and whether members are affiliates of the issuer and its subsidiaries
  - Compensation consultants, counsel and advisors must be selected after consideration of independence factors to be established by SEC
  - Potential Board Action
    - Review compensation committee membership criteria and evaluate and understand sources of compensation paid to compensation committee members
- Disclosure of Board Leadership Structures
  - Dodd-Frank Act requires SEC to adopt rules within 180 days requiring disclosure of a company's decision regarding separation (or not) of chairman and CEO roles
    - This is similar to the proxy disclosure rules recently adopted by the SEC, which require a discussion of, among other things, whether, if the roles are combined, there is a lead independent director and the specific role of such director, and why the company believes its structure is the most appropriate for the company.

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Code of Conduct/Whistleblower

Rewards to Whistleblowers
- Dodd-Frank Act requires the SEC to adopt rules within 270 days providing that a whistleblower who voluntarily provides information to the SEC that leads to a successful enforcement action resulting in over $1 million of monetary sanctions may be awarded between 10-30% of the monetary sanctions collected.
  - Amount of the award will be in the discretion of the SEC
  - Whistleblowers may initially report violations either by name or anonymously
  - Companies could see an increase in the number, volume and size of whistleblower complaints made to the SEC regarding their businesses

Protections for Whistleblowers
- Dodd-Frank Act provides for a new private right of action for reinstatement, two-times back pay and other relief
- Expands the coverage of the existing Sarbanes-Oxley whistleblower protections
- Expands the scope of protected whistleblower activity under the False Claims Act

Code of Conduct
- Whistleblower hotlines at some companies are not used frequently
- Potential Board Action:
  - Review the "tone at the top" with the management team
  - Encourage additional publicizing of hotline and require prompt follow up to any calls
  - Review the substance of hotline calls with the appropriate Board Committee
  - Review the Company's training practices for the Code of Ethics and reminders of the existence of the hotline

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Code of Conduct/Whistleblower

Appointment of a Person Responsible for Reporting Code of Ethics Violations to the Audit Committee

Amendments to the Federal Sentencing Guidelines take effect in November 2010

To get credit for an effective compliance program under certain circumstances, an organization must have procedures that give the person with day-to-day operational responsibility for compliance the express authority to communicate directly with the board or responsible committee:
- promptly on any matter involving criminal conduct or potential criminal conduct; and
- no less than annually on the implementation and effectiveness of the compliance and ethics program

Some companies have made changes to the Audit Committee charter to state that:
- the Audit Committee shall, at least annually, meet to review the implementation and effectiveness of the legal and ethical compliance programs with the person who has day-to-day operational responsibility for compliance; and
- such person shall have the authority to communicate directly to the Audit Committee, promptly, about actual and alleged violations of the Code of Conduct, including any matters involving criminal or potential criminal conduct

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The Current Environment

Proxy Access Specifics
- Rules around ownership:
  - Years holding stock
  - Percentage of stock held
  - Exemptions?

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Board Composition

Succession Planning
- Consider long-term strategic planning when selecting candidates
- Define *exactly* what qualities to look for in future candidates
- Challenges of finding qualified directors

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Point Blank Solutions, Inc.

Shareholder Communications
In the proxy, explain to shareholders:
- The strategic plan
- Board skill sets needed to oversee execution of the plan
- Individual skill sets of board members
- How those skill sets match the strategic plan and add value to the company

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Point Blank Solutions, Inc.

The Company's Strategic Plan

"...established a vision for Point Blank Solutions to be the global leader in safety apparel and protective solutions...based on the following five strategic pillars:"

- Capture new military programs and increase the company's civil market share
- Expand internationally
- Improve the company's cost position
- Pursue strategic ventures to expand and diversify
- Build confidence in leadership and demonstrate financial responsibility

Source: Point Blank Solutions, Inc., 2008 Proxy

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Point Blank Solutions, Inc.

Skill Sets Identified and Disclosed in the Proxy:

- Financial expert
- Government procurement experience
- Turnaround expert
- Industry expertise and experience
- International experience
- Leadership skills
- Corporate governance expert
- Manufacturing expertise
- Public relations and marketing experience

Source: Point Blank Solutions, Inc., 2008 Proxy

Point Blank Solutions, Inc.

Director Background Information Disclosed in the Proxy

- JH – audit committee financial expert
- DB – marketing experience and history as a senior executive
- MH – ties to the law enforcement community
- SH – experience in turning around troubled companies and corporate governance
- Gen. MB – a globe-spanning career with the U.S. Marine Corps (Ret. General)
- Gen LE – a globe-spanning career with the U.S. Army (Ret. General)
- Sen. WC – career as a legislative leader

Source: Point Blank Solutions, Inc., 2008 Proxy

Fiduciary Duties of Corporate Boards

General Principles

Corporate directors and officers owe specific "fiduciary" duties to the corporation and its stockholders that have been developed by the courts:

- Duty of Loyalty – placing the interests of the company first
- Duty of Care – acting diligently and competently
- Duty of Candor – communicating honestly and fully with stockholders and other directors
- Duty of Confidentiality – protecting boardroom deliberations and company confidential information from disclosure to outsiders

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WHITE PAPERS: SERIES I

Risk Oversight | Transparency | Strategy | Executive Compensation

KEY AGREED PRINCIPLES

to Strengthen Corporate Governance
for U.S. Publicly Traded Companies

Published by:
National Association of Corporate Directors®

Key Agreed Principles to Strengthen Corporate Governance
for U.S. Publicly Traded Companies: *White Papers: Series I:*
Risk Oversight, Transparency, Strategy, and Executive Compensation

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Download a copy of the Key Agreed Principles and the White
Paper Series at www.nacdonline.org/KeyPrinciples/.

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Introduction

In the past year, the economic environment has radically changed. Congress and corporations alike are struggling to find the right answers to our current situation and beyond. These events have provoked questions about the effectiveness of boards of directors.

The oversight work of the board is a complex endeavor requiring a collection of skills and resources that coalesce through leadership. Board leadership can and must now weave together the torn fabric of trust and confidence both desired and deserved by investors and other corporate stakeholders.

In October 2008, the National Association of Corporate Directors (NACD) launched a set of principles intended to guide corporate leaders. These principles, known as the Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies (Principles), are the cumulative effort of many organizations and individuals to find a truly shared set of ideas to improve the functioning of America's boardrooms. The Principles can be found at www.nacdonline.org/KeyPrinciples/.

After receiving input from the director community, it became evident that four areas warranted greater work: oversight of risk, development of strategy, approval of executive compensation, and communication of these matters to stakeholders. These subjects are of vital importance because directors cannot have appropriate oversight without addressing all four of them.

NACD has developed White Papers on the four critical areas, offering this series as a catalyst for thoughtful, deliberate debate, and change where required in the boardroom. Companies will face many hurdles in the coming years and the Principles, along with the White Papers, offer guidance. These documents are not meant to prescribe a singular course of action; they point toward a direction—one that only the board, with management, can choose. The time to make that choice is now.

Sincerely,

Kenneth Daly
March 2009

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Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies

I. Board Responsibility for Governance

Governance structures and practices should be designed by the board to position the board to fulfill its duties effectively and efficiently.

II. Corporate Governance Transparency

Governance structures and practices should be transparent—and transparency is more important than strictly following any particular set of best practice recommendations.

III. Director Competency & Commitment

Governance structures and practices should be designed to ensure the competency and commitment of directors.

IV. Board Accountability & Objectivity

Governance structures and practices should be designed to ensure the accountability of the board to shareholders and the objectivity of board decisions.

V. Independent Board Leadership

Governance structures and practices should be designed to provide some form of leadership for the board distinct from management.

VI. Integrity, Ethics & Responsibility

Governance structures and practices should be designed to promote an appropriate corporate culture of integrity, ethics, and corporate social responsibility.

VII. Attention to Information, Agenda & Strategy

Governance structures and practices should be designed to support the board in determining its own priorities, resultant agenda, and information needs and to assist the board in focusing on strategy (and associated risks).

VIII. Protection Against Board Entrenchment

Governance structures and practices should encourage the board to refresh itself.

IX. Shareholder Input in Director Selection

Governance structures and practices should be designed to encourage meaningful shareholder involvement in the selection of directors.

X. Shareholder Communications

Governance structures and practices should be designed to encourage communication with shareholders.

For a complete description of the Principles, see www.nacdonline.org/KeyPrinciples/.

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Executive Summary

Over the past twelve months, economies around the world have undergone alarming declines. Today, in the United States, the federal government and the business community are asking why we are in this situation and how to identify and implement measures that contribute to economic growth and sustainability. What is apparent is that the first step must come from the boardroom. It is time to revisit governance practices, and corporate directors are in the position to lead the way.

In October 2008, the National Association of Corporate Directors (NACD) put forth a set of principles to guide corporate leaders as they make boardroom decisions. These principles, known as the Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies (Principles), are the cumulative effort of many organizations and individuals to identify and agree upon a truly shared set of ideas that will improve the internal functioning of America's boardrooms. However, it is clear that simply stating principles is just the first step to affecting change in the boardroom.

This White Paper series outlines four areas of corporate governance that have been identified as most important and of immediate concern. They are: risk oversight, strategy, executive compensation, and transparency. After setting forth one or more of the relevant Principles in the categories, each chapter examines the current environment and summarizes past NACD recommendations.

Key findings in each area include:

Risk Oversight

Improving the oversight of risk will require directors to assign risk oversight responsibilities, establish risk identification procedures, evaluate risk models, and improve overall information flow.

If the current economic downturn has taught us anything, it is that our processes for risk oversight need improvement. According to the *2008 NACD Public Company Governance Survey* (NACD Survey), 67 percent of companies assign the majority of risk-related tasks directly to the audit committee. The audit committee, however, is the most heavily burdened committee on the board. Many issues lie outside the audit committee and require other committees—if not the full board—to oversee. The full board may want to consider assigning oversight of risks to certain committees to help ensure adequate coverage.

Additionally, in a recent member poll, NACD found that a large majority (76 percent) of directors indicated that management provides the board with the information necessary to effectively execute its risk governance role. However, those same directors said that two of the top challenges in providing risk oversight are: 1) management's capacity to define and explain the organization's risk management

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structure and processes; and 2) the organization's capacity to identify and assess risks. These two challenges fall squarely on management's shoulders, but directors can help by improving their own oversight processes.

Strategy

As boards grapple with the current complexities of strategy, NACD believes the following issues will confront directors in the future: the need for better strategic information, greater board engagement, alignment of board composition with strategy, and better alignment of short-, medium-, and long-term goals.
Typically, management develops a strategy with input from the board. Boards also need to continually review and evaluate the board's size and membership mix to ensure the right skills are present to provide management with proper oversight on strategy and its inherent risks.

Information is essential, but it must be actionable. In strategic planning, the right information can help an organization successfully navigate its way through the marketplace. Management's main job is to bring the right information to the table. Directors must then help management determine how the company will act in response to the information over the short, medium, and long term.

Executive Compensation

Boards need better metrics to judge performance, stronger oversight of human capital development, greater independence of the compensation committee and its advisors, and more proactive shareholder communications.

One of the greatest challenges facing boards and compensation committees is finding better ways to measure the performance of their CEOs and other senior executives. While measures such as total shareholder return (TSR) and net operating profits after taxes (NOPAT) are common, others, like return on assets (ROA) or economic value added (EVA) are also used. Effective boards use a combination of measures, as well as performance criteria that are specific to the individual CEO and the company's circumstances.

Unfortunately, pay and performance are not always aligned. According to the NACD Survey, 88 percent of boards believe compensation for CEOs is too high or somewhat high relative to performance. A majority of those respondents believe that the main cause of inappropriate pay packages is due to the absence of goal-oriented objectives against which performance can be rigorously evaluated.

Compensation should reward behavior that will most likely result in achievement of strategic goals. The performance criteria should always maintain a distinction between long-term and short-term goals. Rewards should reflect success in reaching the milestones that make the most sense for the company. Also, the composition of a compensation committee is critical to ensuring appropriate compensation decision-making processes. By questioning the status quo in an informed exchange of ideas, a committee can engage in objective negotiations while also showing confidence in the organization's leadership.

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Transparency

Improvement in this area will come by increasing and enriching the information flow between the board and shareholders through greater use of technology in communication, with a focus on disclosure of board processes. Greater corporate transparency requires a combination of increased communication and legal protections. Boards must begin by communicating with shareholders more often, in more detail, and in more venues. Next, legal protections through safe harbor rules should be added to current disclosure requirements.

Face-to-face meetings can be helpful, but over one-third of directors responding to the NACD Survey believe that it is never acceptable for a representative of the board to meet with institutional shareholders. In light of such findings, it is all the more important for boards to disclose how and why they make decisions on behalf of shareholders—ideally through disclosures in the annual and quarterly reports to shareholders.

NACD recognizes that a one-size-fits-all approach to strengthening corporate governance can never work. Oversight needs differ from company to company and board processes will vary accordingly. At the same time, there are certain key principles that all responsible corporate leaders must embrace. NACD's Key Agreed Principles and White Papers capture those standards. The Principles will serve as a guidepost for the four identified issues of current concern, as well as for future issues that may arise.

Companies will face many hurdles in the coming years, and directors continue to be the first line of defense against those challenges. Hundreds of directors nationwide, from companies large and small, described the challenges facing them in these areas and proposed possible solutions. These White Papers represent those directors and thousands of others dedicated to the improvement of corporate governance.

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Chapter I: Risk Oversight

***Key findings:** Improving the oversight of risk will require directors to assign risk oversight responsibilities, establish risk identification procedures, evaluate risk models, and improve overall information flow.*

THE NEW NEED FOR STRONGER RISK OVERSIGHT

The National Association of Corporate Directors (NACD) published the *Report of the NACD Blue Ribbon Commission on Risk Oversight* in 2002 as the implosions of Enron, WorldCom, and others created an economic upheaval that prompted reforms from both government and the exchanges. The Commission was convened to provide practical guidance to boards in those turbulent times.

The Report's introduction begins with the following hypothetical scenario: "The stock market plunges. A major company declares an unexpected bankruptcy." This prophetic introduction neatly forecast the current collapse of financial titans and a stock market in turmoil. Today, questionable decisions by the financial industry and the credit rating agencies have put our economy in what many call "the worst economic crisis since the Great Depression."

Over the past few years, as companies booked large net gains from high-yield business transactions portrayed as solid investments, too few asked, "Is this too good to be true?" Concerned groups such as the Organization for Economic Cooperation and Development have concluded that corporate governance routines did not sufficiently safeguard against excessive risk taking.[1] Boards must now exercise risk oversight as never before.

For years, NACD has advocated for increased attention to risk and its oversight. The current economic crisis should be a wake-up call for all boards to renew their focus on this difficult but critical subject.

NACD GUIDANCE ON RISK OVERSIGHT

Boards should seek to mold their risk oversight practices around Key Agreed Principle VII – Attention to Information, Agenda, and Strategy. This principle stresses that governance structures and practices should be designed to support the board in determining its own priorities, agenda, and

[1] Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis," Organization of Economic Cooperation and Development, 2008.

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informational needs, and to assist the board in focusing on strategy and risk. The recommendations from the Report, when followed, offer practical and principled guidance on maintaining that essential risk oversight infrastructure. This section summarizes those recommendations.

Mitigating Risk

The ultimate goal of a risk program is to mitigate the risks in the implementation of a strategy. Eliminating risk completely is impossible and undesirable because a certain amount of risk is inevitable in any activity—and often necessary to make a profit. Setting the right example can go a long way in detecting and preventing undue exposure to risk. Strong corporate culture, reputation, and credibility can mitigate the impact of a crisis situation. The board should proactively encourage, through written policies and individual director actions, a "tone at the top" that conveys basic values of ethical integrity, as well as legal compliance and strong financial reporting and control, to all levels of the organization. Management should be risk-minded as they create systems for employee selection, retention, training, and compensation.

Strategy and Risk Appetite

Companies have different levels of risk appetite. Calculating a company's tolerance for risk requires sustained attention to various elements. To fully assess an organization's risk appetite, the board must be constructively engaged in assessing the company's strengths, weaknesses, opportunities, and threats. The board should also recognize that the corporation's strategic goals may need to change in conjunction with changes in its risk exposure and that, conversely, a company's risk exposure will change as its strategy changes. Additionally, directors need to consider a broader view of risk by factoring in other stakeholders such as employees, customers, and suppliers. A fully developed risk profile encompasses the impact on and from these groups.

Risk Identification

Every company must deal with uncertainty. Generally, management should identify and list the specific material risks the company faces, indicate the likelihood that they will actually occur, and estimate their potential cost versus the cost of prevention. However, management cannot conceive of every possible risk. For their part, boards should probe the legitimacy and scope of management's assessment through constructive skepticism. Directors must help identify potential risks and provide scenarios that management may not have considered. It is unforeseen risks—not the predictable ones—that can cause the most problems for a company.

Monitoring Risk

Directors should continually monitor the financial health of the firm, ensuring accurate accounting and safekeeping of corporate assets. Appropriate attention must be given to detecting and deterring significant risks, particularly those that exceed the established tolerance levels of the company. Directors must also pay increasing attention to risks related to the security of information and information technology.

An important element of risk identification and monitoring is ensuring the quality,

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dependability, and timeliness of information. Management and the board cannot afford information overload, or information that is out-of-date, incomplete, or irrelevant. Management must provide accurate reports on past incidents, current risk management activities, vulnerabilities, and red flags.

Crisis Response
The board is responsible for ensuring that sound crisis response planning has occurred. Such plans should enable the board to continue to oversee management, and enable management to continue to run the company, during a crisis. Planning will help the board and management know what to focus on, decreasing the potential for mistakes by decreasing the number of decisions that must be made on the fly.

The board should remain informed during a crisis. When the situation is most critical, the CEO and the board (or board committee) should be in frequent contact. Management and directors should consider engaging appropriate independent advisors, including crisis management specialists, and they should weigh any advice carefully before acting on it.

Future Challenges for Risk Oversight

Building on NACD's general Principles, boards should set new priorities in response to the new environment. Despite the previous work by NACD and others, there is still need for continuing improvement. As boards move forward, they must prioritize their work in risk oversight. This paper suggests four areas for focus.

Assignment of Risk Oversight Responsibilities
Typically, the role of risk oversight is placed within the audit committee. According to the *2008 NACD Public Company Governance Survey* (NACD Survey), 66.7 percent of companies assign the majority of risk-related tasks directly to the audit committee. The audit committee, however, is the most heavily burdened committee on the board.

The combination of risk oversight with other mandated responsibilities can be overwhelming. While risk events may ultimately find their way to the audit committee because of its responsibility for oversight of financial reporting, other committees as well as the full board should participate. Many risks (e.g., technological obsolescence, product quality, mergers/acquisitions, and sales practices) lie outside the audit committee and require other committees—if not the full board—to oversee. The full board may want to consider assigning oversight of risks to certain committees to help ensure adequate coverage.

Currently, only one out of four boards uses the full board for their risk oversight, while an even slimmer 6 percent use a risk committee. Boards can benefit from weighing the pros and cons of these different oversight paradigms for their

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companies. Whether directors use the full board or committees, they must devote greater attention to the primary duty of vigorously probing and testing management's assumptions.

Risk oversight is a full board responsibility. However, certain elements can be best handled at the committee level with the governance committee coordinating those assignments. Similarly, the board must ask management: "Who is the owner of each risk area?" Management should identify the personnel responsible to manage and mitigate specific risk areas. Assignment of senior level responsibility will improve the accountability and reliability of information coming from management.

Improved Risk Identification Procedures

Management has the primary responsibility for the identification of risk. In a recent NACD member poll, a large majority (76.3 percent) of directors indicated that management provides directors with the information they need to effectively execute their risk governance role. However, those same directors said that two of the top challenges in providing risk oversight are: 1) management's capacity to define and explain the organization's risk management structure and process, and 2) the organization's capacity to identify and assess risks.

Directors are increasingly concerned about risk oversight and will become more actively engaged in supporting the company's efforts to manage risk. Boards can prepare by selecting directors who have broad experience as well as industry expertise. Directors must then utilize their internal and external sources of information. Internal auditors can serve a crucial function because they are often on the front lines in identifying the likelihood of risk events and can raise these issues to the board level. Externally, outside sources of information, such as consultants or even D&O insurance agents, can provide new insight beyond what management supplies.

Directors should also be aware that in some of the recent corporate meltdowns, the high-risk behaviors occurred in relatively small pockets of large companies. Therefore, understanding smaller high-risk operations is an important element. These changes in board behavior will likely improve the overall effectiveness of identifying risks for the company.

Risk Models

If the current economic downturn has taught us anything, it is that our risk models should not be the only source of risk information. Risk models can be extremely useful, especially in the financial services area, but models are only a tool—one that requires judgment to use. Not all risks can be quantified and neatly placed in a model. Furthermore, sole reliance on any model can pose a risk in and of itself. The greatest risk for many companies is the combination of inappropriate governance practices with imperfect models.

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Directors must learn and understand the limitations of models. For example, models rely on probability, which is based on history, but this current economic environment is without recent precedent. There is room, however, for improvement of our risk models. Models can be more strenuously back-tested—taking risk migration into account—and then updated to reflect current economic scenarios and other environmental issues.

Also, some current models failed by making faulty assumptions—including inflated values for assets used as collateral in derivative securities. This led to catastrophic collapse in some cases—not only in the financial industry but others as well.

Information Flow

Information that is relevant, accurate, and timely is critical to the task. Boards often cite the problem of "information overload"—receiving immense amounts of information. However, the issue is not just quantity, but quality: much of the information may be irrelevant and may lack the quality of real risk intelligence.

Boards should consider what information they receive and from whom. In addition, boards need to manage the risk of asymmetrical information—information that comes from one perspective, that of management. Depending on the size and complexity of a corporation, the board may wish to identify a senior officer (EVP or CRO for example), with the responsibility for reporting on enterprise risk to the board, or an appropriate committee, on an established schedule.

However, no amount of information, in any format or from any source, can serve as a substitute for a culture of open and effective information flow. Management and directors need to discuss both positive and negative results in the business. Boards and management can develop a dialogue around "tolerances," where the board must ask three things: What limit was passed or what went wrong? How do we plan to go back within limits? Are the tolerances accurate?

The tolerance dialogue must always be linked back to the business plan, associated risks, and long-term sustainable rewards. Board and committee leaders should also have regular one-on-one communications with the CEO and other senior managers, outside of board meetings, to keep abreast of their perspectives.

Finally, and perhaps most importantly, there is the culture of the board. Boards should consider if there is sufficient skepticism expressed in an acceptable way during some of these critical conversations about risk. There is no substitute for wisdom carefully articulated in a timely fashion.

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Chapter II: Corporate Strategy

Key findings: *Boards need better strategic information, more opportunities to engage in strategy, closer alignment of board composition with strategy, and better alignment of goals in the short, medium, and long term.*

CORPORATE STRATEGY: A NEW DIRECTION

A core responsibility of the board is to engage with management in the development of an effective corporate strategy. After all, corporations are managed "under the direction" of boards, according to most state corporate laws—and therefore the board is ultimately accountable for the quality of the company's management, including any strategic plans made and pursued by management.

As fiduciaries, directors have a duty to protect the corporation against threats to its long-term viability. To be sure, the level of direction provided by a board varies from company to company. Directors can be strategic assets to the corporation in a number of ways: by serving as a sounding board for management; by providing performance-enhancing ideas; and by offering constructive skepticism. Most importantly, the board can be a source of strategically relevant competencies.

As boards anticipate new regulations to come from the new presidential administration, focus on the more intangible aspects of governance, such as strategy, will likely be redirected toward concrete compliance-oriented tasks. In surveys conducted for more than 15 years, NACD has found that director interest in strategy rises and falls in negative correlation to regulatory change affecting boardrooms. Following any period of regulatory reform, interest in strategy tends to wane while interest in compliance rises.

Directors should stay focused on strategy. Principle VII provides the necessary guidance to create governance structures that enhance a board's ability to maintain this focus. Sustaining and enhancing the value of a company through a well-conceived plan is vitally important. Even the best of leaders can fail if they are fulfilling a bad or poorly implemented plan. Boards can veto poor strategic choices and make sure that management's plans, well implemented, enable the organization to fulfill its highest potential for the benefit of all.

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NACD Guidance on Corporate Strategy

NACD has issued a number of recommendations about board involvement in strategy—notably in the *Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy* (issued in 2000 and updated in 2006). The following discussion offers guidance from NACD on how boards can be more strategically engaged.

The nature and extent of the board's involvement in strategy will depend on the particular circumstances of the company and the industry in which it is operating. While the board can—and in some cases should—use a committee of the board or an advisory board to analyze specific aspects of a proposed strategy, the full board should be engaged in the evolution of the strategy.

The board should be a strategic asset—directors should individually and collectively seek to go beyond mere compliance and add value to the corporation. In general, directors can be effectively engaged in strategy by:

- Providing useful advice, counsel, and perspective;
- Challenging the underlying assumptions of management;
- Establishing high, realistic standards;
- Identifying additional opportunities and risks associated with the strategies under discussion; and
- Supporting the CEO during challenging periods of strategic implementation.

Corporate strategy is an ongoing process requiring oversight. Management brings vision while boards bring perspective. Management chooses a direction while the board asks: Why? How? What if?—based on their diverse viewpoints. As such, boards should be constructively engaged with management on an ongoing basis to support the appropriate development, execution, and modification of the company's strategy.

Development

To take full advantage of their respective strengths, management and the board can jointly establish the process the company will use to develop its strategy, including an understanding of the respective roles of management and the board.

There is not always a "bright line" between management's role and the board's role, and involvement may vary. The role of management, ideally, is to engage the board in the strategic discussion and ultimately obtain board approval. The role of the board is to evaluate the strategy and challenge underlying assumptions. The board can serve best by providing strategic thinking and enhancement, rather than suggesting specific tactics. It is important to bear in mind these distinct roles so the board does not usurp management's role, or fail to fulfill its own.

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Companies can benefit from establishing clear yet flexible procedures whereby management and the board can exchange ideas through constructive interaction. This will help management develop a sound strategy, and help the board to ensure the use of appropriate measurement criteria and benchmarks. It will also ensure that both management and the board fully understand and support the long-term direction the company will take. This "team-oriented" or cooperative approach can also foster higher-quality dialogue between management and the board, and enable management to make use of the expertise and experience of board members.

Evaluation and Monitoring

Once a strategy is approved, the role of the board is to provide ongoing evaluation of the strategy by monitoring implementation and encouraging changes, as events require. Therefore, to participate effectively in the strategic process, directors must thoroughly understand the assumptions and analyses upon which the strategy is based. Management should regularly update the board on the implementation and execution of the strategy. Directors should be prepared to ask incisive questions—anticipating, rather than reacting to, issues of major concern.

The board should ensure that management demonstrates commitment to the strategy, allocates adequate resources to its fulfillment, has a professional and financial stake in its execution, and adequately reports on its progress. The board should additionally monitor execution of the strategy against milestones. On an ongoing basis, the board must be willing and able to recognize whether or not the company has a winning strategy—and, if it does not, to urge corrective actions. The board should ensure that management makes modifications to the strategy as necessary.

Linking Strategy and Leadership

There is a strong tie between leadership ability and corporate performance. The board must ensure that the CEO has a very clear understanding of the corporation's strategic vision and has concrete ideas on how to implement that vision.

Moreover, the board needs to understand that leadership competencies are not all the same and industry dynamics are constantly changing. The strategic skills senior managers possess must align with the future strategic challenges they will face. The board should establish achievable executive compensation objectives that reflect the company's strategy, and define and communicate clear metrics and criteria for CEO evaluation that are tied to long-term strategic goals.

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FUTURE CHALLENGES FOR CORPORATE STRATEGY

Directors will always be challenged with finding a winning combination of strategy and risk for their companies. As boards grapple with the current complexities of strategy, NACD believes the following issues will confront them.

Better Strategic Information

Information is essential but it must be actionable. In strategic planning, the right information can help an organization successfully navigate its way through the marketplace. Directors are generally satisfied with the reliability of information contained in reports they receive from management, but the presentation of that information is often difficult to digest. Management's main job is to bring the right information to the table. Directors, on the other hand, must then help management determine how the company will act in response to the information over the short, medium, and long term.

Greater Board Engagement

Typically, management develops a strategy with input from the board. In fact, according to the NACD Survey, slightly more than half of companies follow this model, while about 16 percent of boards work collaboratively with management in developing the strategy. Boards and management should consider earlier and greater collaboration when creating, refining, or (in rare cases) overhauling a strategy.

Directors must increase dialogue with management by asking the questions they want answered, rather than receiving information management wants to provide. Finding the right questions to challenge management's conclusions is a director's most difficult yet most valuable responsibility. As such, directors can ask management to limit their use of presentations in the boardroom and request unscripted time with the CEO for a free exchange of ideas.

Alignment of Board Composition with Strategy

Boards have always tried to recruit accomplished professionals to sit on their boards, but sometimes directors' backgrounds bore little connection to the company's strategy. Today, enlightened boards are seeking directors with particular skill sets and expertise to complement their strategic goals. All boards can benefit from continually reviewing and evaluating the board's size and membership mix to ensure a close fit with the strategic direction of the company.

Board members can develop a matrix of skills and expertise that the board requires in order to identify the leadership needs of the corporation, work with leaders to develop an appropriate strategy, and offer needed perspectives and advice in key areas. For example, a company looking to expand into international markets would seek directors who have business experience in those markets in order to ensure that the board can appropriately oversee the strategic plans—and the underlying risks of those plans.

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Better Alignment of Short-, Medium-, and Long-Term Goals

The problem of short-termism has been well-established by a variety of studies and commissions, including, most recently, the Aspen Principles (*Long-Term Value Creation: Guiding Principles for Corporations and Investors*).[2] The Aspen Principles, supported by NACD, state that companies and investors should recognize that firms have multiple constituencies and many types of investors, and they should seek to balance these interests in accordance with their influence on the corporation's long-term success.

Generally, companies should not seek short-term profit at the cost of long-term value. To avoid this, boards can develop forward-looking strategic metrics of corporate health. At the same time, boards can emphasize the need to achieve long-term goals while retaining benchmarking review for the short- and medium-term goals as well.

[2] See www.aspeninstitute.org/bsp/.

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Chapter III: Executive Compensation

Key findings: *Boards need better performance metrics, stronger oversight of human capital development, greater independence of the compensation committee and its advisors, and more proactive shareholder communications.*

Executive Compensation in the Spotlight

Executive compensation has long been a focal point for shareholders and the public alike. In recent years, that scrutiny has intensified as some prominent corporate executives received high levels of compensation even after their company's performance waned. In some cases, CEOs who were fired by boards for poor performance have left with tens of millions of dollars in severance pay. While these are relatively rare occurrences, cases like these garner a high amount of media attention. Furthermore, according to the NACD Survey, a full 88 percent of board members believe CEO pay is generally too high or somewhat high relative to performance.

Investors have been some of the most outspoken critics of high CEO pay. Recent years have been marked by a huge increase in the level of resolutions for shareholder advisory votes on compensation, or "say-on-pay." In 2006, there were four such shareholder proposals; only two years later, in 2008, shareholders submitted 72 proposals for say-on-pay. Several companies have adopted or are considering adopting provisions for say-on-pay.

Congress has also taken notice by requiring Troubled Asset Relief Program (TARP) recipients to conduct an advisory vote on compensation for those who filed their preliminary or definitive proxy materials after February 17, 2009. Experts believe that say-on-pay will be expanded beyond TARP recipients under the Obama administration.

One of the biggest problems in addressing executive pay is that any pay package can be configured to alter the board's original intent to create a fair and reasonable agreement. Pay packages can be distorted through misguided practices such as the use of inappropriate benchmarking and options backdating or repricing. These practices, once discovered, have a negative impact on a firm's reputation and can even have legal repercussions.

Boards need to take a greater stand and realize that "the buck stops" with them. Proper pay packages reflect the risk appetite and profile of a company and are constructed to dissuade executives from crossing established boundaries. Only boards have the ability to take control of the company's equitable pay practices and build a system that incents the correct behavior.

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NACD Guidance on Executive Compensation

NACD has been concerned about executive compensation since its founding days. Principle VI suggests that boards pay greater attention to management's potential conflicts of interest, particularly in compensation. In addition, the *Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee*, issued in 2003, was updated in 2007 so the timeless recommendations therein would continue to be valuable for boards in light of the changing environment and new compensation disclosure requirements. The key recommendations from the Report encourage a principled approach to compensation for executives. This section summarizes those recommendations.

Philosophy

Each corporate board must begin by adopting a compensation philosophy and a set of principles to guide its actions. Generally, a thorough and appropriate compensation philosophy should reflect a link to performance and the principles of independence, fairness, long-term shareholder value, and transparency. By following this suggested practice, compensation committees and boards can make a critical difference in the future of individual companies and in the future of corporate governance in general.

Independence

Independence must be the bedrock value for both the board and its compensation committee. The board needs to ensure that all the members of the compensation committee are independent, knowledgeable, and diligent in the discharge of their duties. Directors should also be able to speak honestly, set and adhere to appropriate limits, and advocate for change when current practice results in negative outcomes.

Fairness

Compensation committees and boards should strive for pay packages that will be perceived as fair, both internally and externally. Internally, fairness means that all members of an organization benefit when the company does well and share in sacrifices when necessary. Fairness also means that there will not be wide gaps between the CEO's pay and the pay of other senior managers—or between executives and other employees—unless they are justified and explained. Externally, pay should relate to performance and be measured against true peer companies selected by the compensation committee.

Long-Term Shareholder Value

Compensation committees and boards need to design pay packages that encourage long-term commitment to the organization's well-being. While executives do need to meet short-term targets and should be rewarded for doing so, companies should award additional variable compensation based on achieving key metrics over an extended period of time—using company performance measures, rather than stock price alone, as criteria. Tying bonuses, stock grants, or other compensation to such measures can help align management's personal

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financial interests with those of shareholders and employees.

Link to Performance

Pay must motivate and reward performance. Compensation committees and boards should never approve overly generous rewards for executives who have failed to perform or are being terminated. Boards need to set clear performance objectives for senior executives and measure performance against those objectives. Performance objectives should be based on multiple factors—quantitative and qualitative—as opposed to stock price alone. This activity should not be viewed as the sole responsibility of the compensation committee, but should occur with full engagement and approval of the board.

Transparency

Overall, compensation committees and boards need to design plans that are as simple as possible and spell them out in a brief summary that describes company goals, executive performance objectives, and potential payouts under various scenarios. Every element of compensation should be fully and clearly disclosed, even if such disclosure is not required. Simplicity of design and communication will ensure that executives, compensation committees, boards, and investors all understand the compensation package.

Future Challenges for Executive Compensation

Improvements are necessary to make executive compensation fair and appropriate. As companies move forward with selecting and compensating their top management, NACD has identified areas that have been historically problematic, and will continue to challenge directors in the future. These areas warrant greater study so that true, workable solutions can be found.

Better Performance Metrics

One of the greatest challenges facing boards and compensation committees is finding better ways to measure the performance of their CEOs and other senior executives. Common measures include total shareholder return (TSR), net operating profits after taxes (NOPAT), return on assets (ROA), and economic value added (EVA). Boards should use multiple metrics and take individual company and executive factors into consideration. Regardless of method, according to the NACD Survey, 54 percent of board members believe that the main cause of inappropriate CEO pay packages is the absence of goal-oriented performance objectives against which performance can be rigorously evaluated.

Companies should be free to choose their own metrics in accordance with their particular circumstances, but the current system has much room for improvement. Ideally, boards should strive to reward long-term, sustainable performance, as opposed to immediate gains. To focus on the long term, boards may want to begin by relating a clear and detailed strategy to the performance criteria.

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Rewards should reflect success in reaching both long- and short-term milestones that make the most sense for the company. The recent use of "bonus banks," which allow annual bonuses to be paid out over a period of time to executives who meet predetermined benchmarks, presents an interesting possible tool for directors to consider when attempting to match compensation with performance. We encourage more experimentation along these lines.

Stronger Human Capital Development

The concept of hiring outside the company to lure marquee CEOs has gained in popularity in the past decade. The importance of building up the bench of internal executive talent has languished in many companies. As noted in the NACD Survey, only 36 percent of companies have a plan for the development of internal CEO candidates.

Companies should be grooming internal talent, not only as a means to improve long-term corporate performance, but also as a way to avoid the additional, often exorbitant, compensation costs associated with bidding for external CEOs. Boards should maintain formal CEO succession plans that seek internal talent before identifying external candidates. Creating a talent management program begins with the board or management taking inventory of competencies required for key jobs in the company and then developing those competencies in possible candidates. This development may take many forms, including on-the-job training, education, and customized mentoring programs for candidates.

Boards may also want to include executive talent management as a component of their evaluation of the CEO's performance. Directors would then be incentivized to craft more robust internal talent development programs that act as investments in the long-term future of the company.

Composition of the Compensation Committee

The composition of a compensation committee is critical to ensuring appropriate compensation decision-making processes. Essential to the make-up of the group are directors who are not only independent by definition, but who are independent-minded as well. Fostering independence and rigor will better prepare the committee to engage in negotiations and more effectively carry out its duties. Through questioning the status quo and providing for an informed exchange of ideas, the committee will be able to engage in objective negotiations, while also showing confidence in the organization's leadership.

Independent Consultants

The NACD Survey shows that 90 percent of board members who believe their compensation programs have improved corporate performance have engaged independent compensation advisors. The NACD Survey also shows that directors who gave themselves the lowest marks in tying pay to performance were much less likely to engage such advisors. There is no doubt that the use of independent consultants can prove useful to compensation committees, but advice from consultants is just one tool in

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creating a pay package. Boards should remain diligent in making decisions based on the company and its performance, and not solely on what is being promoted by the consultants. Also, boards should make sure that they review the work of their consultants and remain open to using new consultants when circumstances warrant a change.

Proactive Shareholder Communications

In recent years—particularly in light of recent media focus on cases of extremely large CEO compensation packages—shareholders have become increasingly active, requesting meetings and/or proposing resolutions with respect to proxy access, majority voting, and say-on-pay. At the same time, many boards have become more active in responding to and even anticipating this desire for increased participation.

NACD has recently directed attention to this issue in the *2008 Blue Ribbon Commission Report on Board-Shareholder Communications*. This Report is a good first step in helping boards build governance structures and practices designed to encourage communications with shareholders. Principle X also reflects the need to create governance structures that are designed to encourage communications with shareholders. Where compensation is involved, directors should be receptive to input from key investors and listen to their concerns. By making shareholder communications a board priority, and proactively explaining how the compensation philosophy relates to the long-term performance of the company, boards can cultivate investor trust and confidence.

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Chapter 4: Transparency

Key findings: *Boards can be more proactive in shareholder communications, make greater use of technology, and disclose more about board processes (with legal protection through safe harbor laws).*

THE NEED FOR GREATER TRANSPARENCY

Since its founding in 1977, NACD has spoken out on the need for greater transparency surrounding board decisions—notably, the elements of executive and director compensation. In recent times, there has been interest in disclosing more about board processes—but exactly what should be disclosed, and how should those disclosures be made?

NACD has emphasized one important criterion about disclosures: they should not be made merely for the sake of better visibility. Instead, disclosures should be made for the sake of better understanding so that they become the foundation for constructive management oversight, better information for shareholder decisions, and clearer accountability of management and the board. In NACD's view, transparency does not mean disclosure alone; it means useful disclosure.

Clearly, in the current troubled business environment, there will be pressures for more disclosures. Plummeting performance in the financial services arena—coupled with widespread negative impact on local communities—led to passage of the Emergency Economic Stabilization Act of 2008 which includes many new disclosure requirements. From the general tenor of campaign promises made by President Barack Obama, we can anticipate further disclosure requirements.

New disclosure requirements will add to the heavy set already expected of public companies. Yet, this is clearly a vital topic for our times. The goal of new requirements should be to provide a better understanding of company and board decisions rather than to increase mounds of reported information simply for the sake of disclosure.

As boards consider new disclosure requirements, they need to keep transparency in the forefront of their minds. It is not the quantity of a company's disclosures; it is the quality that counts. The goal is a clear (transparent) view on what matters. Once directors know what matters to their investors, they can ensure that this information gets disclosed. At the same time, boards should reach out to their shareholders to learn what they want to know—above and beyond what is currently in required disclosures. This is best done on a company-by-company basis. As boards consider these issues, we strongly recommend NACD's Principles as the place to start.

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NACD Guidance on Greater Transparency

Recent developments in the world of global finance show the value of transparency. Although information about subprime mortgages was disclosed, that information was often not flagged clearly as urgent or even important. Part of the problem lies in the quality of the risk oversight that was occurring, including the use of flawed models. But another part of the blame lies squarely in the area of transparency.

Disclosure requirements must and do keep changing. Each new generation of directors, and indeed each new board, must ask, "What needs to be transparent?" The challenge lies in selectivity. If companies and boards disclose everything about themselves to shareholders, then shareholders will be overwhelmed with data and information. The key is to disclose what is most relevant to investors.

As noted in the Principles, mandating public company disclosure of certain core governance practices will require companies to pay more attention to board governance, yet will still preserve flexibility and diversity in their application to individual boards' needs. Principle II specifically addresses Corporate Governance Transparency, stating "Governance structures and practices should be transparent—and transparency is more important than strictly following any particular set of best practice recommendations."

The discussion of this Principle states:

A variety of structures and practices may support and further effective governance. Boards should tailor governance structures and practices to the needs of the company in a pragmatic search for what is most effective and efficient. Governance best practices should be adopted thoughtfully, and not by rote reliance on the recommendations posited by any entity or group. However, every board should strive to understand generally the parameters of and variations in standards of best practice recommended by NACD, Business Roundtable, and other thoughtful proponents of effective governance practices.

Every board should explain, in proxy materials and other communications with shareholders, why the governance structures and practices it has developed are best suited to the company. Some boards may choose to disclose their own practices in relation to a set of recognized best practice recommendations, identifying those areas where their practices differ and explaining the board's rationale for such differences.

Whether or not a board discloses its practices against a defined set of recommendations, it is the *disclosure* of governance structures and practices, generally, and the *rationale* for divergences from widely accepted leading practices that are most important.

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Disclosure of the practices adopted and adapted by the board, along with the rationale for unusual aspects, is far preferable to the adoption of any prescribed set of best practices. Valuing disclosure over rigid adoption of any set of recommended best practices encourages boards to experiment and develop approaches that address their own particular needs, and avoids rigidity. Boards that explain their practices should be rewarded and not penalized for decisions to adapt best practices to their own needs.

Future Challenges for Greater Transparency

Corporate transparency could benefit from a great many changes. Essentially, improvement will come by increasing and enriching the information flow between the board and the shareholders. This difficult challenge will be solved only when directors focus on, and become engaged in, the following areas:

Board-Shareholder Communications
Shareholders today are asking for greater levels of communication and connection with boards. Many directors, on the other hand, still view greater communication as a fairly radical idea. Over one-third of respondents to the NACD Survey believe that it is never acceptable for a representative of the board to meet with institutional shareholders.

In light of such a finding, it is imperative for boards to disclose how and why they make decisions on behalf of shareholders. Many believe that the relationship between board members and shareholders should be akin to the relationship between a member of Congress and his or her constituency. But current proxy rules make this difficult. Directors don't always know who their shareholders are, and lines of communication are difficult to establish.

The increasing load of disclosure requirements after Sarbanes-Oxley has not helped matters. The challenge is to simplify the information coming from the top; it is often too difficult to interpret, and transparency often takes second place to fear. Directors and shareholders need the ability to speak a common language. The current system can allow company reports to be used against directors, thus forcing companies to "lawyer up." Transparency would be greatly improved through the creation of safe harbor laws that would protect company communications made in good faith.

Use of Technology in Communication
Many companies have embraced the standard means of electronic communications, such as email, webcasts, and regular updates of a company's website. These vehicles are just the first step in greater information flow between the board and the outside world. Future developments in interactive technology will communicate information in a more accessible and simplified fashion. The current reports disclosed by companies are already sufficient; the means to access that information are not.

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The SEC's use of Extensible Business Reporting Language (XBRL) is an example of using technological methods to increase accessibility and comparability of financial information.

Annual shareholder meetings are one notable area where technology will greatly help. The ability to stream live video of the annual shareholder meeting and have remote participants ask direct, real-time questions of board and management would open up the event to a much broader audience. These tools are already implemented in some companies, but as future technologies develop, boards should consider using these alternate web approaches to properly leverage technology to reach a broader shareholder audience.

Disclosure of Board Processes

Enlightened investors are as concerned about the processes behind a decision as they are with the actual decision. Investors want directors to exercise their due diligence in making important decisions, even if they may not agree with the outcome. Unfortunately, the in-boardroom processes remain opaque to outsiders. Boards can do more to shed light on their work.

NACD has suggested that key committee chairs can insert letters into 10-Ks or 10-Qs to alert shareholders to major decisions and the decision-making processes. This advanced disclosure would give shareholders an unprecedented insight into the boardroom. Again, safe harbor laws would be helpful for this new kind of disclosure.

CONCLUSION

Corporate directors play powerful roles in American companies. They can play the parts of both critic and champion for a company; these days both parts are greatly in demand. Overcoming the present hurdles will require significant strength and direction from corporate boards, no matter the role they play.

The NACD Key Agreed Principles offer a generally accepted and comprehensive framework through which all boards can operate in an ethical, transparent, and successful manner. This framework can and should be used to confront the most crucial challenges facing directors, which are:

- **Risk Oversight:** Improving the oversight of risk will require directors to assign risk oversight responsibilities, establish risk identification procedures, evaluate risk models, and improve overall information flow.
- **Strategy:** Creating viable strategies requires a diverse board membership with the ability to clearly identify short-, medium-, and long-term goals.
- **Executive Compensation:** Boards need better performance metrics, stronger oversight of human capital development, greater independence of the compensation committee and its advisors, and more proactive shareholder communications.

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- **Transparency:** Greater corporate transparency requires a combination of increased communication and legal protections. Boards must begin by communicating with shareholders through the use of technology. Next, legal protections through safe harbor rules should be added to current disclosure requirements.

Educating directors is vitally important to enabling boards to succeed. NACD will be delivering these findings to boards directly through our educational initiatives such as our Director Professionalism® Courses and our Board Advisory Services, with the essential goal of empowering directors to act in the changing business, economic, and governance conditions.

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Visit www.nacdonline.org/pubs for more information.

- *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies*
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  - *Board-Shareholder Communications*

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- The Current Governance Environment
- Role of the Board in Corporate Strategy
- Role of the Board in Risk Oversight
- Board Evaluation: Improving Director Effectiveness
- CEO and Board Succession Planning
- Board Dynamics: Improving Communications and Decision Making
- The Board's Role in Mergers & Acquisitions
- Audit Committee: Improving Quality, Independence, and Performance
- Effective Compensation Committees

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Restoring Confidence in Corporate Governance: Directors Leading Change

ABOUT THE INITIATIVE

The National Association of Corporate Directors (NACD) puts forth these Key Agreed Principles, grounded in the common interest of shareholders, boards and corporate management teams, to provide a blueprint to corporate boards and thereby to help improve the quality of discussion and debate about governance issues.

We view these Principles as a first step in strengthening corporate governance. We will continue this work through a national effort that will identify and advocate leading practices that empower board leadership, particularly in the areas of oversight of risk, corporate strategy, compensation, and transparency. Central to this effort will be our continued commitment to educate directors and other stakeholders in these leading practices. Along those lines, NACD has published a White Paper series that further expand on four very important themes for our current times:

- Risk Oversight
- Transparency
- Strategy
- Executive Compensation

The following NACD Alliance Partners provide support to NACD's research and policy efforts, making initiatives such as the NACD Key Agreed Principles and White Papers possible:

Heidrick & Struggles International, Inc.
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CONTRIBUTORS

Hundreds of directors in 21 states, in addition to stakeholders representing the business community and shareholder groups, were instrumental in developing these Principles. To view the comparison of board governance practices between NACD, the Council of Institutional Investors (CII), the Business Roundtable (BRT), and the International Corporate Governance Network (ICGN), download Appendix A of the Principles at www.nacdonline.org/KeyPrinciples. Additionally, NACD acknowledges the extraordinary and pro bono efforts of Ira Millstein, Holly Gregory, and their colleagues at Weil, Gotshal & Manges LLP—Kasara Davidson, Ofer Eldar, Christopher Evans, and Lyn Fay—for their analysis of corporate governance best practices and identification of the commonalities that were the basis for the Principles.

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ABOUT NACD

Founded in 1977, NACD is the only nonprofit organization providing the tools, the professional support and the platform for making corporate directors more effective in boardrooms across the country. NACD's 10,000 members represent the boards of companies ranging from Fortune 100 to smaller public companies, private companies, and nonprofit organizations. NACD conducts research and publishes periodicals and reports on a variety of topics of interest to boards. NACD's more than 30 years of board experience powers the most robust hub of information on corporate governance anywhere.

Since 1992, NACD has published a series of annual reports called the Blue Ribbon Commission series. Subjects singled out for intensive focus include board evaluation, board leadership, director professionalism, executive compensation, risk oversight, board-shareholder relations, and (in separate reports) the role of each key committee: audit, compensation, and governance.

NACD's Blue Ribbon Commission reports have involved a full range of constituencies, including corporate directors, corporate officers (including CEOs and senior officers), institutional shareholders, accountants, attorneys, retired government officials, and corporate governance scholars. In total, more than 300 prominent, knowledgeable individuals have been involved in these Commissions, with up to 40 individuals serving on each Commission. Recommendations of the Commissions have had an impact on both voluntary practices and regulatory and listing standards.

For more information or to join NACD, please visit www.nacdonline.org.

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