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# A Board Roadmap for 2016

In her regular column on corporate governance issues, Holly Gregory explores the issues that will require board attention in 2016.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

The adage that “the more things change, the more they stay the same” is likely to be an apt description of the pressures facing boards in 2016. The most notable trend in corporate governance for the past decade, and likely for the year ahead, relates to the expanding influence of institutional shareholders on the governance of US publicly traded companies.

This influence is evident in public pension fund efforts to expand shareholder rights using the tools of shareholder proposals and negotiated settlements on issues ranging from removal of classified boards to shareholder access to the proxy statement for shareholder nominees. It is also apparent in hedge fund efforts to influence board decisions through activist strategies. While these and other forms of shareholder activism show no signs of abating, they are generating greater engagement between companies and their shareholders.

At the same time that shareholders are seeking greater influence on corporate affairs, investors, regulators, media critics, and the public continue to demand more of the board. The board is expected to defend against all kinds of risks, including failed business strategies, cybersecurity breaches (see *Box, The Board's Role in Addressing Cybersecurity Risks*), and natural disasters.

The expanded expectations of regulators are apparent in a recent speech by SEC Commissioner Luis A. Aguilar, who emphasized three specific areas for board focus:

- Effective engagement with shareholders.
- Company resiliency through effective crisis and risk management.
- Board relevancy and adaptability through attention to board composition and performance in line with changing circumstances.

(Aguilar, *The Important Work of Boards of Directors*, Oct. 14, 2015.)

Aguilar made clear that directors who are doing their jobs by embracing their responsibilities and fulfilling them conscientiously “should have nothing to fear from the SEC.” He also pointed out the risks to companies posed by natural disasters and cybersecurity breaches as particularly critical problems requiring board attention.

While expectations of boards continue to expand, the fiduciary duties of directors have not changed. Acting with due care, without conflict, and in good faith in the best interests of the corporation continue to be the legal standard by which director action is assessed. Moreover, state corporate law does not call for governance by shareholder or proxy advisor referendum. The board is the only body that is empowered by law to direct corporate affairs, and it is the only body positioned to do so as a practical matter.

The board delegates to management, but in the end, it is the board that is charged with running the company, not shareholders, proxy advisors, or media critics. However, the board cannot ignore the viewpoints of investors, regulators, business partners, customers, employees, and key observers or the impact of corporate actions on the wide array of constituents. This is all part of the business complexity that boards must work closely with corporate officers to understand and manage.

In this complex environment of expanding expectations, the board must continue to focus its time and attention on the priorities it identifies, based on the unique circumstances facing the company. While the details will vary from company to company, the main areas of board focus remain:

- Management delegation, performance oversight, and succession planning.
- Strategic direction, risk management, and crisis preparedness.
- Internal controls, financial reporting, and compliance.
- Board composition, leadership, and performance.
- Shareholder activism and engagement.

The board has much to attend to, but it should not be distracted from focusing on providing management with forward-looking guidance, with the majority of its time reserved for assessing the quality of management and discussing corporate strategy and performance.

## MANAGEMENT DELEGATION, PERFORMANCE OVERSIGHT, AND SUCCESSION PLANNING

Boards typically delegate day-to-day management of the company to the CEO and other officers. As fiduciaries, directors may rely on these officers to perform the delegated tasks so long as that reliance is reasonable. Continuing assessment of the reasonableness of this delegation lies at the heart of the board’s oversight role. While it may be tempting for directors to dig in and function at a level similar to that of officers, they risk losing the protection of the exculpatory provision typically included in a company’s articles of incorporation, which is available only to directors.



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With respect to delegation, performance oversight, and succession planning, the primary tasks for the board are:

- Selecting the CEO, and clearly articulating:
  - what authority is delegated to the CEO; and
  - the expectations for CEO performance.
- Monitoring CEO and officer performance and continually assessing whether reliance on these officers is reasonable.
- Planning for succession of key officers in both normal and emergency circumstances.
- Replacing the CEO when appropriate.
- Determining incentives to attract and retain leaders.
- Aligning the pay of key officers with performance expectations.
- Advising and coaching management as appropriate, providing management with the benefit of the board’s collective expertise, but without dictating actions that are clearly within management’s purview.



Search [CEO Succession Planning: Principles and Considerations](#) for more on CEO succession planning.

## The Board's Role in Addressing Cybersecurity Risks

Some of the most significant risks for companies, both large and small, are those posed by cybersecurity breaches. In October 2015, the New York Stock Exchange and Palo Alto Networks published a book, *Navigating the Digital Age: The Definitive Cybersecurity Guide for Directors and Officers*, which offers advice on a range of cybersecurity issues, including:

- Investor perspectives on cybersecurity risks and their implications for the board.
- The role of directors in addressing cybersecurity risks.
- Legal and regulatory considerations.
- Responding to cybersecurity breaches.
- Cybersecurity risk management investment decisions, including investment in cyber insurance.

In addressing cybersecurity risks, the board should ensure that:

- It understands the material cybersecurity risks and vulnerabilities facing the company, in the context

of the company's industry, business, and corporate strategy.

- It understands the processes that management uses to assess, monitor, categorize (and prioritize as most critical), and mitigate cybersecurity risks.
- Management assesses the material cybersecurity risks and vulnerabilities facing the company on a regular basis.
- Management is focusing appropriate resources on cybersecurity and cybersecurity risks.
- Management has sufficient technical expertise on cybersecurity issues.
- Management is adequately prepared for a cybersecurity crisis, including by having a cybersecurity breach response plan in place that is tested on a periodic basis.



Search [Board Oversight of Cybersecurity Risks](#) for more on the board's role in addressing cybersecurity risks.

## STRATEGIC DIRECTION, RISK MANAGEMENT, AND CRISIS PREPAREDNESS

Guiding the long-term strategy of the business and evaluating the risks related to that strategy are central board activities. Discussion of strategic issues and associated risks should account for a significant portion of board meeting time. The board should give special attention to supporting appropriate long-term investment and prudent risk-taking in the face of short-term pressures for immediate returns or other demands. The board should also:

- Approve strategic and operating plans, and related budgets, after active discussion with management and deliberation.
- Determine with management the level of risk (risk appetite) that the company is willing to be exposed to with regard to its strategy and operations.
- Monitor management performance using preset benchmarks, where possible, to determine progress in relation to strategic and operating plans, and related budgets.
- Assess management efforts and related processes and controls related to the identification, monitoring, management, and mitigation of risks.
- Understand the significant risks to the business and how the company is prepared to respond (including by conducting periodic reviews of plans for natural and other disasters, such as broad failures of the power grid and cybersecurity breaches).

- Evaluate management efforts to prepare for crisis incidents, and prepare to be actively involved in circumstances where management may be conflicted.

## INTERNAL CONTROLS, FINANCIAL REPORTING, AND COMPLIANCE

Corporate enforcement activity by federal regulators continues to rise, with a renewed focus on holding accountable the most senior individuals who are responsible for legal and regulatory failures. Sally Quillian Yates, US Deputy Attorney General, recently issued a memorandum that details the Department of Justice's (DOJ's) renewed focus on criminal and civil prosecution of individuals in cases involving corporate compliance failures and corporate malfeasance (*Yates, Individual Accountability for Corporate Wrongdoing*, Sept. 9, 2015).

Yates outlines guidance for federal prosecutors investigating corporate misconduct, including that in order to qualify for the benefits of cooperating with the DOJ, companies must provide all relevant facts relating to the individuals responsible for the misconduct. This guidance has implications for board oversight of compliance and needs to be considered for the board to fulfill its good-faith obligation to see that the company has appropriate compliance systems and related information, reporting systems, and internal controls.

In this environment, oversight of internal controls, financial reporting, and the compliance and ethics programs that help set the tone for corporate culture continues to be important for the board (often with significant aspects of a board's oversight delegated to the audit committee). The board should:

- Ensure that appropriate information and reporting systems and related investigation processes are designed to support the identification of individual wrongdoers.
- Support a tone at the top that stresses that:
  - compliance is strategically important and essential for achieving business priorities; and
  - all individuals have personal responsibility for compliance.
- Establish a corporate culture that encourages cooperation and avoids an unduly defensive strategy when a problem does arise.
- Understand and oversee management's internal controls and procedures to ensure that financial reporting is accurate and the company complies with applicable laws and regulations.
- Attend to the corporate culture, affirm the expectations that management will abide by, and promote within the company ethical behavior, fair dealing, and integrity.
- Oversee management efforts to:
  - educate company personnel about the corporate code of conduct and expected standards of ethical behavior;
  - encourage internal reporting (whistleblowing);
  - monitor compliance; and
  - identify and respond as appropriate to red flags or a series of yellow flags.
- Review and reiterate whistleblower anti-retaliation provisions.
- Pay special attention to related person transactions and other conflicts of interest that involve directors or members of senior management.
- Attend to issues of, and set standards and policies regarding, sustainability and social responsibility, including environmental issues, involvement in the political arena, and human rights.



Search [Internal Control Over Financial Reporting for Counsel: Why Should You Care?](#) for more on issues in implementing internal control over financial reporting.

## BOARD COMPOSITION, LEADERSHIP, AND PERFORMANCE

The quality of board governance begins with the composition of the board. Boards need highly competent and committed directors with expertise and experience that are relevant to the company's business and direction. Being able to provide objective judgment and express and consider diverse viewpoints while driving toward consensus are necessary qualities for directors. Director competency and relevancy are issues that shareholder activists focus on and are also the likely focus for future use of proxy access.

Boards should consider in connection with their annual evaluation and re-nomination processes whether board composition is relevant, and attend to refreshment mechanisms. Individual director evaluation should be a component of that consideration. In this regard, the board needs to:

- Recruit highly qualified directors with relevant expertise who can meet the requisite time commitment.
- Provide compensation for directors that fairly reflects the time and energy that is required, but keep in mind that decisions about director compensation involve inherent conflict and should be demonstrably fair to the company.
- Consider board refreshment mechanisms, including age and tenure limits and individual director evaluation.
- Avoid treating the re-nomination decision as a foregone conclusion. Re-nomination decisions need to be based on an assessment of the director's relevant expertise, time commitment, and actual performance.
- Evaluate and attend to issues of board and committee leadership, ensuring that leadership is in place to provide a strong (though generally supportive) counterweight to management.
- On an annual basis evaluate and discuss the effectiveness of the board, board committees, and board and committee leaders.
- Consider evaluation of individual directors, either as a component of board evaluation or as a component of re-nomination decisions (or both).
- Attend to board culture, including processes designed to assure that diverse views are expressed, yet consensus is developed efficiently. The tone and quality of relations with management and among directors should be one of mutual respect and collegiality, and should support open and constructive discussion.
- Organize the board's work, including determining board and committee agenda and information needs, taking care to ensure that the most important matters receive priority attention.
- Attend to emerging ideas about best practice, trends developing in the proxy season regarding shareholder proposals, and proxy advisor policies, and consider these developments in the annual discussion of board effectiveness and in the annual review of governance principles and committee charters. The board should ensure that corporate governance is tailored to the company's unique and specific needs.



Search [Director Compensation Toolkit](#) for resources to assist a company in developing a director compensation program.

## SHAREHOLDER ACTIVISM AND ENGAGEMENT

Shareholder activism that is focused on strategic and financial initiatives continues to have a significant influence on the corporate governance environment. According to a recent report from FTI Consulting, Inc., 96% of the 24 activist firms surveyed predicted an increase in M&A activism (*FTI Consulting, Inc., The*

*Shareholder Activists' View 2015*). The report notes that activists have recently been targeting larger companies and partnering more frequently with institutional investors and pension funds.

The potential for hedge fund activism and the need for companies to garner shareholder support for the say on pay vote and to withstand shareholder proposals on a range of topics will continue to drive company efforts to engage with shareholders. While boards may not defer their fiduciary judgment to shareholders, they do need to understand the interests of the shareholding body, and this presents challenges given the varied interests of different types of shareholders.



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The proponents of particular strategic, financial, governance, environmental, and social reforms may have interests that are not shared by the broader array of shareholders. Further, there may be a divergence between the interests of pension funds, mutual funds, hedge fund activists, and retail investors. Adding to the complexity, the interests of investment managers are not always wholly aligned with the interests of their beneficiaries, while proxy advisor interests present a whole other layer of divergent interests. These are all conflicts that directors need to understand and process as they interpret the concerns and demands expressed by the more vocal shareholders.

In this area, the board should:

- Engage with key shareholders on a regular basis (in listening mode) to gain insights into their viewpoints, and use shareholder engagement as an opportunity to develop enduring relationships.
- Understand how various shareholder perspectives differ based on their diverse interests.

- Consider and address as appropriate shareholder requests and proposals.
- Stay informed about the perspectives of proxy advisors, but do not fall into the trap of assuming that shareholders' views are in agreement with proxy advisor perspectives.
- Collaborate with the senior executive teams to inform and engage with shareholders about corporate strategy, key board decisions, and the rationales for those decisions so that shareholders do not blindly follow proxy advisor recommendations.
- Understand, but not succumb to, external pressures, while continuing to apply informed and objective judgment. In particular, directors need to continue to make informed decisions that they believe are in the best interests of the company as they help management focus on corporate resiliency and sustainable, long-term performance.

One benefit of regularly engaging with key shareholders and forming relationships that are built on transparency, understanding, and trust is that these shareholders may be more willing to presume that the directors:

- Know the business best.
- Are making business decisions on an informed basis and with the good faith belief that their decisions will serve the best interests of the company.

Just as in the judicial review context, this presumption may be the best hope of reducing the unrelenting pressures on boards and could potentially offer long-term benefits to the broader economy.

*The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.*