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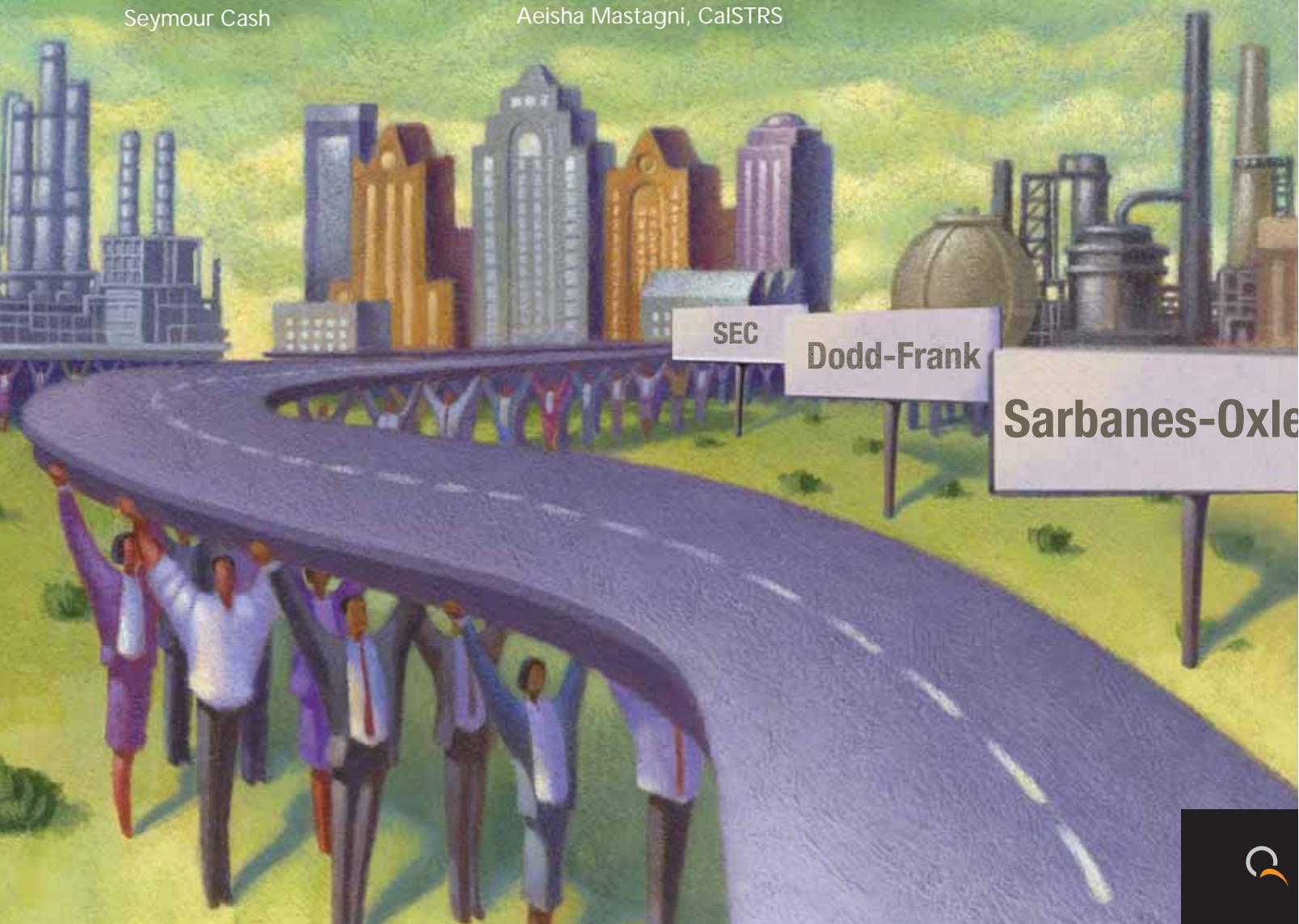
INSIGHT

## THE ROAD TO INDEPENDENCE

Consultant's Corner  
CFOs On Board  
2013 Equity Trends  
Seymour Cash

### INTERVIEWS

Peter Browning, Peter Browning Partners  
John England & Ira Kay, Pay Governance  
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C-SuiteInsight is published by

EQUILAR®  
1100 Marshall St.  
Redwood City, CA 94063  
Phone: (650) 241-6600  
www.equilar.com

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David has led Equilar from a pure start-up since its inception in 2000 to one of the most respected and trusted names in the executive compensation industry.

## INDEPENDENCE MATTERS

AS WE MOVE FURTHER into the post Dodd-Frank era, the topic of board independence has become more prominent in corporate governance discussions around the globe. Issue 11 of *C-SUITE Insight* is dedicated to highlighting the various aspects of the subject including director independence, committee advisors, and conflicts of interest. We take a deep dive into the latest legislative changes defining director independence and committee advisory roles, as well as some of the events that have influenced independence discussions today.

In *C-SUITE*, we interview top industry experts, seasoned governance professionals, and experienced board members and executives. For this issue, we asked contributors to provide insight on board independence from their respective positions in governance. For example, Peter Browning, Lead Director at Nucor and Equilar, provides an insider perspective on board independence and discusses his thoughts on independent compensation consultants.

Additionally, John England and Ira Kay, Managing Partners at Pay Governance, share the story of founding Pay Governance in order to address consultant independence conflicts for board of director clients. Aeisha Mastagni, of CalSTRS Corporate Governance Unit, offers her view on board tenure and its effects on director independence. We continue the dialogue in our Consultant's Corner feature where leading compensation consultants discuss the lasting impacts of evolving independence standards.

We send our sincere thanks to our contributors for providing thought-provoking commentary that has enriched the dialogue regarding board independence. We appreciate you taking the time to read our latest issue and look forward to continuing these discussions at our upcoming Executive Compensation Summit in Boston. I hope to see you there, and as always, please stop by and see me to say hello.

For those of you who are unable to join us, I hope that you find new insights and value in the rich discourse presented in this issue. Please enjoy, and feel free to contact me with your feedback. ☐

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# The Road to Independence

Where are we and  
how did we get here?

BY BELEN E. GOMEZ



In 2004, a group of shareholders brought suit against Martha Stewart Living Omnimedia, Inc., alleging a profound lack of independence on the part of its board of directors. The lawsuit, decided by the Delaware Supreme Court, addressed the murky area of director independence and personal relationships. Although the high court ultimately decided against the plaintiffs, the lawsuit underscored the debate regarding board independence that continues today.

In the intervening years, the corporate governance landscape has been irrevocably changed by landmark legislation formally known as the Dodd-Frank Wall Street Reform and Consumer Protection Act. Since 2010, it has taken its turn in the spotlight as the latest legislative effort to attempt to improve board oversight in order to protect shareholder value and interests. Dodd-Frank introduced a multitude of new governance rules for publicly-traded companies including proxy access, Say on Pay, and the CEO pay ratio, among others.

More specifically, director and board independence have regained high visibility on an international stage as a hot-topic governance issue. Not since the Sarbanes-Oxley Act and the days of high-profile cases involving Oracle and Martha Stewart Living Omnimedia has the topic of board independence seen such rigorous scrutiny. Intuitively, the argument for independence is tethered to the belief that if a board is independent of company management and its advisors it will perform its monitoring function more effectively and without bias. However, conflicting research from academics and governance experts along with boardroom commentary have surfaced various opinions on the definition and effectiveness of board independence.

## HISTORICAL LEGISLATIVE REVIEW

To better understand the matter, it is valuable to review the historical events that have served as catalysts for the current state of board independence discussions. In his recent interview with *C-SUITE Insight*, Peter Browning, Managing Director of Peter Browning Partners LLC, lead director for Nucor Corporation, and board member at Lowe's

Companies, EnPro Industries, and Equilar, shared that “the best way to view the role of the board member and change is to go back not five, but eleven years. If we take a look at the bursting of the dotcom bubble, the market falling off, and the events of 2001, best exemplified by WorldCom, Enron, Tyco, we see two legislative responses. One was Sarbanes-Oxley...The other was the New York Stock Exchange Corporate Accountability and Listing Standards, which really changed board structure.” These events, according to Browning, have reshaped the roles and expectations of independent board members.

In July 2002, the Sarbanes-Oxley Act (SOX) was passed by Congress in response to unprecedented corporate scandals that cost shareholders and employees billions of dollars when share prices plummeted. These scandals demonstrated a failure in the boardroom to properly oversee management and to detect or prevent financial fraud. As a result of SOX, boards of directors’ responsibilities and oversight roles were expanded. Increased emphasis on board independence inevitably followed as rules were implemented regarding external auditors and audit committee independence.

Following on the heels of SOX, the NYSE and NASDAQ exchanges adopted independence standards for all listed companies. Since then, companies have been required to ensure that the majority of board members are independent. Furthermore, the board must determine whether a director meets all standards and requirements for independence after evaluating all of his/her material relationships during the last three years.

Regarding committee independence, the NYSE and NASDAQ’s new listing standards required that companies have an audit committee comprised of all independent board members (at least three). Regarding additional standing committees, only the NYSE further required an independent nominating/

corporate governance committee and an independent compensation committee. NASDAQ has since changed its position in regard to compensation committees under Dodd-Frank, and since 2012 has required listed companies to have a standing compensation committee.

Under Dodd-Frank, the SEC continues to add and refine independence mandates. More specifically, Dodd-Frank focuses on director independence in regard to the compensation committee and the processes for setting executive pay. Further, the Act also called for the SEC to draft rules allowing shareholders to nominate independent directors. Rule 14a-11, known as proxy access, was abandoned after the Court of Appeals for the D.C. Circuit ruled against it in 2011. The SEC did not appeal the decision. However, the SEC did adopt an amendment to Rule 14a-8 prohibiting companies from excluding shareholder proposals which seek to establish procedures for director nomination or election in proxy materials.

BACK TO THE FUTURE: BOARD MEMBER INDEPENDENCE AND THE ROLES OF BOARD COMMITTEES

Today, the combination of these legislative interventions has not only overhauled board structure, it has also expanded the roles and responsibilities of independent directors as committee members.

AUDIT COMMITTEE

Not surprisingly, the oversight burdens placed on audit committees have continued to increase over the last decade. Thus, the focus on committee member independence and the use of independent external auditors and consultants is even more acute. The audit committee is tasked with rigorously monitoring for conflicts of interest that may occur and cast doubt on independence.

The more stringent independence standards brought on by SOX, coupled with the establishment of the Public Company Accounting Oversight Board (PCAOB) to regulate and monitor the quality of audit firms, have added further complexity to the process by which an external auditor is selected, and ultimately, to the committee’s oversight role. Dennis Whalen, Partner at KPMG’s Audit Committee Institute advised in a recent article, “Ten To-Do’s for the Audit Committee,” that in this regulatory environment, audit committees should regularly “monitor the PCAOB’s initiatives on auditor independence and transparency, and consider the implications for the audit committee.” Ultimately, Whalen concludes that the audit committee should skeptically evaluate how it ensures independence and determine if its evaluation process benefits shareholders.

COMPENSATION COMMITTEE

Under Dodd-Frank, the NYSE and NASDAQ implemented new compensation committee rules regarding independence. Most notably, NASDAQ now requires compensation committees for listed companies. Aligned with the NYSE, NASDAQ also requires that all committee members be independent.

Additionally, the new standards require compensation committees to examine the independence of compensation consultants and advisors using a set of key factors provided in Dodd-Frank. Interestingly, consultants are not required to be independent. However, current SEC rules mandate that companies analyze consultant independence as well as conflicts of interest, and disclose material results in their proxy filings.

As a result of these requirements, former SEC Chairman Mary L. Schapiro, explained, “This rule will help to enhance the board’s decision-making process on executive compensation matters, particularly the selection, engagement and oversight of compensation [advisors], and will provide more

transparency with respect to conflicts of interest of consultants engaged by boards.” Despite the burden of ensuring compliance, these standards may provide boards a stronger position for explaining and defending executive compensation strategies to shareholders in the Say on Pay era.

CORPORATE GOVERNANCE & NOMINATING COMMITTEE

Since late 2003, the NYSE and NASDAQ have required that boards of directors be composed of a majority of independent directors. The corporate governance and nominating committee is responsible for promoting good corporate governance practices and compliance and thus is ultimately impacted by the independence requirements set forth for the board and its committees. Specifically, this affects the committee’s board recruiting activities in order to fully staff all board committees in accordance with listing standards.

In the last decade, the topic of board composition and recruiting has experienced increased visibility. Previously, boards of directors were more likely to tap into personal networks to fill board vacancies than to go through a formal recruiting process. That practice increased skepticism regarding the true independence of recruited board members. It was argued that these board members were more likely to align themselves with the directors who recruited them, rather than to act independently in the best interest of shareholders. It also called into question board effectiveness given an overall lack of diversity in experience and perspective.

Currently, the use of board recruiting firms has become more prevalent. In a recent PricewaterhouseCoopers Corporate Director Survey, 67 percent of participants used recruiting firms to find new board talent. Though progress has been made on this front, in the same survey 9 out of every 10 partici-





pants said they still seek recommendations from director colleagues. The continued use of networking to recruit board members is likely to continue to fuel the independence debate, especially as nominating committees seek a wider pool of talent from which to recruit to ensure compliance with listing standards.

THE INDEPENDENCE DEBATE

Despite the recent, more stringent director independence listing standards adopted by the SEC and imposed by the exchanges, many questions have been raised regarding the true definition of independence. For example, a director may meet the checklist requirements for independence, but meeting a list of requirements does not in any way ensure independent thought and action. In a

recent article in *Directors & Boards* magazine, board member and writer Hoffer Kaback stated, “Labels like ‘independent directors’ do not tell us about the presence or absence of important ‘mutual affiliations.’”

A high-profile example of this argument can be seen in the 2004 case of *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*. The plaintiff in the case alleged that three board members were not independent due to their personal relationships with Martha Stewart. The Delaware Supreme Court dismissed the case after it found that “allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director’s independence.” As it stands now, mutual affiliations are evaluated

at the discretion of the board. It is believed by some that these relationships may do more damage to good corporate governance than can be offset by the badge of independence.

Conversely, a director may be considered non-independent based on new standards, but may be the most independent thinker representing shareholder interests on the board. Interestingly, the Delaware Supreme Court also noted that “[The] primary basis upon which a director’s independence must be measured is whether the director’s decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences.” The court’s opinion seems to support this latter argument as well.

Similar discussions have been raised regarding director tenure and independence. It is thought by

some that a director may meet all requirements for independence, but lengthy board tenure may create a bias toward management and away from shareholders. Recently highlighted by *Agenda Week* in the article “How Long is Too Long to Serve on a Board?” author Amanda Gerut asserts, “A director’s independence may erode the longer a director serves on the board of a company. Directors may feel more partial to the management at the company or the other directors around the table that they’ve spent years working with, rather than the shareholders, who often remain anonymous and invisible.”

Similarly, the Managing Director of Deloitte’s Center for Board Governance, Robert Kueppers, weighed in on the issue by drawing a distinction between U.S. practices and international trends in board indepen-



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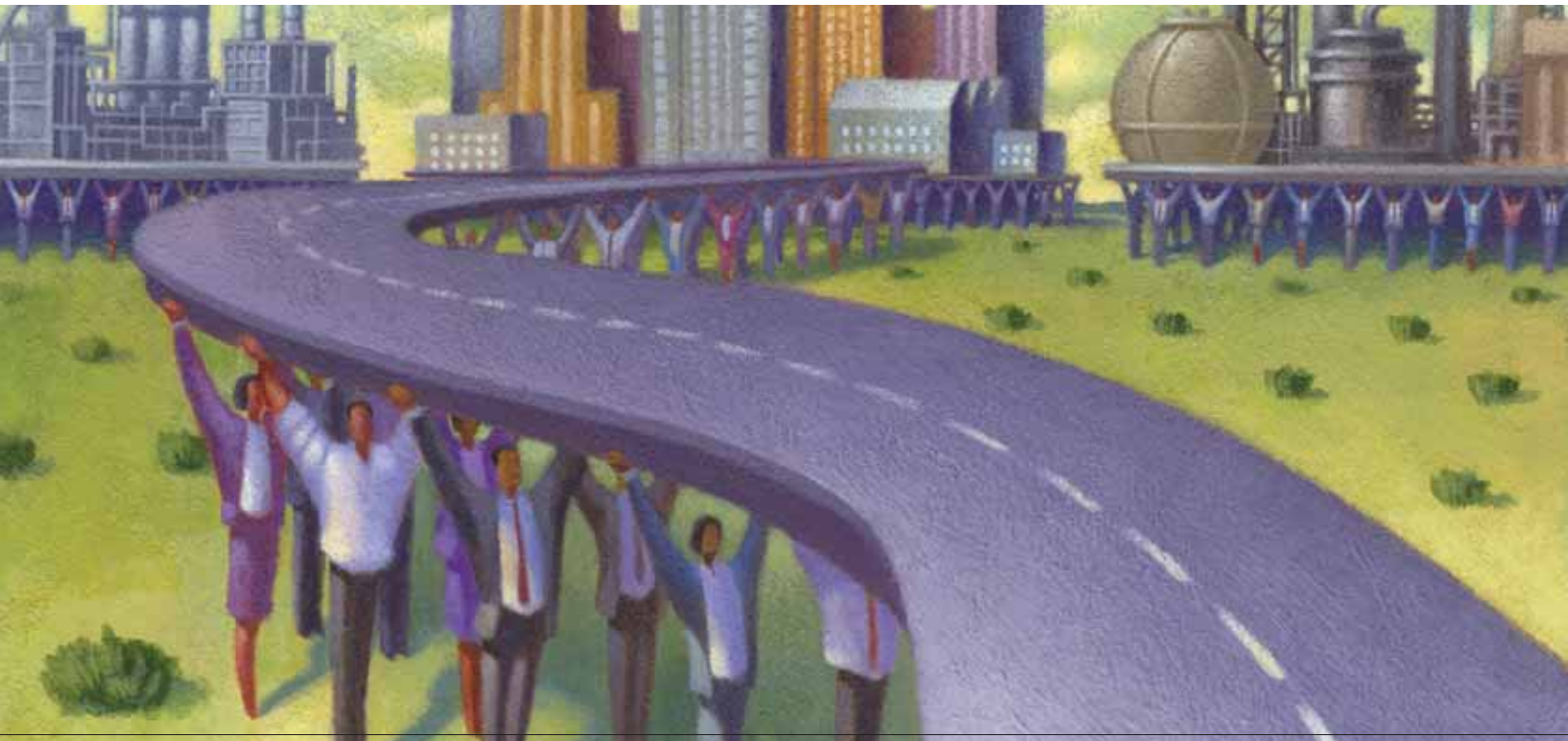
dence. “In the U.S., independence is determined by a series of bright-line legal tests determined by the SEC and the listing exchanges. Abroad, however, there’s a consensus that the longer a director serves on a board, the less independent they are.” In the future, the international approach to director term limits may find its way to our shores. Until then, by legal definition, director tenure is not factored into the independence standards, but will likely remain a staple issue in the independence debate.

In the history of corporate governance, changes to controls and mechanisms have been made in an effort to establish good governance practices and, ultimately, to protect long-term shareholder value. The past decade has been rife with governance reform and efforts to increase boardroom independence. We have experienced extensive legislative action, some of which is

reviewed in this article (and many rules that are not). Academic research on the impact and effectiveness of independence and debate regarding the influence of tenure continue.

Yet, we are left with these questions: How do we truly define an independent director? Regardless of equity ownership, compensation, and affiliations, how can we truly measure independence of thought and action in the best interest of shareholders?

The answer is that director independence is far more complex than the simplicity of a label. To quote Hoffer Kaback, “‘Independent director’ may be what is printed on the nametag you pin to your jacket at a corporate governance conference...It shows us the words but not at all whether they are true...For that, we must ignore what is pinned over the heart, and focus instead on what is within it.”



Enhanced Independence Requirements for the NYSE & NASDAQ  
Approved by the SEC on January 11, 2013

|                                    | NYSE   | NASDAQ   |
|------------------------------------|--|--|
| Compensation Committee Requirement | <ul style="list-style-type: none"><li>Listed companies already required to have a standing compensation committee</li></ul>  | <ul style="list-style-type: none"><li>Listed companies now required to have a compensation committee comprised of at least two independent members*</li></ul>  |
| Compensation Committee Membership  | <ul style="list-style-type: none"><li>Board required to make affirmative determination of independence of compensation committee members</li><li>Board required to consider all factors specifically relevant to determining whether a director has a relationship to the listed company that is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to:<ul style="list-style-type: none"><li>the source of compensation of such director, including any consulting, advisory, or other compensatory fee paid by the listed company to such director</li><li>whether such director is affiliated with the listed company, a subsidiary of the listed company, or an affiliate of a subsidiary of the listed company</li></ul></li></ul> | <ul style="list-style-type: none"><li>Compensation committee members will not be permitted to accept, directly or indirectly, any consulting, advisory, or other compensatory fee from the listed company or any subsidiary thereof, except for fees received for service on the board and board committees and certain retirement plan compensation</li><li>Board will be required to consider whether the director is affiliated with the listed company, a subsidiary of the listed company, or an affiliate of a subsidiary of the listed company to determine whether such affiliation would impair the director's judgment as a member of the compensation committee</li></ul> |

\*Listed companies have until their first annual meeting after January 15, 2014, or October 31, 2014, whichever comes earlier, to comply.  
Source: Wilson Sonsini Goodrich & Rosati

Six Key Factors for Assessing Compensation Consultant Independence  
under Dodd-Frank Rule 10C-1 Approved by the SEC June 20, 2012

- |   |   |   |
|---|---|---|
| 1) Whether a compensation consultant's employer provides other services to the issuer   | 3) The compensation consultant's policies and procedures to prevent conflicts of interest                                     | 5) The compensation consultant's stock ownership in the issuer  |
| 2) The fees the compensation consultant's employer receives from the issuer as a percentage of such employer's total revenues | 4) Business or personal relationships between a compensation consultant and any member of the issuer's compensation committee | 6) Business or personal relationships between a compensation consultant or his/her employer and any executive officer of the issuer |

Source: The Harvard Law School Forum



# CONSULTANT'S CORNER

## Corner Question

What are the lasting impacts of independence standards for directors, compensation committees, and advisors?



**Christopher Chen**  
National Director  
for Executive Compensation  
Hay Group Canada

Directors are becoming better educated, often engaging in extensive on-boarding or formal certification programs. Compensation committees are therefore better equipped to ask the right questions, including: “Is our relationship with our advisor within the realm of ‘best practices’? Is it what’s best for our company?”

The search for defensible objectivity is driving an evolution of board/advisor relationships. We increasingly see the ‘dual advisor’ model, with separate board and management advisors, or the ‘tri-visor’ model, which adds a third firm with the sole mandate of evaluating board compensation.

This shift toward multiple advisors with clearly defined roles has led to: increased competition, as boutique firms emerge and established firms split their practices; and increased discussion, as reports are scrutinized and challenged rather than filed and forgotten.

Advisors are anticipating and engaging in “competitive peer review” in an environment where clients have many alternatives. The lasting impact? A higher caliber of counsel for those boards that reflect on their advisory relationships, understand the implications of each board/advisor relationship model, and execute the model best suited to their company’s needs.

**Christopher Chen** advises clients on supporting stakeholder value through effectively aligning organizational strategy to executive compensation. He has worked extensively with private and public sector clients across Canada in the areas of corporate governance, compensation strategy, competitive benchmarking and incentive design.

Christopher holds a Bachelor of Business Administration degree from Wilfrid Laurier University and a Bachelor of Laws Degree from Osgoode Hall Law School, York University. He is a member of the Law Society of Upper Canada and has completed the Canadian Institute of Chartered Accountants In-depth Tax Course.

**HayGroup**



Wendy Davis  
Partner  
Jones Day

In today’s world of light-speed communications and 24-7 business demands, the independence standards are a reminder to step back, take a breath, and review the process of decision-making on a regular basis. Independence, as a means to an end, has a place in corporate governance, but its virtues can be oversold.

The updated independence requirements on who can make decisions and how/what information reaches those leaders fortunately do not displace the ability of boards, management and advisors to exercise thoughtful, ethical business judgment that takes into account the value of deep, long term relationships and institutional knowledge.

Instead, the standards encourage conversation among these parties, and give them a formal opportunity to regularly stress test their decision-making processes, which is a valuable exercise in an era when we’re always striving to move forward faster and accomplish more in less time.

**Wendy Davis** is a Partner in the Silicon Valley office of Jones Day, where she is a member of the firm’s Employee Benefits & Executive Compensation Practice.

Davis focuses on equity and executive compensation and corporate governance. Her practice addresses the practical design considerations of programs, including the complicated intersection of tax, securities, employment, and corporate laws, as well as shareholder relations issues. She works regularly with clients to develop and maintain their equity and bonus plans, deferred compensation arrangements, and severance and change of control agreements.



Gerard Leider  
Partner  
Meridian Compensation Partners

The new listing standards, effective July 1, 2013, obligate the compensation committee to conduct an independence review, but do not place restrictions on who the compensation committee can select or retain as their advisor, regardless of the outcome of the review (however, disclosure would be required if the committee determines conflict does exist).

With the heightened scrutiny on the selection of compensation committee advisors in light of SEC disclosure requirements, the selection of independent compensation consultants is likely to become increasingly prevalent and in time the predominant practice.

The use of an independent advisory firm has and will result in the use of independent consulting firms such as Meridian. This change requires diligence on the part of companies and their compensation committees to ensure compliance. As part of this process, compensation consultants should provide an independence “comfort letter” that assesses the advisor’s independence against the SEC’s independence factors.

**Gerard Leider** is a Partner and Lead Consultant at Meridian Compensation Partner in Lake Forest, IL. He provides guidance on a broad range of compensation matters including corporate governance issues, compensation strategy, short- and long-term incentive design, incentive valuation and award guideline setting, employment and severance agreements, compensation disclosure, executive recruitment support, and executive and board of directors compensation benchmarking.

Prior to founding Meridian in 2010, Gerard spent 15 years in Hewitt Associates’ executive compensation practice where he was a Principal and a member of the Executive Compensation Leadership Team.







Shekhar Purohit  
Managing Director & Office Director  
Pearl Meyer & Partners

“Independence” is often mistakenly equated with “disinterested.” In fact, the legal duties of directors are care—to do the job properly—and loyalty—not to be financially or otherwise compromised. However, to serve the interests of shareholders, directors also must be vitally interested in the company’s success—one reason that a significant portion of board pay is provided in equity.

Real independence requires that directors’ prime interest be promoting what is right for the company and its shareholders, based on its internal business strategy and how that correlates to human capital strategy, particularly in terms of leadership pipelines and succession planning strategy. When assessing independence, sunlight—as in politics—is a good cure-all. In the boardroom, that translates to a need for good process and appropriate documentation of the how and why of board decision-making.

**Shekhar Purohit**, Managing Director and head of the firm’s Northern California office, joined Pearl Meyer & Partners in 2011. Mr. Purohit advises public, private and family-owned companies on compensation and governance issues including total compensation strategy, incentive, program design, performance measurement, and special situation compensation strategies for IPOs, VCs, and restructurings. His clients include companies in financial services, manufacturing, technology, commercial and investment banking, and oil and gas.

Mr. Purohit also works extensively with U.S. multinationals to align their Asia-Pacific compensation strategy with their global vision and assists leading Indian and Chinese multinational conglomerates to develop their global, regional, and local total rewards and compensation strategies.

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Todd Sirras  
Managing Director  
Semler Brossy Consulting Group

The lasting impact of new independence standards will be subtle and not quantifiable. NYSE and NASDAQ rules provide broad latitude for interpretation and lack of bright-line tests. This likely will create meaningful discussion where necessary and potential changes to committee structures in 2013 and 2014. These standards are generally less burdensome than other aspects of Dodd-Frank, and we expect most companies to rely on existing independence rules in making their interpretations.

With 2014 proxies we will understand how compensation committee membership shifted, a part of which will no doubt be caused by concerns about independence. We will also see some change in board structure at NASDAQ companies that have historically operated without a compensation committee. These standards and associated exchange rules reinforce the requirement that the board must self-monitor and exercise judgment in its decision-making, and that such steps to ensure the independence of the compensation committee are important.

**Todd Sirras** has been in the compensation field since receiving his MBA from New York University’s Stern School of Business in 1998.

In addition to consulting, he also served Bank of America as a Senior Vice President, and has worked as a market maker in equity options for SBC O’Connor and as an equity index futures and options trader for a New York hedge fund.

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Damian Yu  
Principal  
Hugessen Consulting

The ever-increasing independence standards for the people involved in making executive compensation decisions—compensation committees, directors, and consultants—will lead to better decision making processes and better compensation decisions.

That may sound simplistic and self-serving for a consultant who works for a firm that wears its independence as a badge of honor—Hugessen Consulting has no other business line besides executive compensation consulting and only takes on mandates in which we are hired by the board or compensation committee—but it's not hard to imagine what the outcome would be if the opposite were true.

When the economic interest of all directors and consultant are strongly tied to their relationship with management, there leaves little room for tough questions and healthy debates in a pro-management agenda. And for many years, management did have the deck stacked in its favor. In a land where capitalism reigns, frustration with executive compensation from shareholders and the public has perhaps more to do with the perception that the game is rigged than high pay itself.

Independence is no panacea and is not without its cost. True independence tends to entail hard work and can cause friction. But when combined with competence and experience, independence on the part of directors, compensation committees, and advisors is the surest way to more thoughtful, fair, and better compensation outcomes.

**Damian Yu**, CFA, is a Principal with Hugessen Consulting and has over 12 years of experience advising clients in Canada, U.S., U.K., and Asia on a wide range of executive compensation and governance issues. Before joining Hugessen, Canada's largest independent executive compensation consultancy, in 2007, Damian was previously a consultant with the executive compensation practice of Mercer Human Resource Consulting.

Damian graduated with distinction from the Kellogg School of Management at Northwestern University with a MBA.

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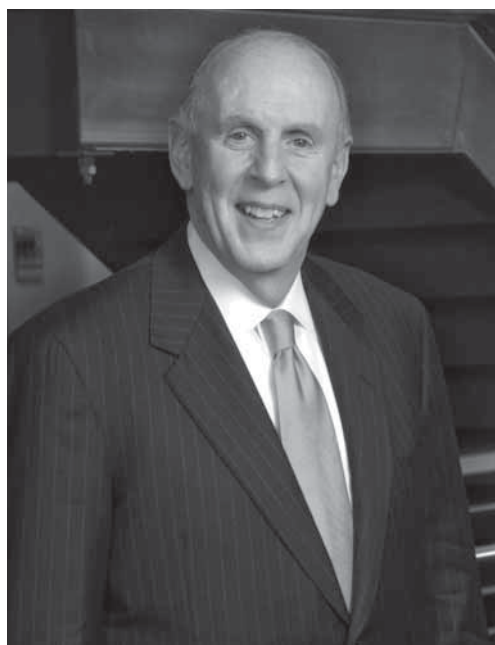
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INTERVIEW WITH **PETER BROWNING**

**PETER BROWNING PARTNERS**  
BOARD ADVISORY SERVICES

**A**s founder and Managing Director of Peter Browning Partners, LLC, a board advisory firm, Peter has a wide range of experience in business. Beginning as a sales trainee, he spent 24 years with the Continental Can Company, including President of two different divisions, last serving as Executive Vice President – Operating Officer. He joined National Gypsum Company in 1989, and in September 1990, was elected Chairman, President and Chief Executive Officer of National Gypsum Company, seeing the company through and out of bankruptcy.

He joined Sonoco Products Company, (a \$4 billion global packaging company) in November 1993 where he last served as President and Chief Executive Officer, before retiring in July 2000. In September 2000, he was elected to the position of non-executive Chairman, Nucor Corporation, until May 2006 when he became Lead Director. In March 2002, he was appointed Dean of the McColl School of Business at Queens University of Charlotte where he served until May 2005.

Since 1989, he has served on the board of directors of 11 publicly traded companies, two as CEO. In that time, he has also been non-executive chair, lead director, and chair of audit, compensation, and governance/nominating committees. In addition to serving as lead director of Nucor Corporation and Acuity Brands, Browning is also a member of the Board of Directors of EnPro Industries, Inc. and Lowe's Companies, Inc.

In January, 2013, he joined the board of Equilar as lead independent director. In the fall of 2004, Board Alert Magazine selected Peter as one of eight "Outstanding Directors of the Year" for his role in the successful CEO transitions at Lowe's and Nucor. He is also the 2009 recipient of Boston University's "Gislason Award for Leadership in Executive Development." He was selected for the "2011 and 2012 NACD Director 100 List" (the list of the most influential people in corporate governance in the boardroom).

He is a native of Boston. A graduate of Colgate University with an AB in history, he earned his MBA from the University of Chicago in 1976. The Harvard Business School prepared a case study regarding his success in effecting changes at Continental's White Cap Division. A case study has also been written on his experience at National Gypsum for use at the University of North Carolina Kenan-Flagler Business School.

**C-Suite Insight:** You've been sitting on boards in the midst of changes during the past few years, the era of the Great Recession and Dodd-Frank. How has your view of being a board member changed over the past few years?

**Peter Browning:** I think the best way to view the role of the board member and change is to go back not five, but 11 years. If we take a look at the bursting of the dotcom bubble, the market falling off, and the events of 2001, best exemplified by WorldCom, Enron, Tyco, we see two legislative responses.

One was Sarbanes-Oxley, which impacted the audit committee, external auditors, and this whole question of internal reporting and integrity of the numbers. The other was the New York Stock Exchange Corporate Accountability and Listing Standards, which really changed board structure. From that point on, people began to look at boards

with changed expectations.

What came out of that was a whole list of things such as annual elections, the majority vote, and examining this whole question of risk.

But the board's ultimate responsibility has never changed, and the board can't run the company. A board needs to ask things such as, do we have the right CEO? Do we know who the immediate short-term successor is, and do we have a good, robust long-term succession plan? Do we have the right strategy and is it being implemented well?

**CSI:** What about the general issue of independent board members?

**Peter:** I think this was an excellent idea. The idea of independent board members meeting in executive session without the CEO was, in fact, the single most fundamental shift. It didn't change those three questions I mentioned, but

it certainly changed the character, the atmosphere, in a positive and constructive way for everyone over time.

**CSI:** On a related topic, what are your views on having independent consultants?

**Peter:** The idea of having independent compensation consultants was part of this governance change, this new environment in which active shareholders were much more engaged and involved. The issue was raised when Pfizer's then-CEO retired with a very handsome package, and the comp consultant who was also advising on Pfizer's pensions and benefits was criticized for being conflicted.

We began to see a change in which large firms that consulted on pay and benefits began to move away from compensation practices. Companies on their own then started to state in their proxies who

their consultants were. So today we have a number of boutique compensation firms that only provide compensation advice and consultation to the board.

**CSI:** What do you think of that?

**Peter:** To me, that's fine. It's a good change. It doesn't change to me the quality of advice that you get.

**CSI:** So how, as a board member, do you view executive compensation structuring, in particular for the CEO?

**Peter:** As I mentioned, make sure you have the right CEO, then make sure you have the appropriate compensation construct. Let's look at long-term incentives, which are at least 50% of a CEO's pay, if not 60%. So make sure you have the right strategies being implemented well, certainly that there are incentives for that large piece of compensation, and that the program you have fairly reflects what the board and management feel should be driving that strategy.

Where companies get in trouble is when they have a disconnect between large pay packages when in fact you don't see performance.

**CSI:** Along those lines, where do perks fit in?

**Peter:** The whole question of excessive perks first came up years ago, and I can tell you they've all disappeared from companies whose boards I'm on. The biggest issue remaining has to do with use of the company plane, and that's started to diminish when we consider the need and the importance of the CEO's and team's time. Personal use of the plane, if anything, would be the remaining issue—but even this is not the case on any of the boards I'm on.

All this other stuff is gone, whether it's cars or clubs. All that went away, believe me, starting in '03 and '04.

**CSI:** Many companies have stock ownership guidelines in place for directors. How effective do you think those are? Are you involved in them and what other ways are there to keep your interests aligned with that of all shareholders?

**Peter:** The board is elected by the shareholders to represent their interests. So if you've got the right people on board, that's their job.

On the boards I'm on, more than 60% of directors' pay is in the form of a stock grant, and you can't get it until you leave the board.

The reality is a board can only focus on the long term. You know, shareholders are sometimes viewed in abstract as a monolith, and they're not. They comprise a wide cross-section of interests and drivers. Some are more interested in social issues than the dividend and the stock price. But a large number of them are very concerned about their own quarterly performance. Some are mechanical in the sense that they're driven by formula, and if your business happens to fall into that category, they pick you up. Others are closely managed.

The only thing boards can focus on is the long term, what's in the best long-term interest for shareholders. That means short-term survival and providing a fair and good long-term return to shareholders for the money they've invested.

**CSI:** Is there a fine line between the board responsibilities you mention and micromanaging, especially in times of crisis?

**Peter:** A board in the S&P 500 will meet fewer than six times a year. It can operate on the notion of "nose in, fingers out," but directors

must always be thinking, "how can the board best fulfill its fiduciary responsibility?" It comes back to having the right CEO, and in knowing who the emergency successor is. A board does get involved and engaged in more detail when there's a crisis, but that's part of its fiduciary duty in terms of acquisitions, mergers, and significant strategic events. These issues can be addressed on phone calls in between meetings, if in fact the board needs to be more engaged. But if a board's trying to manage the company, it is not doing its job.

**CSI:** We'd like to talk a little bit about innovation. One of the boards on which you sit, Nucor, is a well-known, long-time innovator in an old-line business, the steel business. What lessons can we learn from Nucor?

**Peter:** I grew up in Bethlehem, Pennsylvania, so I watched the demise of old steel. What made Nucor unique was the leadership of the CEO, Ken Iverson, and his management belief, philosophy, and style.

He had very few layers of management, very highly incented workers, and when

## "A BOARD DOES GET INVOLVED AND ENGAGED IN MORE DETAIL WHEN THERE'S A CRISIS, BUT THAT'S PART OF ITS FIDUCIARY DUTY IN TERMS OF ACQUISITIONS, MERGERS, AND SIGNIFICANT STRATEGIC EVENTS"

the industry was soft, Ken's pay was low like everyone else's. So everybody shared and he clearly was never overpaid. Neither is the current CEO Dan DiMicco—far from it.

This company continues to have an environment in which everybody is supportive of each other, highly incentivized to produce good quality at the lowest cost.

There is also a willingness to be very open-minded. So rather than have an expansive research and development process like the one that used to sit up on top of a hill for Bethlehem Steel, Nucor's leaders were and are willing to take risks and try new technology. The mini-mill, for which Nucor is famous, was a concept from Europe, for example.

**CSI:** So for other board members who read our publication, can you take some of this wisdom and some of these lessons and impart it to the current day?

**Peter:** Look, if you don't have the right CEO, the pay doesn't do anything. What it does is reinforce direction and people are very efficient at trying to optimize outcomes when it comes to pay.

But a pay program doesn't make anybody work any harder at the senior level and it doesn't make them any smarter, trust me. It never has, it never will.

And if you're not open to innovation and change, you're not going to make it in this day and age. ■



# INTERVIEW WITH JOHN ENGLAND AND IRA KAY



**J**ohn England is an internationally-recognized consultant in the areas of executive compensation and incentive design. His broad experience in assisting boards of directors and senior management in the design and development of impactful total executive reward programs has been sought out by companies in the U.S., Canada, Europe, and Asia.

Prior to founding Pay Governance as a Managing Partner, John served for seven years as Towers Perrin's Global Practice Leader for executive compensation. Before entering the consulting field in 1983, John was a compensation analyst with Texaco Inc.

A graduate of Connecticut College, John received an MBA degree as an Edward Tuck Scholar from the Amos Tuck School at Dartmouth College.



**I**ra Kay, a Managing Partner at Pay Governance LLC, is one of the nation's foremost experts on executive compensation.

He works closely with boards and management to help them develop executive compensation programs that balance executive motivation and shareholder interests. This is particularly important and challenging in a Say on Pay environment.

Ira is considered an expert on the linkage of executive pay to performance and is one of the developers of "Realizable Pay." His research has been used by clients, academics and quoted by the media.

Ira holds a B.S. in Industrial and Labor Relations from Cornell University and a Ph.D. in economics from Wayne State University.



## "EXECUTIVE PAY HAS BECOME THE MOST IMPORTANT CORPORATE GOVERNANCE ISSUE TO COMPANIES"

**C-Suite Insight:** Why did the two of you start Pay Governance, and what were some of the early challenges or key things that you were trying to accomplish?

**John England:** Ira and I had both retired from our former employers, and we each started separate consulting firms to address the client issue of independence—separating the consulting firm providing broad HR consulting from the firm providing executive compensation advice to the board of directors.

One firm serving management and the board was increasingly becoming untenable for many clients.

Having spent 27 years at Towers Perrin, the first challenge was what to call the new firm. To thrive, it needed to be more than my name or some name that connoted nothing at all. I came up with "Pay Governance" so that our mission was immediately understood—we provide consulting advice on the governance of pay.

The next challenge was how to quickly gain scale since being alone in a "rowboat" wasn't a long-term proposition. First came Ira and Richard Meischeld, and after several months, over 50 talented partners and consultants joined us. Particularly gratifying to all of us were the hundreds of clients served by our colleagues in the past who became clients of Pay Governance.

**CSI:** Ira, what was the key challenge that you saw in joining John at Pay Governance?

**Ira Kay:** I was very excited to get the phone call from him to be part of this. It's very challenging to be an independent advisor to the board while employed by a full-service HR firm. But the good news out of Dodd-Frank and the SEC was that Say on Pay created more pressure on companies to create aligned compensation programs for their executives.

Therefore, they appreciate the help of an outside independent advisor. John and I, and all of our partners, concluded that the advantages of being at an independent firm far outweighed the challenges of being a start-up, and that we didn't want to fight our way as a full-service firm.

**CSI:** What are the high level concepts that you're trying to stress to boards when they're designing a compensation package?

**Ira:** In a Say on Pay world the challenge is to balance motivating the executive team with long-term shareholder interests, as defined by a very diverse and heterogeneous group of shareholders. Getting that balance right is our biggest challenge and the answers to that are not always obvious.

**CSI:** When you're working with boards, what do you see as the keys to helping them do what they need to do?

**John:** I'm not sure it's really changed from where it was ten years ago. It's still fundamentally about attracting, retaining, and motivating. The only difference might be now you have shareholders who have a direct voice into the committee room through Say on Pay. But even that doesn't change the analysis.

It's just an additional screen, probably a helpful one that a committee has to think through. How do we best present our programs to shareholders so that they understand how executive compensation is a key tool to help build shareholder value?

**CSI:** Now that people are more settled in with Dodd-Frank and we've re-elected President Obama, in your view what is the current environment for determining and defending executive compensation, particularly for CEOs?

**Ira:** Things have calmed down since the initial sort of panic of the Say on Pay votes of 2011, and things are much more transparent. But because of the proxy

advisors' methodology, even a very long-term, high-performing company can have a problem with its Say on Pay vote. So that pressure is quite continuous.

One of the unfortunate outcomes of all this is that a lot of the plans are losing their diversity. They are becoming very homogeneous. In response, many companies are putting in relative TSRs, and I'm not sure that's always the right metric for all of those companies. Yet they're responding to that external pressure and putting that in.

**CSI:** How has this affected pay?

**John:** I look at the real change being the governance requirement years ago for a compensation committee report that then morphed into a CD&A. That whole process required boards to think about how they would explain their pay programs in plain language. The next governance iteration was a Say on Pay vote on that very report, giving boards fairly immediate feedback on whether shareholders like or

dislike the pay strategy and implementation.

**Ira:** Unless the Say on Pay votes become more informal, I think we're going to see homogeneity. That's what regulation does. But one of the wonderful things about capitalism is that it rewards successful and punishes failed business strategies.

The diversity and the portfolio of business strategies and executive compensation strategies overall have been very good for the U.S. economy. Hopefully, we'll be able to sustain that somehow.

**John:** I agree with Ira's point that homogeneity is not good. How can you have just one set of compensation programs and strategies when there are thousands and thousands of different business strategies?

It defies logic that there is only one best way to pay people and yet, there is a concern both from the consulting profession and from boards that we're marching toward an environment in which it's safer to do what everybody else does.

**CSI:** As you talk about Say on Pay with your clients, how do they view it? Are they looking for 80% approvals? Is it a matter of simply getting a yes vote or is it a matter of getting the highest yes vote possible?

**Ira:** Yes, they want 80% or more. I've even heard in a few instances where a company got a 98% to 99% favorable vote, and some—one—sometimes jokingly but sometimes seriously—will say they should have pushed it a little more!

The serious issue is that the proxy advisors influence 20 to 30 percentage points of the vote, and companies do not want to get a negative recommendation from them.

**CSI:** Ira, you're a big proponent of realizable pay. We've seen this notion become more popular as boards try to improve pay for performance. Do you see realizable pay getting wider adoption?


**Ira:** As a general matter, I think realizable pay is going to become more and more common. The large and mid-

cap companies in the Russell 3000 in particular are probably going to move in that direction. From an alignment perspective, realizable pay is the better way to compare pay and performance for those companies.

In contrast, the summary compensation table has several problems. John has written some excellent pieces on this. In essence, the stock grants shown in the summary compensation table are not generally based on last year's or the last three years' returns to shareholders. It's awkward to try to force that into a pay for performance model.

So we think realizable pay is much better, and that it will continue to grow in importance and popularity.

**John:** One of the great advantages of realizable pay is you get a more real-time measure of how significantly stock price impacts executive rewards. In the stock-grant column, most of those grants would have been made almost a year ago, early in the first quarter—but who knows what would have happened to a company's stock price afterward.

Realizable pay gets you closer to a real-time value, not a value that's an artifact of math and history. 

“ONE OF THE GREAT THINGS ABOUT REALIZABLE PAY IS YOU GET A MORE REAL-TIME MEASURE”



INTERVIEW WITH **AEISHA MASTAGNI**

**A**eisha Mastagni is an Investment Officer III within the Corporate Governance Unit of the California State Teachers' Retirement System (CalSTRS), the nation's largest teacher retirement fund. Aeisha is responsible for working with a dedicated governance team to further CalSTRS' mission to secure the financial future and sustain the trust of California's educators.

Aeisha's main areas of focus are the corporate engagement program, executive compensation, and selecting and monitoring managers in the activist manager portfolio. Aeisha is part of the team that actively engages public corporations to add value and mitigate risk by striving to institute the best governance practices at companies within the CalSTRS portfolio.

Aeisha is often asked to speak at conferences to communicate CalSTRS position as an institutional investor on a variety of topics, including executive compensation, audit and accounting issues, and engagement with portfolio companies. In addition, Aeisha communicates with regulatory authorities and lawmakers, including the Securities and Exchange Commission and the Public Company Accounting Oversight Board, on rule-making or legislation that may affect CalSTRS as an investor.

Aeisha has a Bachelor of Science degree in Economics from the California State University, Sacramento, and has successfully completed level I of the CFA Program.



"EXECUTIVE COMPENSATION IS A CRITICAL ITEM FOR US DURING PROXY SEASON"

**C-Suite Insight:** You've personally written a lot of letters to companies explaining why the California State Teachers' Retirement System (CalSTRS) voted against their Say on Pay proposals. What sort of problems have you seen?

**Aeisha Mastagni:** Principally, I was simply focusing on a lack of pay for performance. A lot of the companies that we looked at had negative absolute return over three and five years, and poor relative performance over three years. There were also a handful of companies that simply overpaid for what we considered to be marginal performance.

**CSI:** Sounds like a lot of work on your behalf.

**Aeisha:** Yes. The letters were customized for each company, and they weren't all just about pay for performance. It was the fundamental issue, but there were other types of

structural problems that we saw at those companies, so we explained our concerns in these areas as well.

**CSI:** What sort of response did you get?

**Aeisha:** We got a huge response from those letters. Between 70% and 80% of companies responded. We've done other letter-writing campaigns and never gotten a response close to that.

**CSI:** What do you make of that response, and what do you plan for this year?

**Aeisha:** It tells us that pay is important to people and it tells us that there are companies out there that we can work with about their executive compensation programs. We're taking a much more targeted approach this year. We'll write to fewer companies, but we want to have more in-depth engagements with them.

**CSI:** What grabs your attention? Do you look for outliers in particular areas?

**Aeisha:** There are, of course, shareholder irritants that get our attention—things like gross-ups and employment agreements—although those are going away. Our job now is to focus on outliers in the pay for performance arena. This year, because the market has done much better, I think we might see a few more of those companies in the category of what I call overpaying for marginal performance.

**CSI:** How do you unearth these companies?

**Aeisha:** Every company has some type of alignment between pay and performance, but the key is to see how steep the slope is between those two metrics. Is the line relatively flat for underperformance, with a sharp slope upward for minimal increases in performance? Is it all upside or do the executives truly have downside risk?

**CSI:** Your organization holds stock in around 7,000 companies. How do you manage communications with that many companies?

**Aeisha:** There's just not enough time in the day to engage all these companies. But it's also important to remember that we're going to be in new stocks forever. We're the ultimate long-term shareholder. We can be patient, so we don't have to tackle all 7,000 at once, and we can be targeted and strategic about those companies that we engage with.

**CSI:** How much do you think things have improved over the last two or three years, since the advent of Say on Pay?

**Aeisha:** Companies have definitely gotten better at telling their stories. They're better at communicating why their programs are structured the way they are, as well as why they chose the metrics that they did. The disclosure and the transparency are getting better.

**CSI:** One issue which CalSTRS has communicated openly with companies about involves a separation of the chairman and CEO roles. How important is this issue to you?

**Aeisha:** We believe that a separate chairman and CEO is the gold standard when it comes to corporate governance. Those two roles have very different and conflicting responsibilities. The chairman is there to lead the board and the independent directors and the CEO is there to lead the management team.

**CSI:** How do you address this concern?

**Aeisha:** We don't generally submit shareholder proposals on this issue. What we like to do is communicate individually with companies, because there are a lot of factors that go into the issue of having a separate chair and CEO. There are certain things that can mitigate it if you have a combined chair and CEO, for example, having a very strong lead independent director and a very strong lead independent duty state-

ment. Those are things that we can work on individually with companies.

**CSI:** You've also expressed opinions about having more diversity on boards. What expectations do you have for board diversity and how it can improve the company's performance for shareholders?

**Aeisha:** I think more people are acknowledging the importance of diversity. For CalSTRS, diversity is about a mix of skill sets, backgrounds, cultures, tenure, and ethnicity and gender. But, taking a look at what happened during the financial crisis, we saw the issue of groupthink in a lot of boardrooms. So the issue is not diversity per se, but what is a company's process for refreshing the board?

We try to talk to companies about the processes they're putting in place to keep institutional knowledge on the board and yet also add new perspectives and ideas.

**CSI:** What are you finding?

**Aeisha:** Companies do it in different ways. Sometimes

## "DIVERSITY IS ABOUT A MIX OF SKILL SETS, BACKGROUNDS, TENURE, AND ETHNICITY AND GENDER"

they use term limits. Sometimes they use age limits. Sometimes it's a restructuring of the board.

**CSI:** Related to this, what concerns do you have about over-boarding and long tenure?

**Aeisha:** The demands of being a director are just increasing, boards are getting older, and we need fresh ideas and new perspectives in the boardrooms to protect our assets going forward.

As one solution to this, we've developed something with CalPERS called 3D or Diverse Director Datasource. It's run by GMI Ratings now, and is used to develop a new pool of potential board candidates.

**CSI:** What are your views about independent directors?

**Aeisha:** That's another thing that we've been exploring. It ties back into the issue of long-tenured directors – it's just human nature that if you've been on a board, say 10 to 25 years, there comes a point where you're no longer completely independent. We talk to companies about developing a way to restructure so that they can keep that institutional knowledge on the board and yet make sure that they're reassessing the needed skill sets, and making sure they get new people and new blood into the boardroom.

**CSI:** So what big messages do you want to convey to companies that you're holding?

**Aeisha:** I think the big message we want to send is to listen and consider the views of your shareholders.

And I always like to say if we write you a letter, it'd be good if you responded. When we write to a company, we always provide our contact information and invite them to engage with us. But every year there are still those companies that don't respond.

**CSI:** So you appreciate the courtesy of a response even if it's negative, right?

**Aeisha:** Exactly. I also want to tell the marketplace that we're not unreasonable shareholders. We truly want what's in the long-term best interest of the companies we invest in, because that's how we pay our beneficiaries.

We genuinely believe in constructive engagement. We want to hear from the companies because we learn something from each and every engagement. ■



## A PROFILE OF CFOs SERVING AS INDEPENDENT BOARD MEMBERS

**A**S CORPORATE GOVERNANCE continues to evolve, board composition has come under increased scrutiny by regulators, shareholders, and the general public. Recruiting new board talent is one of the most critical responsibilities for Nominating and Governance Committees today.

Ensuring that the board of directors has the optimal and appropriate mix of skills and experience is one of the primary objectives, as well as one of the most difficult challenges, for any Nom-Gov Committee. Historically, however, the methodology for building a board of directors has been characterized as an “old boy’s network” in which boards of the past were homogenous with very little diversity, accountability, or independence.

*This article is based on a report from Equilar Inc. entitled, “Executives on Boards: A Profile of CFOs Serving as Independent Board Members, May 2013.” To request a copy of the full report please email [info@equilar.com](mailto:info@equilar.com).*



PAST MISSTEPS, NEW DEMANDS

Due to a series of high-profile corporate missteps, significant legislative action, and an ever-expanding global marketplace, both board composition and the board recruiting process have evolved. Demands for director diversity and independence, and justification of the value each director brings to a board have irreversibly impacted the board recruiting process.

Today, boards of directors seek a deeper pool of talent from which to recruit, in order to bring valuable experiences and broader perspectives to boards, and thus are recruiting not only CEOs of other organizations, but also other C-level executives.

This shift has inevitably created more opportunities for current C-level executives to serve on boards of directors. Further, board service has recently been recognized as a valuable professional development tool for C-level executives, especially as a part of companies’ succession planning processes in preparing potential CEO candidates.

These executives typically have high visibility and are highly engaged with their own companies’ boards. However, serving on an outside board provides the opportunity for executives to gain exposure to complementary industry strategies and challenges, learn from experienced board colleagues, and further refine leadership abilities.

For these executives, serving on an outside board can provide extremely valuable experiences in preparation for the CEO role. Additionally, companies may obtain immediate value if the lessons and perspectives gained from board service are timely and applicable to an executive’s current role.

Thus, there are several advantages that may encourage companies to make greater efforts to support their C-level executives’ board service opportunities.

S&P 500 ANALYSIS

To explore these implications, Equilar performed an in-depth analysis of S&P 500 CFOs and their service on outside boards. CFOs were selected based on the value they may provide as a result of extensive experience in corporate finance and knowledge of corporate governance practices. As financial expertise is in constant demand by boards, current CFOs are well positioned for board service. Likewise, CFOs are likely to be on the short list in CEO succession plans.

By comparing data for CFOs serving and not serving on boards, Equilar compiled statistics on the prevalence of board service, company performance, and key demographic information for these individuals.

LEADING OUTPERFORMING COMPANIES

This analysis consisted of an examination of three-year TSR for CEOs and CFOs in the S&P 500 index, categorized by independent board service. The table below contains the total number of companies that fall into each category as well as the median three-year TSR for each group.

| Company Category                   | Total # of Companies | Three-Year TSR |
|------------------------------------|----------------------|----------------|
| CFOs Serving on Outside Boards     | 63                   | 19.9%          |
| CFOs Not Serving on Outside Boards | 182                  | 15.2%          |
| CEOs Serving on Outside Boards     | 143                  | 15.5%          |
| CEOs Not Serving on Outside Boards | 150                  | 15.7%          |

Table 1

With a median three-year TSR of 19.9 percent, this analysis shows CFOs who are serving on outside boards are leading higher-performing companies compared to the other three groups. Also, it is interesting to note that companies that do not have their CFOs serving on a board of directors have the lowest median three-year TSR, with 15.2 percent.

BUT THE MAJORITY DO NOT SERVE

Following the TSR analysis, a review of the data revealed that only 102 CFOs in the S&P 500 are serving on an outside board (see Chart 1).

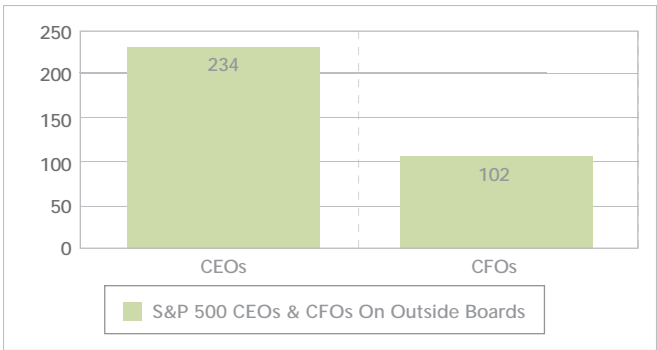


Chart 1

This number represents less than 50 percent of the number of CEOs who are serving on outside boards. Almost half of the S&P 500 CEOs are serving on an outside board of directors with a total of 234. Clearly, it is more common for companies to have CEOs serving on external boards. However, this study shows that even this occurs for less than 50 percent of the companies in the S&P 500 index.

LEADING LARGER COMPANIES

An analysis was conducted to determine the relative size of CFOs’ companies. CFOs in the S&P 500 who are serving on outside boards are executives of larger companies, based on median market cap, than those not serving on an outside board, \$14.9 billion and \$10.6 billion, respectively.

HIGHER-PERFORMING COMPANIES

There are 27 companies that have both their CEO and CFO serving on an outside board who have also been in their executive positions at least three years. When analyzing the three-year TSR of these companies compared to companies that have neither executive serving on an outside board, the data show that 27 companies are outperforming with a median three-year TSR of 19.5 percent.

| Company Category                             | Total # of Companies | Three-Year TSR |
|--|----------------------|----------------|
| Both CEO & CFO Serving on Outside Boards     | 27                   | 19.5%          |
| Both CEO & CFO Not Serving on Outside Boards | 212                  | 14.5%          |

Table 2

HIGHER COMPENSATION

In a comparison of executive compensation for CFOs serving as outside directors and those who do not, the data show the median total compensation for the former is approximately ten percent higher. The median total compensation for CFOs who are serving is \$3.4 million compared to \$3.1 million for those not serving (see Chart 2).

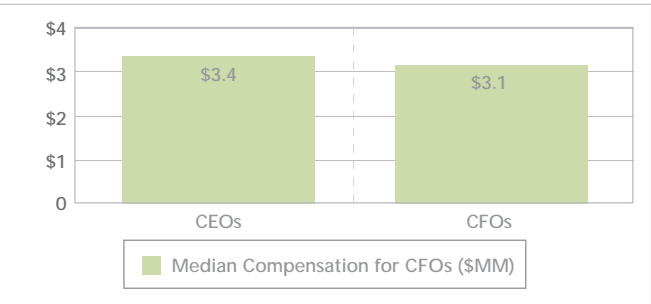


Chart 2

Though there is a ten percent premium for CFOs on boards, this may be due to a variety of factors including the size and performance of the executives’ companies. As reported earlier, CFOs serving as outside board members are executives at companies that have higher median market cap and higher median three-year TSR. Further research is needed to determine if there is a significant positive correlation between executive compensation and outside board service.



FEMALE CFOs

It is widely recognized that the gender disparity on publicly-traded boards has remained relatively stagnant over the past few years. According to an Ernst & Young report, in 2012, 14 percent of S&P 1500 company board seats were held by women, only a three percentage point increase over a six year period. Reflecting this trend, of the 102 CFOs serving on boards only 20 are women.

However, this is a larger percentage of the total number of women CFOs, in the S&P 500, 45.5 percent, compared to the percentage of male CFOs serving, 18.7 percent.

OLDER THAN NON-SERVING CFOs

In an analysis of age, the table below shows the median age for CFOs serving on boards is 54. This is two years older than the median for CFOs who are not serving, at 52 years of age. This may imply that boards seek current executives who are older and more experienced in their roles. Though, further research will need to explore a positive correlation between age and tenure to validate.

| Category                           | Median Age |
|------------------------------------|------------|
| CFOs Serving on Outside Boards     | 54         |
| CFOs Not Serving on Outside Boards | 52         |


Table 3

LEADS TO INTERESTING QUESTIONS

These findings produce interesting questions for further research, but can serve as the foundation for data-driven profiles of executives serving on external boards, specifically for CFOs. While the correlation of financial performance and board service doesn’t indicate causation, it certainly raises interesting points for companies to consider in executive development and succession planning discussions.

For instance, does board service lead to higher TSR? Or, does higher TSR make candidates more attractive for board service? Do larger companies produce better-qualified board candidates? Or, do these firms produce more sought-after candidates due to market position and brand recognition? Or, do smaller firms simply prevent executives from serving and why?

Likewise, boards of directors would benefit from these analyses as a part of comprehensive board recruiting and vetting processes.

Equilar will continue this line of research, and extend it to other C-level positions, to deliver the most up-to-date trends on this relatively new pool of potential director candidates. 

*For more information, please contact Aaron Boyd at [aboyn@equilar.com](mailto:aboyn@equilar.com). Aaron Boyd is the Director of Governance Research at Equilar. The contributing author of this report is Belen E. Gomez, Content Marketing Manager.*



CFOs On Board  
KEY FINDINGS

- **Companies that have their CFOs serving on outside boards outperform.** Looking at median three-year total shareholder return (TSR), S&P 500 CFOs serving on outside boards are leading companies that outperformed companies where the CFO did not serve on an outside board, 19.9 percent vs. 15.2 percent, respectively.
- **The majority of CFOs do not serve on outside boards of directors.** In 2012, 102 CFOs in the S&P 500 served on an external board, compared to 234 CEOs.
- **CFOs serving on boards are leading larger companies.** The median market cap for companies that have their CFOs serving on outside boards is \$14.9 billion, compared to the median market cap of \$10.6 billion for companies where the CFO does not serve on an outside board.
- **Higher-performing companies have both their CEOs & CFOs serving on outside boards.** A total of 27 companies in the S&P 500 where both the CEO and CFO serve on external boards outperformed companies where neither serve on a board. Companies where both served on outside boards had a median three-year TSR of 19.5 percent.
- **CFO executive compensation is higher for board members.** The median total compensation for CFOs who are serving on outside boards is \$3.4 million compared to \$3.1 million for those not serving.
- **There is a higher percentage of female CFOs serving on boards, but male CFOs still outnumber.** Of the 102 CFOs serving on boards, only 20 are women. However, this is a larger percentage of the total number of female CFOs in the S&P 500, 45.5 percent, compared to the percentage of male CFOs serving, 18.7 percent.
- **CFOs serving on boards are older than non-serving CFOs.** The median age for CFOs serving on outside boards is 54, two years older than the median for CFOs who are not serving.

2013  
EQUITY TRENDS

PERFORMANCE-BASED EQUITY  
CONTINUES TO RISE

EQUITY VEHICLES ARE one of the cornerstones of an effective compensation strategy. Equity can be utilized to align executives’ interests to those of shareholders, and/or provide ownership opportunities to rank-and-file employees. In both cases, granting equity is a valuable method to motivate and promote retention throughout a corporation. Due in part to the volatility of the stock market over the last several years, the rise of new equity vehicles is one key issue facing investors, directors, and compensation professionals.

The 2013 proxy season marks the third year in which Say on Pay proposals will appear in the proxies of publicly-traded companies. Shareholders will make their voting decisions regarding executive pay based on a variety of factors, including the mix of equity awarded to executives.

Establishing a strong equity component in an executive’s pay provides a clear incentive to strive for long-term growth. An important element to be considered when making Say on Pay decisions is a company’s use of performance-based equity. Linking compensation directly to the achievement of specific goals has become more prevalent in recent years.

Many companies focus on implementing strong pay for performance compensation strategies with the use of performance-based shares. This focus has helped drive the trends found in this report, as full-value shares continue to replace options as the primary equity vehicle.

Equilar studied companies in the S&P 1500 index to provide insight into equity-granting practices. Examining data from fiscal years 2007 through 2012, this report reveals that companies have continued to shift away from options while placing a greater focus on granting full-value shares. The report covers a variety of topics including options and restricted-stock grant practices, performance-based equity, vesting details, measures of dilution including overhang and run rate, and valuation model assumptions.

In fiscal year 2012, S&P 1500 companies had median annual revenues of approximately \$1.9 billion, growing at an annual rate of 4.8 percent from 2007 to 2012.

Fiscal year-end market capitalization for S&P 1500 companies dipped in 2008 as a result of the global financial crisis. However, market cap grew from 2007 to 2012 at an annual rate of 3.3 percent. In fiscal year 2012, S&P 1500 companies had a median fiscal year-end market capitalization of approximately \$2.7 billion.

Table 1 outlines key financial information for each industry group.

| Industry Name    | Prevalence | 2012 Median Annual Revenue (\$BB) | 2012 Median Fiscal Year-End Market Capitalization (\$BB) |
|------------------|------------|-----------------------------------|--|
| Basic Materials  | 9.6%       | \$2.8                             | \$3.5  |
| Conglomerates    | 0.5%       | \$29.9                            | \$38.9   |
| Consumer Goods   | 11.1%      | \$3.1                             | \$3.2  |
| Financial        | 18.6%      | \$0.9                             | \$2.7  |
| Healthcare       | 8.9%       | \$1.8                             | \$2.7  |
| Industrial Goods | 10.6%      | \$2.1                             | \$2.5  |
| Services         | 18.8%      | \$2.4                             | \$2.0  |
| Technology       | 17.2%      | \$1.1                             | \$1.7  |
| Utilities        | 4.7%       | \$3.7                             | \$4.5  |

Table 1

STOCK OPTION TRENDS

The number of options granted fell for the third straight year in 2012, after consecutive years of growth in 2008 and 2009. This growth was primarily caused by the declining stock market during those years forcing companies to grant more options to equal values given in previous years.

The recent decrease continues a trend from earlier in the decade as the use of options has been declining. From 2007 to 2012, the median number of total stock options granted annually by S&P 1500 firms fell at an annual rate of 4.8 percent, reaching a median of 578,000 options in 2012. The number of companies reporting employee option grants also fell from 78.5 percent to 65.2 percent during the same six-year period.

Table 2 illustrates option-grant trends at S&P 1500 companies.

Unsurprisingly, as the size and number of stock option grants at S&P 1500 firms declined, so too did the median number of options outstanding at the end of each fiscal year. As was the case with the granting of options, the rise in options outstanding in 2009 is attributed to the large declines in stock prices resulting in fewer option exercises and more option grants.

| Percent of S&P 1500 Companies that Granted Options |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| 2007   | 2008  | 2009  | 2010  | 2011  | 2012  |
| 78.5%  | 77.2% | 75.1% | 73.2% | 69.8% | 65.2% |

Table 2

This article is based on a report from Equilar Inc. entitled, "2013 Equity Trends." To request a copy of the full report, including breakdowns by market sector, please email [info@equilar.com](mailto:info@equilar.com).



The declines in 2010 through 2012 continue the trends seen before 2007; from 2007 to 2012 median options outstanding declined at an annual rate of 7.4 percent (see Chart 1).

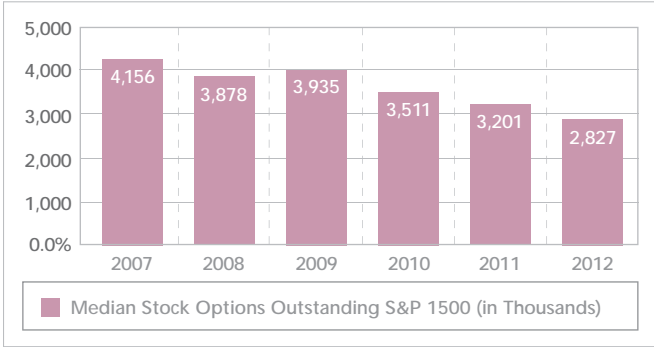


Chart 1

The median number of total stock options granted in 2012 varied significantly among key industry groups. In 2012, Financial companies granted the fewest options, awarding a median of 412,500 options. Although only 19.0 percent of Utilities companies granted options, Utilities companies were at the opposite end of the spectrum, granting a median of 1,041,385 options in 2012.

RESTRICTED STOCK TRENDS

From 2007 to 2012, the median number of total restricted shares granted annually by S&P 1500 companies increased at an annual rate of 11.9 percent, reaching a median of 491,320 shares in 2012. The increase is primarily attributed to 2007 and 2008, as the number of restricted shares granted has remained relatively flat since. Furthermore, the number of companies reporting restricted-stock grants increased from 80.1 percent in 2007 to 92.8 percent in 2012.

Table 3 illustrates restricted stock grant trends at S&P 1500 companies.

| Percent of S&P 1500 Companies that Granted Restricted Shares |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| 2007   | 2008  | 2009  | 2010  | 2011  | 2012  |
| 80.1%  | 84.7% | 87.0% | 89.8% | 91.3% | 92.8% |

Table 3

Following a pattern opposite of stock options, the median number of restricted shares outstanding at S&P 1500 companies increased from 617,000 in 2007 to 1,125,762 in 2012, at an average annual increase of 12.8 percent.

GRANT PRACTICES

From 2007 to 2012, the number of S&P 1500 companies awarding only stock options to their employees fell from 16.2 percent to 5.0 percent. In contrast, the number of companies granting only restricted stock increased from 17.8 percent to 32.6 percent.

The number of companies granting both equity vehicles had been increasing from 2007 to 2010 until the most recent years. In 2012, the number of companies granting both restricted stock and options fell below 2007 levels as companies moved away from granting options to employees.

Table 4 shows that a majority of S&P 1500 companies (60.2 percent) granted a mix of equity compensation vehicles to their employees in 2012.

| Fiscal Year | Stock Options Only | Restricted Stock Only | Both Equity Vehicles | Neither Equity Vehicle |
|-------------|--------------------|-----------------------|----------------------|------------------------|
| 2012        | 5.0%               | 32.6%                 | 60.2%                | 2.2%                   |
| 2011        | 6.8%               | 28.3%                 | 63.0%                | 2.0%                   |
| 2010        | 7.8%               | 24.3%                 | 65.4%                | 2.4%                   |
| 2009        | 10.1%              | 22.0%                 | 65.0%                | 2.9%                   |
| 2008        | 13.0%              | 20.4%                 | 64.3%                | 2.3%                   |
| 2007        | 16.2%              | 17.8%                 | 62.3%                | 3.7%                   |

Table 4

Table 5 summarizes 2012 equity grant practices within each S&P 1500 industry group.

| Industry Group   | Stock Options Only | Restricted Stock Only | Both Equity Vehicles | Neither Equity Vehicle |
|------------------|--------------------|-----------------------|----------------------|------------------------|
| Basic Materials  | 0.8%               | 37.0%                 | 60.6%                | 1.6%                   |
| Consumer Foods   | 5.4%               | 27.9%                 | 65.3%                | 1.4%                   |
| Financial        | 4.9%               | 43.3%                 | 48.2%                | 3.6%                   |
| Healthcare       | 6.8%               | 17.8%                 | 74.6%                | 0.8%                   |
| Industrial Goods | 6.4%               | 24.3%                 | 65.7%                | 3.6%                   |
| Services         | 4.8%               | 28.4%                 | 65.2%                | 1.6%                   |
| Technology       | 6.6%               | 27.2%                 | 64.0%                | 2.2%                   |
| Utilities        | 0.0%               | 79.4%                 | 19.0%                | 1.6%                   |

Table 5

PERFORMANCE-BASED EQUITY AWARDS ARE A POPULAR VEHICLE TO PROVIDE VALUE TO EXECUTIVES WHILE LINKING PAY WITH PERFORMANCE

PERFORMANCE-BASED EQUITY

Performance-based equity awards are a popular vehicle to provide value to executives while linking pay with performance. Since disclosure surrounding performance shares on a company-wide basis is not consistent, Equilar looked at awards to chief executives at S&P 1500 companies that filed their 2013 proxy by March 18, 2013. A total of 477 companies were included in this early study of performance shares. These numbers may be included in the restricted stock numbers disclosed earlier in this report.

From 2010 to 2012, the number of companies providing performance-based equity granted to chief executives increased from 50.1 percent to 61.8 percent of companies. The majority of these shares are granted as long term incentive plan stock or units.

A closer examination highlights the use of performance-based equity as a long-term incentive. Approximately 66.2 percent of all performance equity vehicles were granted with a long-term performance period.

VESTING TRENDS

Equilar examined Form 4 filings for time vesting equity awards granted to S&P 1500 chief executive officers during 2012. The study provided insight into the most common types of vesting, as well as the prevalence of various vesting period lengths.

For this study, units were included as part of stock, and stock appreciation rights were included as part of options. Both stock and option awards primarily had a graded vesting schedule, rather than a cliff vesting schedule. There were about twice as many stock awards granted with graded vesting than cliff vesting. Even more pronounced was that 93.2 percent of option awards were granted with graded vesting.

In general, 78.0 percent of all time vesting equity awards had a graded vesting schedule.

The Financial and Utilities industries granted the most stock, with stock representing 66.5 percent and 80.0 percent of each industry’s total equity granted, respectively.

In the Utilities industry, the percentage of cliff stock granted was nearly twice as much as any other industry, but the percent-

age of graded options was less than half as much as the amount granted by almost all other sectors. In addition, the Utilities industry also had the highest percentage of cliff vesting equity at 44.0 percent, while the Technology firms granted the most equity with graded vesting at 87.6 percent.

With regards to cliff options, Consumer Goods led the way with 8.3 percent, which was considerably more than the second highest industry, Basic Materials, at 4.9 percent.

Not surprisingly, executives in relatively stable industries like Utilities and Consumer Goods receive more awards with a cliff vesting schedule, because the stability allows executives to stay longer and gain value from the awards. Graded vesting awards are more typical in volatile industries like Technology, since those companies provide opportunities for their employees to cash in some of the award value throughout uncertain periods.

OVERHANG

Options-only overhang rates at S&P 1500 companies declined steadily from 2007 to 2012, falling from a median of 5.6 percent in 2007 to a median of 3.5 percent in 2012.

This change is primarily driven by a decrease in the median number of outstanding stock options at S&P 1500 firms. As described earlier, from 2007 to 2012, median options outstanding (the numerator in the calculation of options-only overhang) declined at an annual rate of 7.4 percent. Meanwhile, median total common shares outstanding (the denominator in the calculation) increased. From 2007 to 2012, median total common shares outstanding at S&P 1500 firms increased at an annual rate of 1.8 percent.

RUN RATE

Run rates (or burn rates) are another common measure of shareholder dilution. Rather than examining the potential effects of currently outstanding equity awards, run rates measure actual equity-grant activity in relation to the total number of shares outstanding at each company.

From 2007 to 2012 there was an 11.9 percent annual increase in

the median number of total full-value shares granted at S&P 1500 companies each year, which contributed to the increase in median run rates from 1.6 percent in 2007 to 1.7 percent in 2012.

Partially offsetting the rise in full-value shares granted annually is the fact that the median number of stock options granted each year decreased at an annual rate of 4.8 percent over the same period. As mentioned extensively throughout this report, 2008 and 2009 saw trends opposite that seen most recently as companies granted higher volumes of equity to keep up with rapidly declining stock prices (see Chart 2).

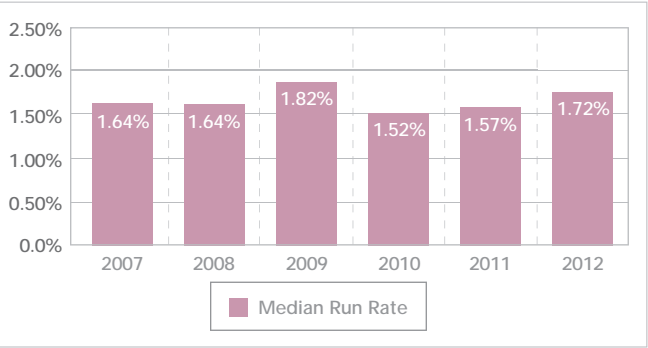


Chart 2

When assessing the impact of restricted-share grants on run-rate calculations, it should be noted that the treatment of restricted-stock grants in run-rate calculations typically varies from company to company, depending on each company’s historic stock-price volatility.

For example, the conversion premiums used to convert restricted shares to options in the run-rate methodology used in this analysis is shown in Table 6.

| Historical Volatility | Conversion Premium<br>(Restricted Shares for Options) |
|-----------------------|---|
| 54.6% or higher       | 1 for 1.5   |
| 36.1% to 54.6%        | 1 for 2.0   |
| 24.9% to 36.1%        | 1 for 2.5   |
| 16.5% to 24.9%        | 1 for 3.0   |
| 7.9% to 16.5%         | 1 for 3.5   |
| 7.9% or less          | 1 for 4.0   |

Table 6

FAS123R

Public companies are required to disclose several key assumptions used in the valuation of new stock option awards under FASB Statement of Financial Accounting Standards No. 123 Revised, also known as FAS 123R. These assumptions, and the numerous valuation models they supply, have a large impact on the stock-based compensation expense recorded each year by corporations in their financial statements.

VOLATILITY

Over the past six fiscal years, median volatility assumptions for option valuation models at S&P 1500 companies rose, climbing from a median of 30.9 percent in 2007 to a median of 40.9 percent in 2012.

The large spike in volatility was obviously due to the market turmoil during 2008 and 2009. As the economy, and subsequently the stock market, has slowly begun to stabilize over the last several years, the volatility seen in 2008 and 2009 has also begun to fade. Since many companies use a three-year volatility measure, declines in volatility will continue to be seen in future years, assuming the market continues to stabilize (see Chart 3).

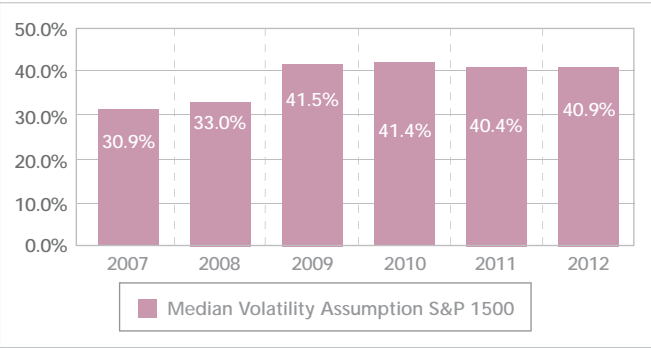


Chart 3

For more information, please contact Aaron Boyd at [aboyn@equilar.com](mailto:aboyn@equilar.com). Aaron Boyd is the Director of Governance Research at Equilar. The contributing authors of this paper are Chris Chin and Felicia Wong, Senior Research Analysts, Ankur Prabhakar, Research Analyst.

KEY EQUITY TRENDS FINDINGS

- **Number of Options Granted Fell for the Third Straight Year.** Over the past three years, the median number of total stock options granted by S&P 1500 companies decreased to 578,000 shares per company in 2012. The percentage of S&P 1500 companies granting options fell from 78.5 percent in 2007 to 65.2 percent in 2012.
- **Restricted Stock Granted is at an All-Time High.** From 2007 to 2012, the percentage of S&P 1500 companies granting restricted stock for employees increased from 80.1 percent to 92.8 percent. Additionally, the median number of restricted shares granted per company increased at an annual rate of 11.9 percent over the six-year period.
- **Performance-Based Equity Continues to Rise in Popularity.** An early look at proxies filed with fiscal 2012 information reveals that 61.8 percent of S&P 1500 CEOs received performance-based equity grants, compared to 55.8 percent in 2011. 66.2 percent of CEOs received shares in performance periods spanning multiple years.
- **Equity Grant Rates Increased Slightly.** Median run rates increased from 1.6 percent in 2007 to 1.7 percent in 2012.
- **Less Potential Total Dilution.** From 2007 to 2012, median options-only overhang rates at S&P 1500 companies fell from 5.6 percent to 3.5 percent, while median options and restricted stock overhang rates fell from 6.3 percent to 5.0 percent.
- **Volatility Remained Consistent.** Following an increase from 30.9 percent in 2007 to 41.5 percent in 2009, the median volatility assumption for option-valuation models has differed by a maximum of 110 basis points.



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## BOARDROOM REALITIES

BY TK KERSTETTER

### HAS THE PUSH FOR BOARD INDEPENDENCE BENEFITED SHAREHOLDERS?

Since the fallout from the Enron and WorldCom events in 2000 and 2001, we have seen a concentrated effort to get more director independence in the boardroom. Both the NYSE and NASDAQ were quick to roll out updated listing guidelines that required their issuers to follow a much more stringent definition of what constituted an independent director.

We saw many companies respond quickly to reduce the number of insiders and ensure new directors were not conflicted by a personal or business link to the corporation. Companies that continued to have three or more inside directors were targeted by proxy advisory firms and institutional investors to get on board with this investor-encouraged governance best practice.

There are still some holdouts, which we'll address in a second, but the question to be asked is: Has this push for board independence actually benefited shareholders and enhanced company value?

### MIXED EVIDENCE

Simply put, when I examine the research to date on this question, the empirical evidence is mixed. To ultimately answer the question of whether board independence has a correlation to increased shareholder value, we would need to weigh the variables of short-term performance, long-term performance, fraud prevention, and, in a perfect analytical world, one's culture. Multiple studies, just looking at performance, suggest that there is no correlation between the percentage of independent board members and the bottom-line company performance.

At the same time, I found one reputable study that concluded that there is a correlation between the percentage of independent directors and the likelihood of corporate wrongdoing. One of the problems, however, is this study was done in 2004 and doesn't incorporate any of the empirical results from the infamous financial meltdown from 2008 to 2010.

Interestingly, one of the much talked about questions following that period was, "Would boards have provided better oversight and

potential whistleblowing if having knowledge about the business was given similar emphasis as board independence?"

### GOING TOO FAR

My take is that independence at the expense of industry knowledge has swung too far. Technically, these two objectives don't have to be mutually exclusive. But the reality is, finding an independent director who is knowledgeable about the business is not a challenge in some industries but is very difficult in others. (This is a similar challenge when building compensation peer groups.) In discussions with leading proxy advisors and institutional investors there has been increasing support for making sure directors have industry knowledge or experience.

In some cases, I feel they've even hinted at including additional insiders on the board, but I actually haven't heard anyone come out and support that. I'm sure that most people still would be concerned that a CFO or COO board member would be beholden to the CEO, and I understand that concern. For what it's worth, I did a stint as an inside director as president and COO of the public company and never had a problem with being independent, and my CEO encouraged me to serve that role as I saw fit. Many might argue that this situation is the exception, however.

Board independence is another one of those governance issues where one size doesn't fit all and therefore, it probably will be debated forever. I'd never argue against boards' being independent and certainly don't want director recruitment returning to the "good ole boy" days.

But in the end, I favor boards that are industry knowledgeable rather than favoring independence for independence sake. Yes, boards have benefited from the independence push, but don't accept that independence alone is the solution to creating an effective board. ■

*TK Kerstetter is the chairman of Corporate Board Member and is a second generation pioneer of governance thought leadership and board education.*



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# Will your company pass Say on Pay?

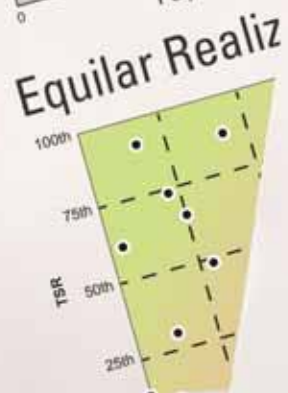
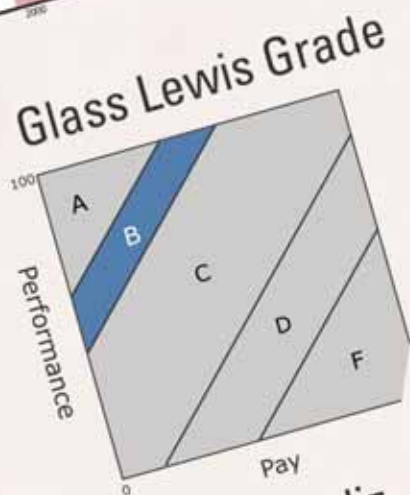
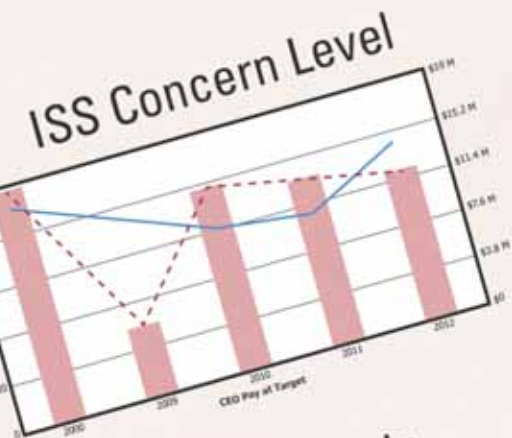
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