CORPORATE BOARD MEMBER®

DIRECTOR FUNDAMENTALS GUIDE

A guide to operating practices, roles and responsibilities in corporate governance.

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SECTION 1:

ROLE OF THE DIRECTOR

A board of directors is a governing body elected to represent the interests of a company's shareholders. As a board member, your responsibilities are twofold: advising management in areas like establishing a strategic direction, setting goals and assessing risk, and overseeing management operations and performance. These roles are carried out with a fiduciary responsibility to the shareholders of the company. The board of directors delegates the duties of day-to-day management of the corporation to various executives, whom the board selects and who are accountable to the board of directors. In addition, directors have legal obligations under federal securities laws as well as state corporate laws.

Duties & Responsibilities

FIDUCIARY DUTIES

As a board member, you have a legal obligation to act in the interest of the corporation and its shareholders. Your primary fiduciary duties, which are principally derived from Common Law of Delaware, include the following:

DUTY OF LOYALTY

The basic definition of the duty of loyalty is the obligation to act in good faith and always in the best interests of the corporation rather than the fiduciary's own interest. The duty of loyalty also precludes acting for unlawful purposes and affirmatively requires directors to make a good-faith effort to monitor the corporation's affairs and compliance with law. Therefore, a company's directors must:

- ensure the company has policies that comply with laws and regulations and that management adheres to them;
- ensure all actions taken by management put the interests of the company and its shareholders above all others; and
- ensure directors remain independent and do not take advantage of their positions to act in their own interests, i.e., partake in self-dealing.

It is generally accepted under Delaware law that a director's duty of confidentiality falls under the duty of loyalty. All companies should have comprehensive corporate confidentiality policies that apply to employees as well as directors.

DUTY OF CARE

The duty of care requires that directors devote the same care and concern to their fiduciary responsibilities that any prudent person in a like position would exercise under similar circumstances. To satisfy the duty of care, it is critical that the board:

- always acts in good faith for the benefit of the company and within the confines of the authority it is granted by its governing documents
- review all pertinent, credible information and conduct reasonable due diligence to ensure actions are in the company's best interest; and
- understand the consequences that will flow from each decision before making a decision, which may require the advice of legal or financial experts.

Some corporate charters contain a provision immunizing directors from personal monetary liability for violating their duty of care. However, a company cannot shield directors from liability if duty of loyalty is breached.

DUTY OF CANDOR

The Delaware Supreme Court has held that corporate directors owe shareholders a fiduciary duty to disclose, in an atmosphere of complete candor, all material information that is important to their evaluation of the company and its management. In the absence of direct knowledge of wrongdoing, the board is permitted to rely on management assurances that such information is complete and accurate.

CONFIDENTIALITY

Information in any category that is material and nonpublic may be disclosed by company insiders only in specific ways prescribed by federal securities laws, including Regulation FD. For these reasons, all companies should have comprehensive corporate confidentiality policies that apply to employees as well as directors. The authorized processes and channels for disclosure of confidential corporate information should be well-defined and understood within the company, as improper disclosures can lead to criminal and civil liability in certain circumstances.

There are legal ramifications for some breaches of confidentiality. A damaging leak of confidential material could, in certain circumstances, amount to a breach of the duty of loyalty, which could result in personal liability for damages and limit a director's legal and contractual protections against such liability.

There are three categories of confidential board information:

- Proprietary information that is of competitive, commercial value
- Inside information about finances and strategy
- Sensitive information regarding board proceedings and deliberation

BEST PRACTICES

The obligation of confidentiality fundamentally derives from the fiduciary duties of loyalty and care, and questions of disclosure are, when not covered by existing agreements or company policy, matters of business judgment. As a best practice, boards should establish and maintain clear policies about the handling of confidential board information and the process to be followed in the event of a leak. Confidentiality agreements should be required in situations where directors may be sharing confidential information with their sponsors.

Decision Making

THE BUSINESS JUDGMENT RULE

Courts rarely rule against a company for a breach of duty of care. Even when hindsight demonstrates that a board's decision was misguided or resulted in a situation that was not in the best interest of shareholders, if the board can show that it followed the standards of the duty of care, courts will generally follow the Business Judgment Rule in evaluating board conduct. The Delaware Chancery Court has noted that the Business Judgment Rule focuses on the board's decision-making process rather than on a substantive evaluation of the merits of the decision. Thus, according to the ruling, the business judgment rule "prevents judicial second-guessing of the decision if the directors employed a rational process and considered all material information reasonably available—a standard measured by concepts of gross negligence."

Exceptions

There are special situations where heightened scrutiny—rather than business judgment rule protection—will apply to directors' decisions. These include:

DEFENSIVE MEASURES

When a company is subject to a hostile takeover, falls under attack from activists or faces similar risk and decides to take defensive action, such as the adoption of a "poison pill," directors must satisfy what has come to be known as the Unocal test (derived from the 1985 case of *Unocal Corp. v. Mesa Petroleum Co.)*. This test puts the burden on the board to demonstrate that the defensive action taken was reasonable in relation to the threat to the company and its business objectives.

SALE TRANSACTIONS

If the decision has been made to sell the company or when the market or other conditions make the sale of the company inevitable, the board operates in a so-called Revlon mode (derived from the 1986 case of *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.)*. Revlon duties obligate the directors to obtain the best price reasonably available for the stockholders. At the same time, the Delaware courts recognize that there is no "one way" to sell a company, and the process directors choose to employ will be given deference if "reasonable" and free of conflicts of interest.

LANDMARK CASES YOU SHOULD KNOW

1985
Smith v. Van Gorkom "Trans Union Case"

THE CASE
Shareholders filed a class-action suit against the directors and CEO of Trans Union, challenging a merger that was approved.

THE RULING
The court ruled that the board was grossly negligent and in breach of the duty of care for its approval of the merger based on limited information and unsubstantiated share price valuation that was provided to them by the CEO. The board was also held in breach of the duty of disclosure for not providing shareholders with all the facts germane to the transaction. The directors were also found personally liable for the breach, which led to increased concerns about liability and the need for D&O insurance.

1985
Unocal Corp v. Mesa Petroleum Co.

THE CASE
Unocal appealed the lower court decision that ruled that it was not legally permitted to exclude a shareholder from a tender offer. Unocal was able to provide substantial evidence that the company was in reasonable danger and thus was justified in denying the takeover.

THE RULING
The Delaware Supreme Court ruled in favor of Unocal and the board's reaction to the threat posed. Thus, the "Unocal test" standard was created in relation to the decision-making process during takeovers.

1986
Revlon Inc. v. MacAndrews & Forbes Holdings Inc.

THE CASE
Pantry Pride brought action to the Delaware Court after Revlon's board of directors approved deal-protection measures that blocked Pantry Pride's superior bid over another offer from a company they felt was more suitable.

THE RULING
When selling a company, the duty of the board changes from serving the long-term wellbeing of the company to maximizing the immediate value of shares for stockholders. Thus, the "Revlon duties" standard was created in relation to company sales transactions.

1996
In re Caremark International Inc. Derivative Litigation

THE CASE
Following a federal investigation that led to $250 million in fines, a group of shareholders claimed that the board of directors did not exercise proper oversight of internal controls surrounding employee compliance with the Anti-Referral Payments Law (ARPL). The company agreed to settle and asked the court to approve the agreement.

THE RULING
The court approved the settlement but concluded that the board had made a good-faith attempt to ensure compliance with the law. The case led the court to further define what constitutes a violation of the duty of oversight.

1998
In re Walt Disney Co. Derivative Litigation

THE CASE
Shareholders alleged that Disney's directors were in breach of their fiduciary duties by approving an employee agreement for its new president that included a large severance provision awarded after only 14 months of service.

THE RULING
The court ruled that the hiring and firing decisions made by the board and CEO were done under the business judgment rule and to counter that, gross negligence or bad faith must be proved.

2006
Stone v. Ritter

THE CASE
Shareholders of AmSouth alleged the board was in breach of its duty to monitor and acted in bad faith by allowing for employee violation of various banking and AML regulations.

THE RULING
The court rejected the claim by finding that the company had a comprehensive reporting system in place and the board had helped design the compliance program and oversaw it in good faith. Stone resulted in a reformulation of the Caremark standard by limiting the scope of the duty to monitor and stating "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."

2019
In re Marchand v Barnhill

THE CASE
Following a listeria outbreak in ice cream made by Blue Bell Creameries USA Inc. that sickened many consumers, caused three deaths and resulted in a total product recall, the plaintiffs asserted a derivative claim against the directors for lack of oversight of a key known risk area.

THE RULING

The court supported the claim, citing *Caremark* and *Stone ex rel. AmSouth Bancorporation v. Ritter,* which recognized a duty to attempt in good faith to assure that a corporate information and reporting system exists such that appropriate information will come to the board's attention in a timely manner. The court attributed the fact that testing reports identifying listeria contamination in certain plans never made their way to the board as failure to make a good-faith effort to exercise its duty of care.

Director Liability

LITIGATION TRENDS

Every public company is vulnerable to to lawsuits, especially securities class action suits, merger objections and shareholder derivative suits, against its officers and directors.

In 2020, 326 federal class-action securities cases were filed, according to NERA Economic Consulting. The figure represents a 22 percent decline from the prior year, which may be at least partly a byproduct of Covid-19's impact on business transactions and operations. When analyzed by industry, the electronic technology and technology services sector faced the most filings, followed closely by defendants in the health technology and services sector. 2020 also saw the emergence of a new common allegation; 35 percent of the complaints included a claim related to misled future performance.

Another common source of corporate litigation stems from shareholders acting on behalf of a corporation to bring a "derivative suit" against directors and management for fraud, mismanagement, self-dealing or dishonesty, charging a breach of fiduciary responsibility. Shareholder derivative suits are brought for the benefit of the corporation, whereas shareholder direct and class actions address unique, direct harm to a particular shareholder. To determine which party suffered the alleged harm, courts apply the "Tooley test" derived from the 2004 case of *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.* The Tooley test entails asking two questions: (1) Who suffered the alleged harm (the corporation or the stockholders)? (2) Who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)? If the corporation suffered the harm and would receive the benefit of any recovery, then the claim is derivative.

BEST PRACTICES

If you are sued in your capacity as a director or officer, there are a number of steps you can take to protect your rights and help work toward the best possible outcome. These include the following:

- Retain independent and experienced counsel immediately
- Understand the rights and protections available to you and
- Preserve documents

Finally, the board's crisis management plan should include provisions regarding director leaks of sensitive board information, whether private or public and whether intentional or inadvertent. Advance preparation can help ensure procedural fairness and prevent emotional responses to what could be perceived as a personal betrayal, thus clouding the board's judgment.

PROTECTIONS

CORPORATE INDEMNIFICATION

Under Section 102(b)(7) of the Delaware General Corporation Law, a corporation may, in its certificate of incorporation, provide for the elimination or limitation of directors' personal liability to the corporation or to its stockholders for breaches of directors' fiduciary duties. Such a provision, when included in a company's charter, shields directors from personal monetary liability for decisions not otherwise protected by the business judgment rule—i.e., gross negligence. Specifically excepted from the scope of this protection are breaches of fiduciary duty involving improper personal benefits for directors (loyalty issues), bad faith conduct or intentional misconduct, and certain unlawful issuances of dividends, stock purchases and stock redemptions.

STATUTORY INDEMNIFICATION

Another significant substantive protection available to directors of a Delaware corporation is a Delaware statute that protects directors who, in the performance of their duties, rely in good faith on the records of the corporation or on information, opinions, reports or other statements provided to directors by officers, employees or committees of the corporation or by certain outside advisers, such as attorneys and auditors. This statutory protection, found at Section 144 of the Delaware General Corporation Law, recognizes that directors typically do not run or direct the day-to-day operations and administrative functions of a business and are not experts in all aspects of business. Directors, therefore, can and should rely on information provided to them by those who do run the day-to-day business or who are experts.

D&O INSURANCE

Under Delaware law, a company may, but is not required to, provide insurance for directors at the company's expense against any liability that may arise as a result of directors' conduct. The company may provide such insurance to directors whether or not the company could indemnify the director, thus making insurance a potentially broader protection against personal liability than indemnification. The primary limitations on insurance are found within the policies themselves. Just as with indemnification provisions, a person should obtain and, along with his or her counsel, carefully review a corporation's insurance policy, if any, before agreeing to serve on the board. A serving director who is covered under such a policy should also ask for an annual update on D&O coverage and policy inclusions and exclusions, particularly in anticipation of a policy renewal.

Oversight of Strategy & Risk

Contributing to corporate strategy—and ensuring the proper oversight of management's execution of that strategy—is a core responsibility of the board of directors. There are several foundational aspects to the board's role in this regard. It must first define the corporate strategy and then work with executive management to develop a business model that translates the strategy into shareholder value. Once that model is in place, the board has a responsibility to monitor management's execution of the strategy through evaluative means that provide measurable indicators of performance.

Implicit in the board's role to develop and monitor strategy is a coinciding role to measure and oversee risk. Every corporate strategy involves risk, and each company's unique appetite for risk may be found on a spectrum from risk averse to risk tolerant. The board must agree on the proper appetite for risk and ensure that the corporate strategy remains in balance with that tolerance. Finally, overarching all these considerations is an imperative to ensure the corporate strategy is designed to create long-term value for shareholders.

To fulfill their role to oversee strategy and risk, directors are often confronted with making decisions that are, by nature, affected by underlying economic, geopolitical, regulatory market, financial and technological trends. Therefore, it is critical for board members to understand these macro trends as well as challenges and opportunities related to digital transformation, capital allocation, market position and operations.

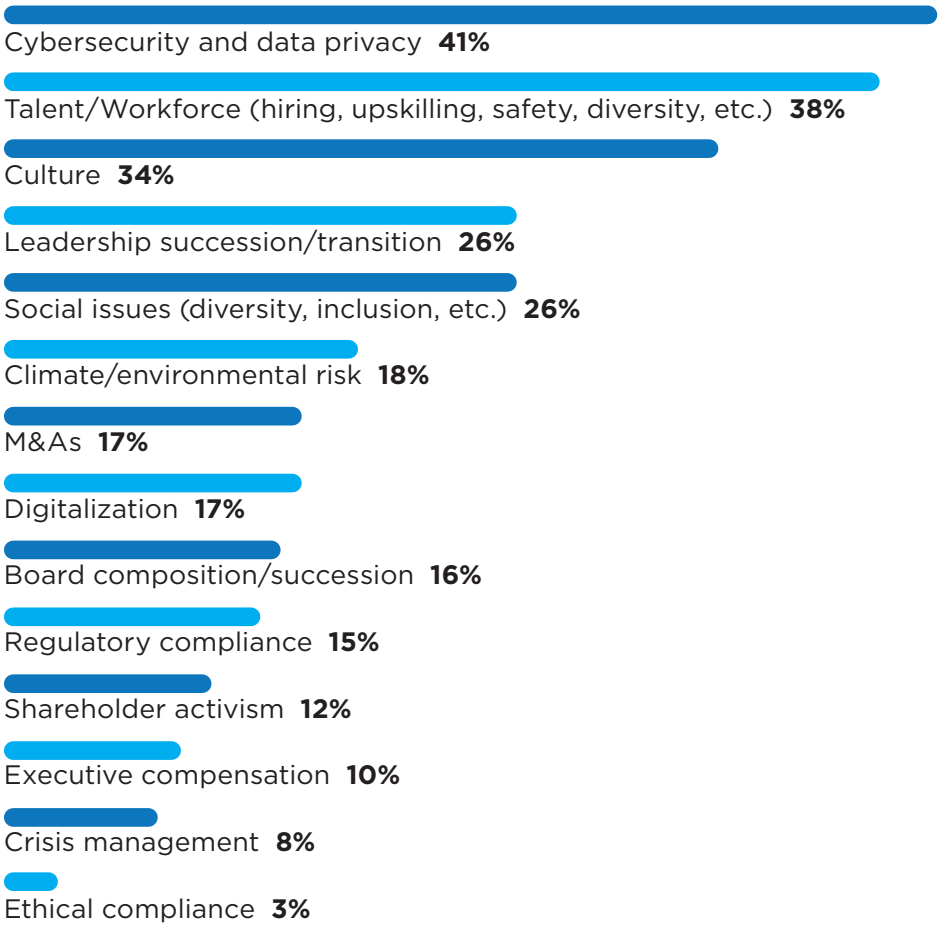
QUESTIONS YOU SHOULD ASK: **STRATEGIC OVERSIGHT**

Do the board and management understand how various operational and financial activities of the company work together to achieve the corporate strategy?

Have they determined what events might cause one or more of these activities to fail?

Are these risks being properly managed or mitigated?

MOST CHALLENGING ISSUES TO OVERSEE



**Respondents were asked to select top 3.*

Source: 2022 What Directors Think Survey, Corporate Board Member & Diligent Institute Research Report

Ensuring proper oversight of management's execution of strategy is a core board responsibility.

Leadership & Executive Compensation

One of the most critical jobs of the board of directors is to ensure the company has the right leadership at the helm to carry out the agreed-upon strategic objectives as well as to oversee a sound CEO succession plan. Doing so ensures continuity of leadership if a CEO unexpectedly departs or is subject to a forced turnover, provides confidence to shareholders and the market, and creates a sense of stability to employees and other stakeholders during times of transition.

QUESTIONS YOU SHOULD ASK: CEO SUCCESSION

- Is the CEO succession plan operational?
- Have qualified internal and external potential CEO candidates been identified?
- How will the company go about developing leadership criteria and assessing candidates against it?
- Does the company engage in the rigorous evaluation of internal talent and manage their development to support long-term succession needs?
- How are the competitive environment and strategic goals of the company evolving, and what will that mean for its future talent and leadership needs?

CEO EVALUATION

The board is responsible for conducting an objective evaluation of the CEO on a regular basis to ensure performance and leadership expectations are being met. While financial measures are used quite often to benchmark and measure CEO performance, CEOs are, at their essence, decision-makers who must be able to lead, inspire and garner respect. Thus, the board must be confident that the CEO is making decisions using an informed, objective process and setting the appropriate tone at the top for the entire organization.

SUCCESSION

The most critical element of engineering a successful leadership transition is for the board to oversee management's development of internal talent and identification of potential external candidates on an ongoing basis. The CEO plays a pivotal role in ensuring talent is being identified and mentoring primary candidates for an eventual leadership role. Yet the board holds the ultimate responsibility for and control of CEO succession as a part of its fiduciary responsibility to shareholders. Top areas of concern during succession planning include:

Developing a Future-Focused Criteria: Weigh emerging risks and opportunities when identifying the necessary leadership skills and experience.

Objective and Predictive Data: Consider outside assessments that can mitigate bias by providing useful objective and predictive data on candidates.

Consider Culture: Assess how well a new leader coming in from outside will work with the rest of the C-level team and employees. A poor cultural fit can derail a succession.

EXECUTIVE COMPENSATION

The board sets and oversees the executive compensation plan for the CEO and other named officers, in accordance with appropriate performance targets and in strategic alignment with the overall goals for the company. The environment for executive compensation is constantly evolving to respond to shareholders, the public and legislative and regulatory oversight of compensation matters. The ways in which executive compensation plans are structured can have far-reaching implications as they set the tone for performance expectations and cultural alignment.

The board's compensation committee holds primary responsibility for executive pay programs. (NYSE requires compensation committees to be composed entirely of independent directors; Nasdaq requires at least two independent directors.) Plans should be designed to attract, retain and motivate executives, while also aligning with corporate strategy. The most common elements of compensation packages include annual salary, annual bonus, stock options, restricted stock and performance shares. Certain limitations may apply depending on contractual or company policy matters, such as stock ownership guidelines, clawback provisions and deferred payout provisions.

SEC disclosure rules require that the annual proxy statements of public companies disclose the criteria used in reaching executive compensation decisions and the relationship between the company's executive compensation practices and corporate performance. As an outgrowth of the Dodd-Frank Act and codified by SEC rule 10D-1 in 2015, companies are required to disclose the median annual total compensation of all employees other than the CEO, the median annual total compensation of the CEO and the ratio of those two numbers.

The Dodd-Frank Act also requires that shareholders be given a chance to approve these plans on a regular basis (every one to three years) during the annual shareholders meeting in a "say on pay" vote. Risk of low shareholder support has led many companies to move away from pay practices deemed potentially problematic, such as inclusion of tax gross-up rights or single trigger severance arrangements. Dodd-Frank also requires that companies develop and disclose a policy for "clawing back" incorrectly paid incentive compensation, such when misconduct results in an accounting restatement.

QUESTIONS YOU SHOULD ASK:
EXECUTIVE COMPENSATION

How is the compensation package expected to attract, retain and motivate qualified executive talent?

What performance metrics are used, and how well do they align with the goals set forth in the business model?

Does the compensation program properly encourage short- and long-term performance without excessive risk?

SECTION 2:

BOARD STRUCTURE & OPERATIONS

The organizational structure of a board of directors is dictated by state law, federal regulations, its corporate charter and exchange listing rules. However, many aspects are also determined by the needs of each individual company. This section will discuss the basic tenets of board and committee structure, size, terms and primary leadership roles and responsibilities.

Board Composition

In recent years, pressure from internal and external stakeholders has been driving notable changes in board composition. While boards have traditionally sought to sure they have a good balance of perspectives and skill sets, greater emphasis on the need for diversity of gender, ethnicity and age has led boards to take steps to address shortfalls in the desired compositional mix. Robust evaluations of board effectiveness are key to ensuring boards maintain the proper blend of skills and objectivity to oversee strategy, monitor risk and fulfill their fiduciary responsibilities.

BOARD DEMOGRAPHICS
(ON AVERAGE)

BOARD SEATS (PER DIRECTOR)	TENURE (YEARS)	DIRECTORS ON A BOARD	AGE
2.1	10.7	11	63.5

BOARD SIZE AND DIRECTOR TERMS

When determining board size, companies consider independence requirements and desired board composition. Typically, the board's size, term limits and other specifications are set forth in the company's bylaws.

S&P 500 BOARDS BY THE NUMBERS

- **33%** of new appointments in 2018 were women*
- Women now fill **30%** of all board seats**
- **68%** of boards include at least one director born outside the U.S.**
- **38%** disclose a director skills matrix***
- **70%** report a mandatory retirement age***
- **6%** set explicit term limits

**S&P 500 Trend Report: Board Composition Diversity and Beyond, Diligent **2021 S&P 500 Board Diversity Snapshot, Spencer Stuart ***Board composition: The road to strategic refreshment and succession, Spencer Stuart, 2021*

DIRECTOR COMPENSATION

In recent years, the acceleration of regulatory changes and required disclosures have increased the time commitment and workload of board membership. Consequently, director compensation packages have changed in both design and execution. Typical director compensation arrangements include a mix of cash and equity retainers, with an average mix of 42 percent cash and 58 percent equity. The majority of companies provide additional compensation for committee membership, as well as retainers for non-executive chairs/lead directors and committee chairs. The majority also have stock ownership guidelines and holding requirements consistent with those for senior executives. Recent years have seen a move away from payment of meeting fees, which are now in place at only 16 percent of companies. Also trending are compensation limits for directors, which are now in place at approximately 68 percent of companies.

Source: FW Cook

DIRECTOR ELECTIONS

Traditionally, board members are elected for one-year terms; some boards have adopted two- or three-year terms with elections of members staggered so that an entire board cannot be replaced in any single year. Increasingly, however, staggered boards (also known as "classified boards") have fallen out of favor with investors, and today the vast majority of companies hold election of the full board at each annual meeting.

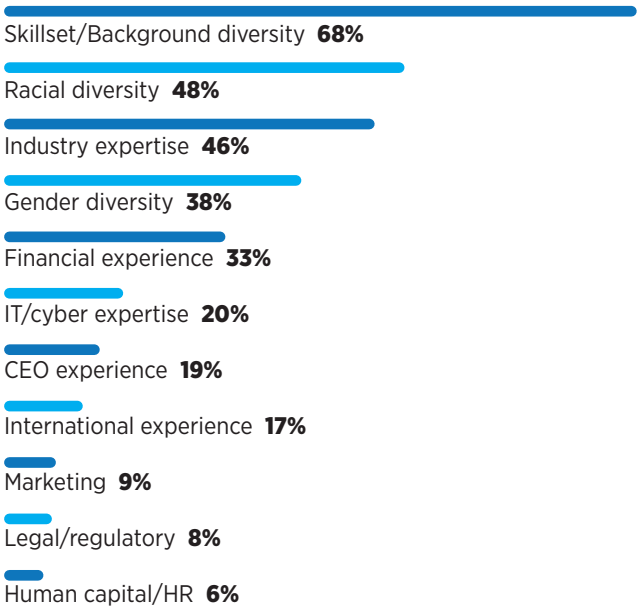
In general, directors are elected by the shareholders either by majority voting, which requires a simple majority of all outstanding votes, or plurality voting, where a director may be elected by virtue of receiving the most votes. The outcomes of these two methods can be vastly different: In a majority vote, even an uncontested director must affirmatively be voted in by a majority of shareholders; with a plurality vote, only one vote is needed to elect an uncontested director. In recent years, there has been a widespread push by shareholders for boards to adopt the majority-voting standard.

BOARD EVALUATIONS

While the majority of boards conduct annual assessments of the board's performance, the process varies widely. For example, in 2018, just 24 percent of boards evaluated individual board members, in addition to the full board and committees. Most boards conduct the assessment in house through surveys and interviews, but 22 percent used or considered using a third-party governance advisory firm or external counsel.

Source: EY Center for Board Matters

HOW IMPORTANT ARE THE FOLLOWING ATTRIBUTES TO THE SELECTION OF YOUR BOARD'S NEXT NEW MEMBER?



*Respondents were asked to select all that apply

Source: 2021 What Directors Think Survey, Corporate Board Member & Diligent Institute Research Report

In 2018, 24% of S&P 500 boards evaluated individual directors, in addition to the full board and committees.

Board Leadership Roles

The roles of the board chair, lead director and corporate secretary are all germane to an understanding of the board's operations and governance structure.

ROLE OF THE BOARD CHAIR

The chair of the board works closely with management to set the board agenda, plans and presides over meetings, facilitates discussion and communicates board priorities, policies and concerns internally and externally. In addition, the chair is expected to recommend committee heads and serve as an ex-officio member of all committee meetings. Chairs serve as a direct liaison between the board and management and are charged with ensuring that board members engage productively in conversations on strategic planning, enterprise risk management, director compensation, succession planning, director recruitment and mergers and acquisitions.

The board chair also coordinates the CEO's annual evaluation and the board's self-evaluation, and implements recommendations for improvement.

While approximately 41 percent of S&P 500 boards* combine the CEO and chair roles, separating the two roles has become steadily more common over the past decade.

** 2021 U.S. Spencer Stuart Board Index*

ROLE OF THE LEAD DIRECTOR

Pressure from investors and regulators for greater board independence has led to greater emphasis on the independent lead director role at companies that combine the chair and CEO roles. Following the passage of Sarbanes-Oxley, NYSE amended its listing requirements (the commentary to Section 303A.03 of the NYSE Listed Company Manual) to require listed companies to have non-management directors meet in regularly scheduled executive sessions without management, overseen by a "presiding" director. This requirement, combined with investor and regulator pressure, has strengthened the position of independent lead directors.

Typically, the lead director's primary responsibilities include:

- Serving as a sounding board and counsel to the chair
- Fostering a productive relationship between the CEO and the board
- Evaluating the chair's performance
- Leading the board and management in times of crisis

ROLE OF THE CORPORATE SECRETARY

Considered legal representatives of the corporation, a "corporate secretary" is required by state corporation laws for every corporation. Individual corporate bylaws set forth the powers and duties of the corporate secretary. A key responsibility of the corporate secretary is to ensure that board members have the proper advice and resources for discharging their fiduciary duties to shareholders under state law. A corporate secretary is responsible for ensuring that the records and minutes of the board's actions during a board meeting reflect the proper exercise of those fiduciary duties.

While the duty of recording accurate and sufficient documentation to meet legal requirements (record management) is of primary importance, the corporate secretary is also a confidante and resource to the board and senior management, providing advice and counsel on board responsibilities and logistics. In recent years, the corporate secretary has emerged as a senior, strategic-level corporate officer who plays a leading role in the company's corporate governance.

41% of S&P 500 companies combine the CEO and chair roles

**Spencer Stuart Board Index 2021*

Audit Committee

The SEC requires that all U.S. public companies have an audit committee—a longstanding mandate that was formalized by the 2002 Sarbanes-Oxley Act—and that each audit committee have a designated "financial expert." Both the New York Stock Exchange and NASDAQ also have audit committee mandates, including the requirement that audit committees be comprised entirely of independent members.

The primary role of the audit committee is to provide oversight and ensure integrity of the company's financial reporting, audit process, system of internal controls, disclosures and compliance with laws and regulations. However, its role has steadily expanded over the past decade to encompass oversight of risk management across the corporation, including escalating areas of concern such as digital transformation, cybersecurity, ESG and corporate culture. As corporate risks continue to evolve, so does the scope of the audit committee's purview, which generally entails capital markets investor protection framework.

The primary responsibilities of the audit committee include oversight of:

- financial reporting,
- changes in accounting principles and adequacy of internal controls,
- the internal and external auditors,
- fraud detection and prevention,
- identification of major financial risk exposures and plans to monitor and control risks and
- ethics and compliance

OVERSIGHT OF FINANCIAL REPORTING

Audit committee responsibilities require that committee members know and understand NYSE and NASDAQ auditing requirements. Audit committees must review financial communications, including financial statements and disclosures, earnings releases and earnings guidance, and evaluate such communications to ensure that they fairly represent the material financial positions of the company, as well as to ensure the disclosures are clear and transparent. In addition, it is the role of the audit committee to oversee management's systems of internal controls over financial reporting (ICOFR) and its disclosure controls and procedures.

OVERSIGHT OF EXTERNAL AUDITORS

Members of the audit committee are responsible for overseeing the appointment, retention, evaluation and compensation of the external auditor and for monitoring and ensuring that the external audit is an independent body. Periodically, the audit committee should hold executive sessions with the external auditor to ask questions without management present.

A number of laws and regulations address the audit committee's relationship with the external auditor, such as Section 301(2) of the Sarbanes-Oxley Act of 2002, which requires audit committees of listed companies to appoint, compensate, retain and oversee the external auditor, and Section 301 of Sarbanes-Oxley, which requires that audit committees establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal controls or auditing matters, as well as confidential, anonymous submission by company employees about questionable accounting or auditing matters. In addition, Section 922 of the Dodd-Frank Act provides financial rewards to individuals who provide information to the SEC with respect to securities violations and protects them against retaliation.

OVERSIGHT OF INTERNAL AUDITORS

In addition to communicating with and managing the relationship with external auditors, audit committees are responsible for reviewing with the external auditor the responsibilities, staffing and budget of the internal audit functions, as well as holding executive sessions with the internal auditor. Clearly articulated lines of communication and reporting among the audit committee, management and internal audit function are critical in order for internal audit to exist as an efficient, well-functioning model. It is crucial, therefore, for the chief audit executive (CAE) and the audit committee chair to have clear and ongoing communication and well-defined roles.

QUESTIONS YOU SHOULD ASK: **AUDIT COMMITTEE**

Is the committee acting in accordance with all legal, regulatory and other requirements?

Does the scope of the committee's work strike the right balance between required responsibilities and broader organizational risk?

Is risk oversight integrated? Are controls in place to mitigate all types of risks?

Does the committee monitor pending financial reporting and regulatory developments and how they may affect the company?

Does the committee stay abreast of changes in the operating environment that can introduce competitive pressures and risks?

Does the committee include members with financial and technological expertise germane to the issues the company faces?

Compensation Committee

Compensation committees are charged with developing incentive- and equity-based compensation plans for the CEO and executive officers. Compensation committees meet year-round to review and assess pay and performance targets, ensuring that pay packages align with the company's operating philosophy and long-term business goals.

Compensation committees are also responsible for analyzing and reviewing disclosures to ensure compliance with requirements, including those outlined in the 2010 Dodd-Frank Act. The need for more robust communication regarding equity plans, incentives, goal setting and other aspects of compensation has intensified in recent years due to pressure from regulators investors for greater transparency.

NYSE-listed companies are required to have fully independent compensation committees, based on independence standards that require consideration of the source of compensation for the director (such as consulting, advisory or other compensatory fees paid by the company) and whether the director is affiliated with the company. Under NASDAQ-listing rules, at least two members of the compensation committee must be deemed independent.

The primary responsibilities of the compensation committee include:

• Defining the company's compensation philosophy

• Setting CEO and executive performance objectives and goals, and reviewing performance relative to those goals

• Defining and recommending executive pay packages that align with business goals

• Drafting the compensation committee report that reviews the Compensation Discussion & Analysis (CD&A)

• Setting board compensation

• Hiring compensation consultants as appropriate

COMPENSATION PHILOSOPHY

A compensation committee must develop a compensation policy that aligns with specific business objectives to determine executive compensation goals. In addition, the SEC requires the CD&A to include discussion of such a policy.

CEO PERFORMANCE GOALS

In evaluating and setting chief executive officer compensation, a compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, a compensation committee should discuss whether, and to what degree, the criteria have been satisfied.

SETTING EXECUTIVE PAY

The committee is responsible for defining the compensation package for the company's senior executives, which typically consists of several components: base salary, annual bonus, short- and long-term incentives and benefits.

COMPENSATION COMMITTEE REPORT AND CD&A

The compensation committee report attests that the compensation committee has reviewed the Compensation Discussion & Analysis (CD&A) section of its annual proxy statement, discussed it with management and recommended its filing with the SEC to the board. The CD&A provides investors with information about the principal components of executive pay, the business rationale underlying the pay-plan design and the methods of calculation. Since the CD&A is the primary communication tool of the company's compensation philosophy to shareholders, the committee is responsible for ensuring the information is accurate. The CD&A is a critical component of shareholder communication as it can influence the outcome of the annual vote on executive pay.

DIRECTOR COMPENSATION

NYSE rules do not specify that responsibility for director compensation must be assigned to any particular committee. However, it should be made the responsibility of either a board committee (such as the compensation committee), the governance and nominating committee or the full board of directors.

OUTSIDE CONSULTANTS

Compensation committees are charged with hiring and overseeing compensation consultants, legal counsel and other committee advisers. Companies need to provide appropriate funding for the retention of such advisers. When engaging compensation consultants, legal counsel or other advisers, compensation committees will be required to consider certain independence factors to be determined by the SEC, including factors that examine the relationship between the employer of the consultant or adviser and the company. Public companies will also be subject to additional disclosure requirements regarding the use of compensation consultants.

QUESTIONS YOU SHOULD ASK: **COMPENSATION COMMITTEE**

Does the committee's compensation philosophy provide incentives that properly align performance and strategy?

Does the CD&A accurately and clearly communicate the business rationale for the company's compensation decisions?

Is the committee aware of the shareholders' views on compensation?

Nominating/Governance Committee

Recognition of the importance of diverse perspectives has led to greater scrutiny of selection, retention and succession practices at both the corporate and board levels, which, in turn, has raised awareness of the nominating/governance committee's role in shaping executive leadership and board composition. Today, this committee is at the center of many hotly debated questions about governance issues and policies, from whether to separate the chair and CEO roles to the pros and cons of setting term or board service limits.

The nominating/governance committee is responsible for oversight of composition, governance structure, operations and evaluation of the board and its committees; assisting the board with CEO succession planning; and identifying, evaluating and recommending director candidates to the board.

The primary responsibilities of the nominating/governance committee include:

- Oversight of board and committee composition
- Oversight of board function and evaluations
- Executive and CEO succession planning

BOARD AND COMMITTEE COMPOSITION

The members of the nominating/governance committee are charged with establishing criteria for board and committee membership as well as reviewing the structure of board committees. They also recommend candidates for board and committee membership and ensure new members meet applicable independence and qualification standards. Fulfilling this responsibility encompasses analyzing the skills and attributes of current directors against what the board needs, and adding expertise or bringing in outside experts to fill any gaps.

To help the board assess its leadership pipeline, some companies make a practice of giving the board an annual presentation of the top talent in the company and what is being done to build their skills and experience.

BOARD FUNCTION AND EVALUATION

Nominating/governance committees must develop and recommend a set of corporate governance principles, review policies related to board and committee meetings and agendas and establish procedures for retirement or replacement of board members. Within this scope, they are also responsible for managing the process and cadence of board, committee and individual director performance evaluations.

CEO AND EXECUTIVE SUCCESSION PLANNING

Leadership development and CEO succession planning are among the most critical functions of a board. Nominating/governance committees work to set and evaluate the processes in place for talent development and work with the CEO and full board to identify candidates for executive positions whose qualifications best suit the company's strategy for the future.

QUESTIONS YOU SHOULD ASK: **NOMINATING/GOVERNANCE COMMITTEE**

Does the committee have a process in place to uncover conflicts of interest or other potential issues relative to independence?

Are the board and its committees comprised of members with the right mix of skills and expertise to manage responsibilities appropriately?

What is the committee's mechanism to provide feedback to the board and committees after the evaluation process?

Does the company have a robust pipeline of executive talent and a regular process for evaluating its talent needs?

Does the board have a CEO succession plan, including provisions for an emergency transition and a process for regularly reviewing that plan?

SECTION 3:

COMPLIANCE

Corporate risk stems from a variety of issues and situations—operations, finance, compliance, investors—that are inherent in the operations of a public company. The board is responsible for ensuring that an effective corporate compliance program is in place, overseeing that program and taking regular steps to stay informed of the program's content and operation. This means directors must understand risk and compliance issues so that they may effectively challenge and assess how executives are managing risk from a performance and liability perspective.

Anticorruption

The adage "noses in, fingers out" is universally accepted in virtually every aspect of governance, but when it comes to the oversight of compliance risk, board members should ask whatever questions they deem necessary to ensure management is upholding a true culture of compliance. Moreover, to properly discharge their duties, directors must be confident that the company supports and follows a code of conduct, allows for reporting without recrimination and follows up on any wrongdoing or malfeasance that comes to light.

QUESTIONS YOU SHOULD ASK: **COMPLIANCE**

How are we assessing our risk on an ongoing basis?

How effective are our compliance and training programs?

How do we monitor the effectiveness of our compliance program?

Have we set the appropriate tone at the top?

Board members should ask questions to ensure management is upholding a true culture of compliance.

PREVENTING COMPLIANCE FAILURES

In April 2019, the U.S. Department of Justice issued a "Guidance Document" outlining factors the DOJ considers in determining whether to investigate or prosecute companies for compliance failures. The publication underscored the critical role boards play in overseeing corporate ethics and compliance programs, including the need for:

- Top leaders—the board of directors and executives—to set the tone for the rest of the company
- Compliance expertise to be made available to the board of directors
- Those responsible for compliance to have adequate autonomy from management, including direct access to the board of directors

The Foreign Corrupt Practices Act (FCPA) is the most notable anticorruption law since its reach is substantial, and violations can occur not only through direct evidence of an unlawful payment but also if there is a failure to keep accurate records of transactions or to comply with provisions of the FCPA dealing with accounting and control. Two provisions, in particular, are often used by prosecutors to reach a compromise on settlements, even when direct evidence of a bribe does not exist.

The FCPA applies to all U.S. persons and certain foreign issuers of securities, as well as to foreign firms and persons who cause, directly or through agents, an act in furtherance of a corrupt payment to take place within the territory of the United States. In 2016, the Department of Justice strengthened enforcement by adding enforcement personnel and increasing collaboration with foreign prosecution officials. Significant fines in the millions of dollars and possible imprisonment are applicable under a successful FCPA prosecution. More recently still, messaging from the federal government has indicated the possibility of a more aggressive approach to corporate investigations.

A NARROW EXCEPTION:

The FCPA provides a narrow exception for facilitation payments. The exception applies only to payments made to foreign officials with the purpose of facilitating or expediting routine governmental action. The exception focuses on the purpose of the payment rather than on its value. Facilitation payments that are not properly documented may violate the FCPA's accounting provisions.

ANTICORRUPTION LAWS

It is important for directors to understand the ramifications of several federal and w laws associated with anticorruption enforcement, which include:

The Foreign Corrupt Practices Act (FCPA)

This act makes it illegal for a company to make payments to foreign officials (who are defined broadly to include even low-level officials of government-owned companies) for the purpose of obtaining or retaining business. With proper documentation, there are exceptions for facilitation payments. (See column at left for more information.)

The UK Bribery Act

This act applies to UK companies operating abroad and applies to offering a bribe of any type, not just those to government officials. UK Ministry of Justice guidance encourages use of external verification or assurance of the effectiveness of anti-bribery policies.

The Bank Secrecy Act and Anti-Money Laundering (AML) Laws

These rules strengthen the government's ability to detect and report suspicious activity, such as securities fraud and market manipulation, that may be tied to money laundering and terrorist financing.

The Brazilian Clean Company Act

This act imposes strict liability on companies operating in Brazil for domestic and foreign bribery and provides no exception for facilitation payments, making it among the toughest anticorruption laws in the world.

The SEC's Whistleblower Program

Established in 2010, the SEC Whistleblower Program employs monetary awards to incentivize individuals to help the Commission detect wrongdoing. The program's rules were amended in 2020 to limit the SEC's whistleblower protections to individuals who report information in writing directly to the SEC. Enforcement actions from whistleblower tips have resulted in more than $2.5 billion in ordered financial remedies.*

**SEC.gov*

Insider Trading

Corporate officers and directors are often privy to financial and operational information that has not yet been made public. Directors and other insiders are restricted from trading on the basis of such knowledge or from sharing such information with others who subsequently make trades based on that knowledge. If such transactions occur, individuals have committed insider-trading violations that may be punishable with financial penalties or imprisonment. The SEC prioritizes the detection and prosecution of insider-trading violations because insider trading undermines investor confidence in the fairness and integrity of the securities markets.

Examples of insider-trading cases that have been brought by the SEC are cases against:

• corporate officers, directors and employees who traded the corporation's securities after learning of significant, confidential corporate developments;

• friends, business associates, family members and other "tippees" of such officers, directors and employees, who traded the securities after receiving such information;

• employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded;

• government employees who learned of such information because of their employment by the government; and

• other persons who misappropriated and took advantage of confidential information from their employers.

SEC RULE 10B5-1

This rule affords some protection to insiders regularly exposed to material, nonpublic information. It outlines procedures for legal insider trades, i.e., through the use of a third party to execute trades and by having such trade instructions based upon a stated algorithm and during a time when the insider did not have knowledge of material, nonpublic information. The rule also sets forth several affirmative defenses or exceptions to liability. Disclosure of trades is not required under this rule; however, transparent procedures for its adoption and use by companies are a recommended practice.

SEC RULE 10B5-2

This rule addresses the issue of when a breach of a family or other nonbusiness relationship may give rise to liability under the misappropriation theory of insider trading. The rule provides more clarity around this issue by setting forth three nonexclusive bases for determining that a duty of trust or confidence was owed by a person receiving information:

• whenever a person agrees to maintain information in confidence;

• when a past history, pattern or practice of sharing confidences exists between two parties such that the party receiving the information knows or reasonably should know that the disclosing party expects the information to remain confidential and

• when the disclosing party and the receiving party have a spousal, parent-child or sibling relationship.

DID YOU KNOW?

In November of 2018, Deputy Attorney General Rod J. Rosenstein announced the results of the Department of Justice's review and revision of policies governing efforts to hold individuals accountable for corporate misconduct. The revisions moderately modified policies announced in a 2015 memo by then-Deputy Attorney General Sally Yates entitled "Individual Accountability for Corporate Wrongdoing." Under the revision, the DOJ's policy holds that:

• To be eligible for any cooperation credit, corporations must provide to the DOJ all relevant facts about every individual substantially involved in or responsible for criminal conduct, regardless of their position, status or seniority, and provide all relevant facts related to that misconduct.

• Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation.

• Companies should actively engage with government lawyers and maintain clear lines of communication throughout the investigation.

• Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay, such as whether the person's misconduct was serious, whether it was actionable and whether the admissible evidence is likely to be sufficient to obtain and sustain a judgment and whether pursuing the action reflects an important federal interest.

• Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.

In 2020, the SEC enforced action on 33 companies, which represented 8 percent of the agency's 405 actions.

Source: *Annual Report for Fiscal Year 2020, Division of Enforcement, SEC*

SECTION 4:

DISCLOSURES & REPORTING

Government oversight of the capital markets began with the Securities Exchange Acts of 1933 and 1934, which created the Securities and Exchange Commission (SEC) regulatory body and mandated that companies disclose information so that investors can make informed investment decisions. The SEC requires annual reports (called a Form 10-K), quarterly reports (called a Form 10-Q) and reports about certain important events (called a Form 8-K). The Exchange Act also mandates disclosure during proxy contests—when various parties might solicit an investor's vote on a corporate action or to vote for certain board members—as well as information by anyone seeking to acquire more than 5 percent of a company's securities by direct purchase or tender offer.

Financial Reporting & Controls

Passed in the wake of accounting fraud scandals at Enron and other companies, the Sarbanes-Oxley Act of 2002 mandated a number of reforms to enhance corporate responsibility and financial disclosures, as well as to combat corporate malfeasance and fraud. Thus, the board's effective oversight of the legal mandates set out by Sarbanes-Oxley is integral. Here are several key areas for directors:

SECTION 302

The act covers corporate responsibility for financial reporting. Under this section, the company's CEO and the CFO must certify financial reports and in so doing, attest that they are accurate and do not contain omissions or misleading information, fairly represent the company and that the company's internal controls have been reviewed and are adequate.

SECTION 401

Under this section of the act, companies must publish financial statements that are accurate and include all material off-balance-sheet liabilities, obligations and transactions in an effort to promote transparent reporting.

QUESTIONS YOU SHOULD ASK **INTERNAL CONTROLS**

Has the board robustly challenged management's assumptions that underlie accounting judgments and estimates?

Have there been any significant or unusual transactions or events that would create a risk of material misstatement?

Are accounting policies consistent with others in the industry?

Do policies provide appropriate incentive to achieve the goals set forth in the business model?

SECTION 402

This section stipulates that companies must publish a statement within their annual statement that describes the scope and adequacy of internal controls. It also states that the registered accounting firm for the company must attest to the internal controls and financial reporting procedures. If a deficiency is found, the auditor must communicate it to management and to the audit committee. Any material weaknesses must be disclosed in the company's 10-K filing.

SECTION 802

Finally, this section created criminal penalties, including fines and up to 20 years imprisonment for altering, destroying, mutilating, concealing or falsifying records, documents or tangible objects with the intent to obstruct, impede or influence a legal investigation.

SEC Reporting

The annual report to shareholders is a document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the CEO, financial data, results of operations, market segment information, new product plans, subsidiary activities and research and development activities on future programs. Reporting companies must send annual reports to their shareholders when they hold annual meetings to elect directors. Under the proxy rules, reporting companies are required to post their proxy materials, including their annual reports, on their company websites.

The company's annual report to shareholders is distinct from the annual report on Form 10-K, which must be filed with the SEC and which often contains more detailed information about the company's financial condition than the annual report to shareholders. It will also include the annual financial statements of the company. Companies sometimes elect to send their annual report on Form 10-K to their shareholders in lieu of, or in addition to, providing shareholders with a separate annual report.

All directors should review the 10-K report, understand the disclosures within and be provided with the opportunity to comment and ask questions before it is filed. Directors are not expected to independently verify the facts within a report but should be satisfied with the governance controls in place to ensure accuracy of reports and public releases. The CEO and CFO are required to review and certify the information within quarterly and annual reports and, in so doing, attest that they are accurate and do not contain omissions or misleading information and that the company's internal controls are adequate. Smaller public companies that are not "accelerated filers" or "large accelerated filers" are exempt from Sarbanes-Oxley internal control requirements.

If events or conditions cause a company's financial condition to undergo material changes, the company is obligated under Sarbanes-Oxley Section 409 to immediately disclose such material facts to the public. These disclosures are to be presented in terms that are easy to understand, supported by trend and qualitative information and graphic presentations as appropriate.

Additionally, under the SEC Rule 10b-5, there are civil or criminal ramifications for disclosing misleading, deceptive or manipulative information. Rule 10b-5 declares that it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange to:

- employ any device, scheme or artifice to defraud,
- make any untrue statement of a material fact or to omit stating a material fact necessary in order to make the statements not misleading or
- engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

The rule is quite sweeping in its definition of illegal behavior and prohibits misrepresentations, half-truths, omissions and concealments of after-acquired information. Furthermore, it stipulates deception may be accomplished either by words or by nonverbal conduct.

REGULATION FAIR DISCLOSURE

When material information is disclosed to any investor or group, it must be disclosed publicly under Regulation Fair Disclosure. The SEC considers information to be material if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.

The following are examples of information that, if disclosed, the SEC would likely consider as material:

- earnings information
- mergers, acquisitions, tender offers, joint ventures or changes in assets
- new products or discoveries;
- developments regarding customers or suppliers, such as the acquisition or loss of a contract
- changes in control or management
- defaults on senior securities
- stock splits or dividends
- change in auditors or auditor notification that an issuer may no longer rely on an auditor's report
- redemptions or repurchases of securities
- public or private sales of securities
- bankruptcy

There is often confusion about when Reg FD applies to communications and when it does not. Reg FD does not prohibit an issuer's directors from speaking privately with a shareholder or groups of shareholders—provided a director does not disclose material nonpublic information during those meetings. Alternatively, the SEC has said, a private communication between a director and a shareholder would not present Regulation FD issues if the shareholder expressly agrees to maintain the disclosed information in confidence. However, the SEC also recommends pre-clearing discussion topics with the shareholder or having counsel participate in the meeting.

Federal securities laws are driven by the principle that investment and voting decisions should only be made on the basis of full disclosure of all information necessary "to bring into full glare of publicity those elements of real and unreal values which lie behind a security." These laws make it unlawful to disclose any untrue statement of material fact or to omit a material fact that is necessary to prevent statements already made from becoming misleading in connection with the purchase or sale of securities.

The general rule that has judicially evolved for determining the materiality of particular information is whether there is a substantial likelihood that a reasonable investor would have considered the information important in making his or her investment or voting decision. Put another way, there must be a substantial likelihood that the misstated or omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.

> Material information is information that an investor would consider important when considering an investment decision.

SECTION 5:

BOARDS & SHAREHOLDER ENGAGEMENT

Traditionally, boards of directors' primary shareholder engagement responsibility has been ensuring that the company is communicating accurate, objective and timely information in its regulatory filings and disclosures throughout the year and at the annual shareholder meeting. However, recent years have seen investors and proxy advisors seeking direct engagement with directors, particularly with respect to executive compensation, ESG and risk management.

Shareholder Landscape

SHAREHOLDER ENGAGEMENT LANDSCAPE

Changes to the corporate governance landscape over the past two decades have led corporate boards to play a greater role in how companies engage with their shareholders. The shift began with passage of the Sarbanes-Oxley and Dodd-Frank legislations that expanded oversight responsibilities and shined a spotlight on financial and corporate governance matters within U.S. public companies. That higher level of scrutiny from the public sector was further exacerbated by the proliferation of institutional investors that used their financial clout to influence the composition and governance practices of corporate boards. Boasting more than $61 trillion in assets (as of year-end 2020),* these investors have been increasingly active in their engagement of portfolio companies and influential with regard to their approach to proxy voting decisions.

In addition, institutional funds have become more supportive of shareholder activist campaigns, of which there were 182 in 2020, with M&A the most common objective, featuring in 41 percent of campaigns, according to Lazard's Shareholder Advisory Group. Other objectives gaining momentum include calls for greater diversity and adoption of sustainability strategies.

Taken together, these shifts are playing a pivotal role in changing both how and when companies engage with their shareholders—many of which now do so in greater depth and year round rather than only during proxy season. While the topics of engagement are unique to each company's strategy and challenges, there are some common threads. Increasingly, shareholders are asking companies to:

- clearly articulate a vision for the business,
- explain the rationale for capital allocation,
- enhance sustainability reporting and/or adopt sustainability strategies,
- outline a well-vetted strategic plan,
- demonstrate they have the right people in place to achieve objectives and
- provide the rationale behind executive compensation plan.

If shareholders believe a company's management and board are falling short in any of these objectives, they seek to effect changes they believe will increase shareholder value. Tactics range from friendly to aggressive—from asking to engage with management and the board about their concerns to gearing up for an all-out proxy battle, which can be costly and distracting for all involved.

**Boston Consulting Group*

Representing approximately 59% of global assets under management, institutional investors often exert considerable influence on governance, especially the alignment of management and shareholder interests.

There are two broad categories of shareholders: institutional and individual. Within each category, investors may be classified by their activity level as passive or active.

INSTITUTIONAL INVESTORS

The universe of institutional investors includes mutual funds, pension funds, endowments, insurance companies and a wide variety of hedge funds and managed accounts, many of which are unregulated. Institutional investors may be passively managed (i.e., index funds) or actively managed, depending on the turnover of the portfolio and whether their objective is to match or try to beat the market. Actively managed portfolios partake of both long-term investing behavior (e.g., establishing and maintaining a position in a desired stock, often for years) and short-term buying and selling (e.g., to adjust the size of a portfolio position in reaction to one or more macro and micro factors affecting the portfolio company).

The role and influence of institutional investors such as Vanguard, BlackRock, State Street and others has grown over time, as has the proportion of U.S. public equities managed by institutions. These groups often exert considerable influence on positions related to governance, especially as it relates to the alignment of managements' and shareholders' interests. They do so by voting for management recommendations on company-sponsored proxy matters such as equity-based compensation plans, director elections, ESG practices and bylaw amendments. BlackRock, for example, reported voting against one or more management proposals at 37 percent of the 16,200 shareholder meetings at which it voted during the 2019-2020 reporting period.*

** Investment Stewardship Annual Report, BlackRock*

INDIVIDUAL INVESTORS

There are two broad types of individual investors that are best described by their level of activity in the stock: passive retail investors and active investors, sometimes referred to as activists.

Passive retail investors are characterized by their large number but small influence, based upon their relatively small holdings. Activists, on the other hand, are relatively few in number but wield considerable influence by virtue of their percentage of holdings in a company's stock, which garners the attention of the board, management and, often, the public at large and legally affords them access to submit proposals on a company's proxy. Exemplified by investors like Carl Icahn, Bill Ackman (Pershing Square), Nelson Peltz (Trian) and Starboard Value, activists' sphere of influence has been steadily growing, as signified by a significant uptick of proxy battles, often resulting in favorable outcomes for activist investors.

Engagement Practices

ENHANCING ENGAGEMENT

At at time of heightened investor expectations, a proactive approach to shareholder engagement by management and the board is essential. In addition to the disclosures proxy statements are required to include, today's shareholders want a better understanding of how things like incentive compensation, diversity metrics and ESG initiatives fit into the organization's long-term strategy.

Many shareholders are also closely monitoring who is representing them in the boardroom and evaluating those directors more rigorously. In cases where shareholders are not satisfied with a company's understanding of and response to their concerns or are unhappy with its track record on engagement, they increasingly seek to place candidates on the nomination slate.

The advent of proxy access has opened an easier path for such shareholders, who can add their own nominees to the company's proxy card under the so-called 3/3/25 standard adopted by most companies—that is, they must hold at least 3 percent of the stock for three years and can nominate up to 25 percent of a board's slate. This lets investors avoid the cost of sending out their own proxy cards when they are dissatisfied with a corporate board and want to run their own candidates for director.

In 2020, according to Lazard's Shareholder Advisory Group, activists succeeded in obtaining 131 board seats, a figure that underscores the importance of making a persuasive argument that the current board leadership is providing appropriate guidance and oversight and is the right group to carry the company forward.

BOLSTERING COMMUNICATIONS

Acknowledging the shifting engagement landscape, many boards have been opening conversations with large investors between September and December, before the burden of proxy season gets started, to articulate their strategy and objectives and address any concerns. Some invite their largest shareholders for limited presentations with the board, engage with organizational groups such as the Council on Institutional Investors or meet with proxy advisory firms to gain a better understanding of their investor base. Another good strategy may be to proactively reach out to top shareholders when a new board member joins the fold to ensure the board's vision and intentions are clearly understood. More frequent communication can lead to a better understanding and higher comfort level with management and board decision-making.

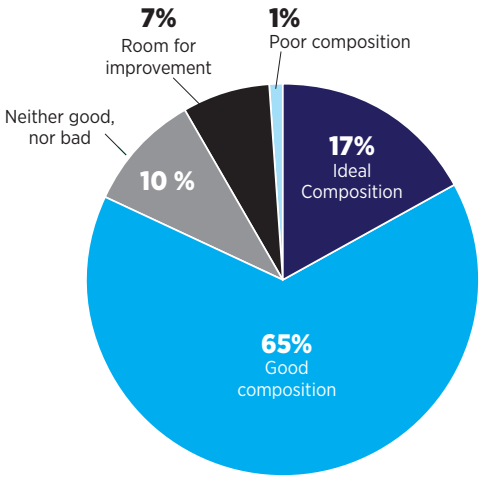
Boards should discuss and review shareholder communications plans regularly, especially within the context of any new development or challenge the company is facing. Discussion should include determining who on the board is the best spokesperson to speak on behalf of the board in shareholder meetings. In most cases, this individual would be the chair or the lead director, but in others, another director, perhaps someone with expertise in a given area, may be in the best position to assume that role.

ADDRESSING COMPOSITION CONCERNS

The quality of board composition is increasingly becoming a top priority for shareholders, yet boards have been slow to proactively address it. Only 6 percent of S&P 500 boards have term limits, according to the 2021 Spencer Stuart Board Index; most boards still use age as the mechanism for refreshment, with more than half having a mandatory retirement age of 75 or older. Many directors, therefore, are comprised of longtime members. To shareholders, these boards appear entrenched, which raises concerns about their collective competency moving forward.

Board evaluations can play a key role in addressing areas of concern or vulnerability on an annual basis. Boards need a process within their nominating/governance committees to demonstrate that board evaluation is not simply a process on paper but one that is live and ongoing, and communicate that effectively to shareholders.

HOW DIRECTORS RANK THEIR BOARD COMPOSITION



Source: 2021 What Directors Think Survey, Corporate Board Member & Diligent Institute Research Report

Communicating with Investors

SHAREHOLDER PROPOSALS

One of the most common ways for shareholders to focus management's attention on an issue is by filing a shareholder resolution (also known as a shareholder proposal), which is a right granted by the SEC under Rule 14a-8. Proposals are recommendations for a specific course of action to be voted on at shareholder meetings. Proposals may address a wide range of matters, including the election of board members, the issuance of additional stock, a proposed merger or acquistion, an amendment to the articles of incorporation and bylaws or executive compensation. The board of directors recommends in the proxy materials whether it supports or opposes management and shareholder proposals.

Once a company receives a shareholder proposal, it may choose to include the proposal in its proxy materials, work with the shareholder toward a mutually agreeable solution (which may include withdrawal of the proposal) or submit a no-action request to the SEC in order to exclude the proposal from the company's proxy materials.

Shareholders who do not want to rely on the company's proxy materials and who may be circulating their own proxy statement and proxy card must give the company at least a 120-day advance notice of their proposal. To be eligible to submit a proposal, a shareholder must own at least $2,000 in market value, or 1 percent, of a company's outstanding stock for at least one year, and they must continue to hold those shares through the meeting date.

Common reasons a no-action request may be granted include if the proposal:

- is not a proper subject for shareholder action under state law,
- would violate a law if adopted,
- is materially false or misleading,
- relates to a matter of the company's ordinary business operations or
- has already been substantially implemented.

Shareholder advocates use their position as owners of a company to "open the boardroom door" to ideas or voices that may not routinely be entertained there. This is possible because a properly crafted resolution—one couched in terms of long-term shareholder value—speaks to the core of a board of directors' fiduciary duty to serve shareholders.

Common changes shareholders push for:

- Shifts in capital allocation
- Diversity in management and in the boardroom
- Adoption of ESG practices
- Change of CEO/management
- Sale of the company
- M&A activity
- Structural changes
- Bylaw changes
- Return on capital
- Operational changes
- Board seats
- Governance change

ANNUAL MEETINGS AND PROXY DISCLOSURES

Traditionally, companies stay in touch with shareholders through an annual meeting and proxy statement filings. Every public company in the U.S. is required by its charter documents, the corporate law of its state of incorporation and federal securities laws to hold a meeting of shareholders at least once each year. The annual meeting allows shareholders to express a judgment on management's stewardship of their company, allows management to obtain shareholder approval of important matters and provides a forum for management and shareholders to discuss the progress and direction of the company's business.

INVESTOR RELATIONS FUNCTION

The investor relations function is responsible for controlling the flow of information between a company, its investors and its stakeholders by:

• providing financial information to investors in a timely and accurate way,

• receiving investor feedback and presenting it to the company's management and board and

• representing the company to the investors and the investment community to the company.

PROXY ADVISORY FIRMS

Proxy advisory firms provide institutional investors with research and proxy proposal recommendations that are voted on at a company's annual meeting. In 2003, the SEC enacted a rule allowing institutional investors to rely on advice from third-party advisory firms to fulfill their fiduciary obligations when voting their shares. The influence proxy advisory firms now have on the level of support a shareholder proposal receives is a hotly contested issue.

The primary proxy advisory firms in the U.S. are Institutional Shareholder Services (ISS) and Glass Lewis. Each year, the firms update their proxy voting policies to include guidance on current issues. Recent areas of focus have included board diversity and refreshment, oversight of ESG matters, executive compensation and shareholder rights policies.

Shareholder Activism

Activist investors, or shareholders who advocate for changes at a publicly traded company, have gained momentum in the U.S. capital markets over recent years. The nature and degree of activism varies by investor. Some take an aggressive approach, publicly pushing for a specific event, such as a leadership transition, divestiture or operational restructing, in the hope of boosting the company's stock price. Others target underperforming companies where they see issues or concerns, such as outdated executive pay practices, poor leadership, flaws in board composition or lack of transparency, pressing for changes they view as a path to better performance.

Given the prevalence of activist investors armed with financial firepower and complex, well-researched analyses, it's important that boards take steps to mitigate the risk of finding themselves targeted by an activist investor:

- Conduct a candid and constructive assessment to identify and address areas of perceived weakness.
- Consider adopting a stock surveillance program.
- Identify areas of vulnerability, such as transactions that could be viewed as ways of "unlocking value" or a cash heavy balance sheet.
- Formulate an activist team that will respond to a contested election, proxy proposal or other campaign.

U.S. ACTIVIST DEMANDS BY TYPE

(Breakdown of public activist demands made at U.S.-based companies by time period)

	Full Year						
Demand Type	2014	2015	2016	2017	2018	2019	2020
Balance Sheet	10%	12%	9%	8%	7%	8%	9%
Board-Related	41%	42%	44%	41%	39%	44%	38%
Business Strategy	9%	8%	5%	7%	7%	4%	4%
M&A/Breakup	18%	19%	17%	14%	17%	15%	10%
Other	1%	1%	2%	3%	2%	1%	6%
Other Governance	16%	13%	19%	23%	24%	23%	27%
Remuneration	5%	5%	4%	5%	4%	5%	5%

Source: Activist Insight, January 2021

WHAT ACTIVISTS LOOK FOR

• Does the company deliver low shareholder returns, especially relative to its peers and industry benchmarks?

• Does the current capital structure offer potential ways in for activists and options to exert influence?

• Is the company "hoarding" cash, or does it have a cash-heavy balance sheet capable of having a leveraged recapitalization and paying a dividend to stockholders?

• Has the company suffered execution challenges and thus may be ripe for strategic and operational optimization, such as reducing its cost structure to increase operating income and free cash flow?

• Is the company in a rapidly consolidating or disrupted industry where a case could be made that stockholders would benefit more from its sale rather than the risk of continuing operations?

• Would the proceeds of splitting up the company and selling off divisions now materially exceed expected future market capitalization of remaining whole?

• Does a particular business unit demonstrate poor margins, growth, returns on assets or returns on capital that suggest it is a drag on the stock price?

• Does the board have long-tenured directors viewed as potentially too close socially or otherwise to management?

• Does the company's compensation program include any unusual or out-of-market perquisites for management or generous separation or change-of-control packages?

• Is the CEO's compensation package comparable to those of his or her peer company CEOs?

Conclusion

The fiduciary duties that directors owe to shareholders constitute the centerpiece of U.S. corporate governance and provide a foundation of strength, confidence and reliance on the modern capital markets system. As a prime objective, therefore, directors must assume these responsibilities with clarity and a full understanding of the legal and regulatory framework and the ethical principles that underpin an increasingly complex corporate environment.

Key Takeaways

• By law, directors have a duty of loyalty to act in the best interest of the corporation and a duty of care to act in good faith. The business judgment rule protects directors and prevents judicial second-guessing as long as boards follow a rational process for decision-making within the context of the duty of care.

• Directors must adhere to standards of confidentiality and understand the concept of materiality with regard to disclosure of information about the company.

• There are several protections for director liability, including corporate indemnification, statutory indemnification and directors and officers (D&O) liability insurance.

• The primary role for a public company board member is to oversee strategy and risk and to ensure the proper executive leadership is in place.

• Each board must designate either a chair or lead director to act in the capacity of an independent board leader to preside over board meeting discussions, plan and prioritize agendas, and communicate internally and externally.

• Standing committees at public companies include an audit committee, a compensation committee and a nominating/governance committee, each with a specific mandate of responsibilities and a charter. Other committees may be created on an ad hoc basis.

• The board should set the proper tone at the top and oversee adherence with regulatory compliance, ethics, SEC reporting and internal controls.

• Shareholder engagement is an increasingly important issue for boards, and directors must listen, respond and communicate with shareholders to ensure they articulate the corporate strategy and risks, as well as to provide meaningful information and assurances for shareholders to make sound investment decisions.

Corporate Board Member *has developed this guide to provide an overview of principles to assist new directors during the onboarding process as well as a periodic refresher for current or longstanding directors. The information within the guide is by no means exhaustive; for those wishing to learn more,* Corporate Board Member *recommends discussing questions and issues with your company's general counsel or corporate secretary for additional guidance and resources.*

CORPORATE BOARD MEMBER®

Corporate Board Member, a division of Chief Executive Group, has been the market leader in board education for 20 years. The quarterly publication provides public company board members, CEOs, general counsel and corporate secretaries decision-making tools to address the wide range of corporate governance, risk oversight and shareholder engagement issues facing their boards. *Corporate Board Member* further extends its thought leadership through online resources, webinars, timely research, conferences and peer-driven roundtables. The company maintains the most comprehensive database of directors and officers of publicly traded companies listed with NYSE, NYSE Amex and Nasdaq. Learn more at BoardMember.com.

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