REPRINT | FINANCIER WORLDWIDE MAGAZINE

SPECIAL REPORT

# OPERATING AN EFFECTIVE BOARD

REPRINTED FROM:
MAY 2013 ISSUE

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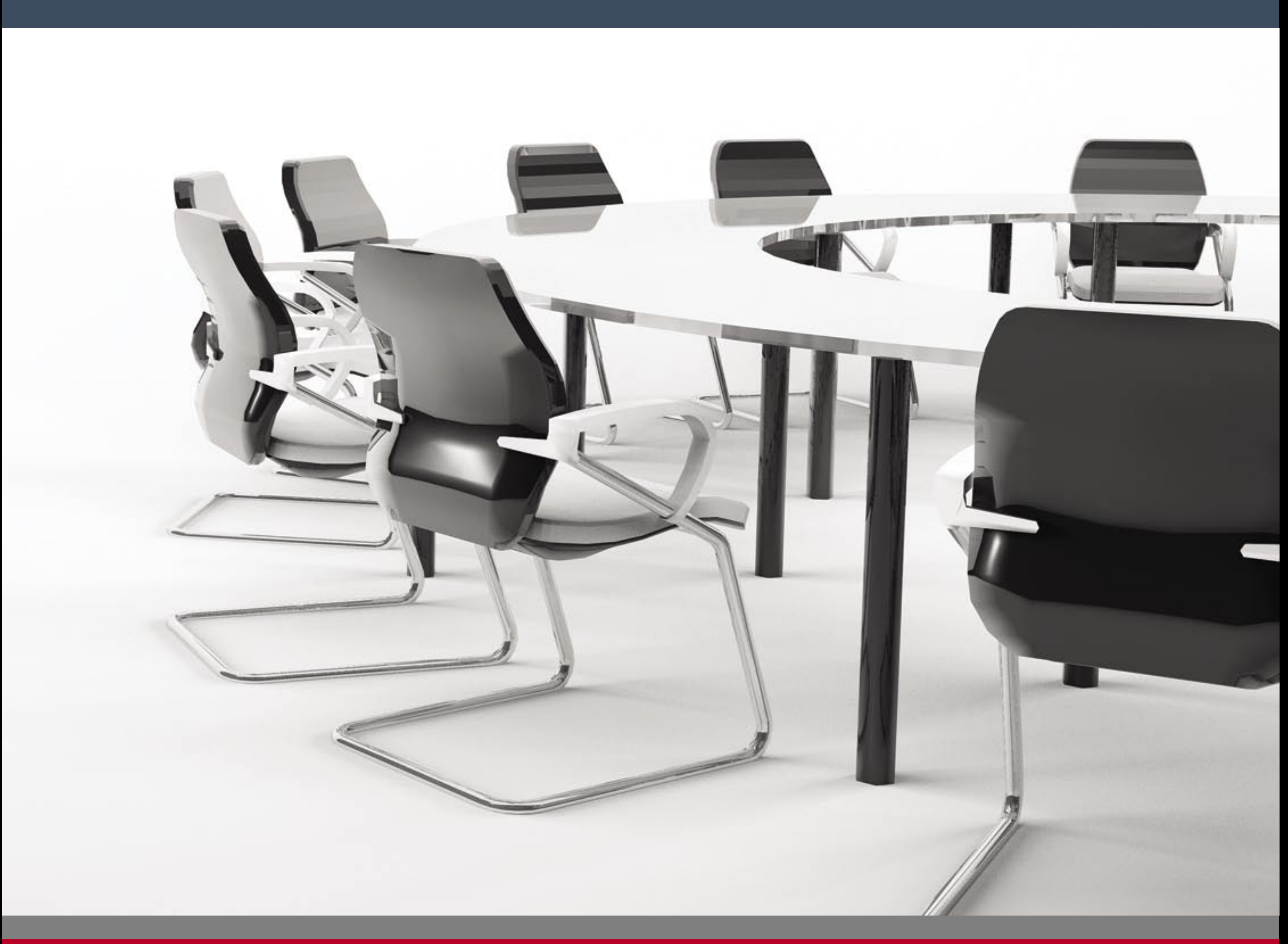
FW MAGAZINE

FINANCIER WORLDWIDE corporatefinanceintelligence

# Operating an effective board



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## FORUM

# Executive compensation and the pay-for-performance challenge

FW moderates a discussion on executive compensation between Pamela Baker at Dentons US, Carl Sjostrom at Hay Group, James E. Gregory at Proskauer, and Jens Massman at Ernst & Young.

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Dr Carl Sjostrom advises companies on the compensation of senior executives and associated corporate governance issues. He has been working with compensation advice for over 18 years, based in the UK, Hong Kong and the US. His career includes partnerships at two 'Big Four' advisory firms in London and, before joining Hay Group in 2011, he was global head of Compensation & Benefits at Ericsson, based in his native Sweden.

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***FW: How would you describe media and public perceptions of executive pay in the current economic climate? What progress has been made on the issue since the onset of the global financial crisis:***

***Baker:*** The man-on-the-street public, incited and urged by the popular media, perceives executive compensation as too high, full stop. Eye-popping bonuses appear excessive with unemployment remaining high. Most of the clients I work with, however, genuinely seek to satisfy both shareholder interests, limiting the equity plan 'burn rate', and public interests – that is, the ratio of CEO pay to median pay. In recent years perks and tax gross-ups have largely been eliminated, as have many automatic payouts on a change in control. In addition, cash severance amounts for top executives have been reduced. Companies are careful to call performance-based annual incentive pay just that, not a 'bonus'. Performance criteria are heavily weighted to financial results. This is a very long way from the status quo a decade or more ago.

***Massmann:*** The media and public continue to perceive executive pay as high and often disconnected from company performance. However, we believe that shareholders are gaining greater confidence in company approaches to executive pay given the changes that are occurring globally regarding shareholders' ability to influence, and in some cases control, executive pay decisions. In general, transparency has increased due to changes in regulations regarding executive pay around the globe. These changes are in large part a result of the global financial crisis and continue to evolve as the global economy continues to recover. The media continues to scrutinise executive pay and occasionally creates issues without underlying shareholder concerns. Say on pay approval rates remain very high despite media coverage. To many companies' credit, they are seeking a closer alignment with their executive pay to the company's financial and total shareholder return performance. Much of the recent activity in the executive compensation area is a result of increased shareholder engagement earlier in the process. This has led to newer concepts like pay at grant, realisable pay, and take home pay. As a result, compensation committees must manage media relations in addition to investor relations.

***Sjostrom:*** Public perceptions continue to be fuelled by the media, which politicians across the spectrum encourage by keeping the debate very emotional. In spite of many commentators trying to separate the technical from the emotional arguments to provide a greater understanding, it remains the case that in a difficult economic climate you will never gain broad support for high levels of remuneration, no matter how well deserved, linked to performance or market aligned. The worry is hence less public perception than it is that countries' leaders are unwilling to engage in discussions around how improvements can be made to executive pay to support economic recovery.

***Gregory:*** Both the general media and the public tend to focus on proxy disclosure, which is governed by specific accounting and securities rules. In fact, 'actual value' to executives can vary widely up or down. Also, there is an accounting expense or disclosure required for equity awards, even if those awards may never vest. Clearly there are many examples of misalignment between company performance and executive pay, and media reports tend to focus on these outliers. Readers should be sceptical when they see reports about pension and deferred compensation benefits – in many cases, these amounts have been earned or accrued for many years, yet they are treated as though the company decided at the time of termination to make giant multi-million dollar payouts – this often just isn't the case. Since the financial crisis, progress arguably has been made with new rules that enhance compensation committee independence and require further transparency, although there is widespread disagreement about the overall effectiveness of these rules.

***FW: Are companies finding it tougher to retain top talent in the current market?***

***Massmann:*** We don't necessarily see it being more difficult currently, as compared to prior years, to retain top talent; however, the focus on retaining top talent continues to be a priority for all high performing companies around the world. As the economy continues to improve, especially in high growth markets, companies have to be more creative and aggressive in designing compensation programs that will both motivate and retain top talent. The perceived value of executive remuneration has declined given mandatory deferrals, long-term orientation of pay and increased base pay – particularly outside the US. As it has been in the past, top talent is always more difficult to retain in dynamic situations beyond the steady state, for example in restructurings, and so on.

***Sjostrom:*** In difficult times mobility slows down, but that means that it is to some extent bottled up. More of an issue though is that retention of top talent is critical for capitalising on recovery. A lot of recent European regulations are not encouraging retention and our expectation is that the consequence is less an immediate exodus but more likely slower growth. Take the Financial Services sector, for example. We expect that some people will react to reduced pay levels and leave the industry but, most of all, firms will be reluctant to make investments in regions that introduce erratic regulations that micromanage their operations and perhaps restrict their ability to recruit the required quality of talent.

***Gregory:*** I get the sense from my CEO and executive clients that they are much, much more willing to walk away now than they were for the last three to five years during the recession. So yes, given this trend there seems to be a bigger push to retain top talent. Many top executives at public companies just feel like it is not as much fun and less rewarding than it used to be and of course the scrutiny is much greater. Also, in the financial ▸▸

services sector, many more clients seem to be considering moving to privately-held hedge funds or private equity funds, and getting out of the public company and regulated banking sector altogether. However, much of what I and others hear is anecdotal and it remains to be seen whether this represents something more systemic.

*Baker:* Rumours of executives moving to private equity concerns to avoid pay disclosures are exaggerated. Financial institutions under compensation strictures may have had trouble retaining top talent, but generally companies are able to find appropriate talent. Companies will fare better or worse, depending on the trends in their financials and stock price. A company perceived as tightening its belt more than its competitors in the financial crisis may lose some high and mid-level talent. Although companies have reduced the number of personnel eligible for stock options, these cutbacks have had little effect on the ability to retain talent. At levels where equity compensation is critical to retention, options have been replaced by restricted stock or restricted stock units, which retain value even if the stock price falls, unlike options. As the US stock market continues to climb out of the depths, equity is becoming a popular retention tool again.

***FW: In your opinion, can executive performance be accurately quantified? Do current models of executive pay motivate executives toward higher levels of performance?***

*Sjostrom:* Of course, executive performance can be accurately quantified – much of it has very tangible outcomes. However, all executive performance cannot be measured at the same time, nor can every aspect of it. Performance is in the eye of the beholder, which is why it is so important to be clear about what it is we are talking about when discussing the design of executive reward. This is also why there is such conflict when companies are accused of not paying for performance. They are always paying for performance, it just may not be the level and type of performance that you want to see. Pay and motivation is very tricky and there is an intense debate with contradictory research being thrown behind all sides of the argument. As far as I am concerned everybody is motivated by pay, the problem is that the extent is very individual. Some people will do vile things for a small banknote whilst others will refuse to compromise for a fortune – hence we cannot rely on the motivational effect when it comes to reward but we can rely on it for signalling. Pay is one of the loudest forms of communication an organisation, and its shareholders, can use to signal what behaviours and what outcome are important.

*Gregory:* It really depends on the company and the industry. I don't think anyone seriously disputes that pay models can motivate performance. In any event, how do you measure 'higher levels of performance'? Short term profits? Long term growth? Market share? That is the problem nowadays – what are we rewarding and at who's expense? If the goals are aligned with awards, motivation works. If the goal is clearly set – whether to sell the company or increase stock price, for instance – then that's what the executive is going to focus on doing. Executive performance is judged by the market and activist investors who seek change if the company's market performance is down. If a company's market performance is at the 99th percentile, it would be hard to complain if the CEO's compensation is at the 90th percentile.

*Baker:* Executive performance can only be quantified relative to prior performance, whether of the company in question or of its peers. It is not like footraces in controlled physical environments. Each company is different and has its own challenges. 'Performance' is also not a uniform criterion, unlike a footrace where speed is the only measurement. I have seen, with my clients, that a change in performance criteria for earning incentive compensation does change behaviour. Does the company need greater market share? A reduction in expenses? Increased cash flow? A well-structured incentive program will lead to improved performance in those areas, which is to the benefit of shareholders. Equity compensation, the ultimate link to shareholder value, also drives performance, but only the highest level executives have the discretion to make strategic decisions that can affect stock price.

*Massmann:* It depends on the level of executive. For example, we believe a CEO's performance can be judged, in large part, based on the overall performance of the company. Similarly, the performance of executives who are direct reports to the CEO can, in many cases, be judged based on their job responsibilities – for example CFO, Business Unit Leader, and so on – by referencing the performance of the function or unit they are leading. Evaluation of an executive's performance depends on performance against other key performance indicators as well. It is important to evaluate performance over both the short- and long-term to ensure long-term results don't suffer for short-term gain. Financial performance is more easily quantified than non-financial performance. We believe models that tie executive pay closely to the short-term financial performance of the company generally produce higher levels of performance. Models that are more discretionary in nature often times do not, because the line of sight between executive performance and executive reward may not be as clear. From a long-term perspective it is less clear, particularly with respect to stock-based incentives, because of the number of factors impacting stock value that are outside the control of the executive team – for example, market fluctuations. Even though it may be more difficult to closely link executive performance to long-term incentive results, we believe long-term incentives are critical to focus executive behaviours on the creation of long-term shareholder value.

***FW: To what extent has shareholder influence grown since the global financial crisis? In what ways are shareholders exercising new rights and powers that affect executive compensation?***

*Gregory:* I would say shareholder influence has grown quite a bit – the clearest example is Dodd-Frank's 'say on pay' voting rules. Even though these votes are non-binding, proxy advisory firms like Institutional Shareholder Services (ISS) will frequently base recommendations for Compensation Committee directors – and other directors – on say on pay results, and so most companies pay close attention to the outcomes of such advisory votes. Remember, these votes didn't even exist a few years ago and ISS *et al* are becoming not only more well known in the investor community but also more aggressive in their positions. Among other things, these shareholder 'advocates' are pushing companies to adopt long-term share ownership guidelines and claw back short-term gains.

*Baker:* In the US the most visible shareholder voice is the annual say-on-pay (SOP) vote. It's a non-binding referendum on the reported pay of the top few executives in a public company, now in its third year of existence. While most companies pass SOP with a 90 percent-plus approval rating from shareholders, some prominent companies have failed spectacularly, and all companies pay more attention to the optics of their compensation programs and disclosures than previously. SOP has also led to very substantial influence of shareholder advisory services which issue reports to institutional shareholders analysing reported executive pay and recommend a 'yes' or 'no' vote on SOP. Unfortunately, the shareholder advisory services have taken such a prominent role that companies tend to design their compensation programs to align with whatev-

er the advisory services require as a condition of giving a 'yes' recommendation.

*Massmann:* Shareholder influence has increased significantly over the past few years. In most major regions, shareholders now have at least a non-binding vote on executive remuneration; while some countries such as Switzerland have adopted or are considering a binding vote. Even where the vote is non-binding, remuneration committees will likely not ignore shareholder views in making decisions regarding executive remuneration. Therefore the significance of shareholder influence is high. Shareholders continue to follow closely the views of shareholder advocacy groups such as ISS which in turn impacts the compensation programs of many companies. All of this activity has resulted in increased communication between companies and their shareholders regarding potential planned changes in executive pay packages. This increased level of communication and consultation should prove to further strengthen overall shareholder confidence.

*Sjostrom:* Influence has formally grown in many jurisdictions where 'say-on-pay' legislation has been introduced, or similar shareholder rights reinforcements. In most places this has had a very positive impact on the quality of corporate governance. However, shareholder rights is not all that it takes – there are important aspects to the exercise of those rights too. In most countries we have seen an ever increasing institutionalisation of capital as ownership disperses and large institutional investors emerge. The consequence of this is a dilution of interest and engagement that has led to formulaic voting behaviours – many institutions thus welcome the right to influence but bemoan the need to exercise such rights.

***FW: What regulatory developments on executive pay have you seen in recent months?***

*Baker:* There have been few US regulatory developments on executive pay in recent months, though more are expected in 2013. There has been a plethora of shareholder derivative suits claiming breach of fiduciary duty by boards and compensation committees for various actions, including: granting pay that is not deductible; failing to disclose in elaborate enough detail the possible effects of a new equity compensation plan; and foot-faults in the documentation procedure for equity grants. These suits get the company's attention by being filed a few weeks prior to the annual shareholder meeting and seeking to enjoin the meeting. Most have been dismissed and very few shareholder meetings have had to be rescheduled. Companies, by and large, view the suits as meritless – a play for attorney fees by the firms that bring them. Nevertheless, they have caused companies to give even greater scrutiny to their procedures and ever more fulsome disclosures.

*Massmann:* In the US we have not seen regulations related specifically to the amount or form of executive in recent months. However, there has been activity around compensation committee and advisor independence and disclosures. The SEC continues to issue rules around how compensation committees are structured and the use of outside advisors. These rules stem from the provisions under the Dodd-Frank Act. In January 2013, the SEC approved the NYSE and NASDAQ listing standards related to director independence, as well as assessing the independence of the compensation committee advisor. In addition, compensation committees must now have a formal written charter including a provision related to the compensation advisor's role and duties. Outside the US however, there have been much stronger regulations adopted including a proposal to limit bonus payouts to no more than one times base salary.

*Sjostrom:* The most notable developments have been the EU intervention in how pay is delivered in the Financial Services sector and the re-invigoration of 'say-on-pay' in Europe following the Swiss 'Minder' referendum. The regulation of bankers' and fund managers' pay is very unfortunate and will have an impact far beyond the financial services sector. The way we see it, high pay levels are part of a deeper, systemic problem with the way firms in the sector work and behave. And capping bonuses isn't going to fix that. Capping could stop firms from making a positive contribution to the economy in the future. The most likely way they'll respond to the regulation is by shifting from bonuses to unsustainably high fixed salaries – a cost they'll have to bear year-on-year, irrespective of how they perform. The risk shifts back from employee to employer at a time when we desperately need stability in the sector and support for growth. But increased salaries are in themselves a minor worry. Compared to that it will also cement the way banks and fund managers reward their people, rather than encouraging them to explore approaches that fit the new realities of the sector. As capital has got scarcer, the fundamentals of how the sector works and pays its people have begun to shift. And they need to carry on shifting. We think that, rather than offering a way out of a difficult situation, regulation will reinforce the bad old ways of working, and – ironically – make it harder for regulators to curb risk-taking behaviour through things like bonus clawbacks. The Swiss vote is yet another example of politics forcing changes to compensation. Whilst some frustration at corporate governance standards may be justified, this has led to a very serious situation where responsibility for how companies are run has shifted first from boards to investors, and is now shifting to political control. Regulators and investors should instead be seeking a much more meaningful debate as to what the business case is for both composition and levels of executive pay.

*Gregory:* Dodd-Frank includes provisions to enhance the role played by shareholders in determining compensation philosophy and practice; strengthen the independence of compensation committees; provide additional disclosure of the relationship between pay and company performance; provide disclosure of median employee and CEO pay ratios; and mandate the adoption and implementation of

claw back policies. Also, there are new rules that increase proxy disclosure rules for compensation and change in control benefits. The exchanges have adopted compensation committee independence rules that basically mirror the SEC rule-making under Dodd-Frank.

***FW: Are you seeing more companies adopt clawback provisions? How straightforward is the drafting of clawbacks – and are they easily enforced?***

***Massmann:*** The prevalence of clawback provisions continues to increase. Many regulatory bodies actually require clawback provisions, although they may not provide specific guidance on the design of the provisions. Due to the lack of regulatory guidance, the design of clawbacks is varied and more difficult, particularly as it relates to long-term incentives. The enforceability of clawbacks and the issues related thereto remains to be seen.

***Sjostrom:*** We do see an increase in formal clawback provisions across the World, combined with an increase in deferred compensation – and we have seen a few public cases where they have been enforced. However, it is questionable how much this has actually mattered much. Deferrals and clawbacks have been around for a long time and the impact on behaviour is not sufficient on their own. Companies that are truly concerned with not rewarding the wrong performance and behaviour tend to instead concentrate their efforts on the purpose, formulation and measurement of performance that drives incentive outcomes.

***Gregory:*** Dodd-Frank requires that the SEC issue rules requiring companies to recover, or 'claw back' excessive incentive-based compensation – including stock options – paid to executive officers where the company is required to restate its accounting statements because of material noncompliance with financial reporting requirements, regardless of an executive's fault. Dodd-Frank also requires the SEC to promulgate rules regarding the disclosure of clawback policies. Although the SEC has not yet issued rules to implement these rules, Dodd-Frank requires that a company's clawback policy provide that if the company is required to prepare a restatement as a result of its material noncompliance with financial reporting requirements under securities laws, the company must claw back incentive compensation that is in excess of what the executive officer would have been paid under the accounting restatement. The clawback would apply to all incentive compensation paid during the three-year period preceding the date on which the company is required to prepare the restatement. Additionally, this clawback requirement applies to both current and former executive officers, so the incentive compensation of any such officer will be at risk if it was paid during that three-year period, regardless of whether the officer was an executive officer at the time of the restatement or whether the compensation was accrued prior to the three-year period, so long as it is actually paid during such period. Since Dodd-Frank rules haven't come out yet, many companies are waiting to see what the laws will provide. Drafting will depend – if the provisions are required by law or accounting restatement, this is usually fairly straightforward – especially given that this is supported by SOX and Dodd-Frank. If the clawback is based on poor performance or 'bad acts', drafting can be tricky and may be difficult to enforce. This is especially true where the clawback relates to breach of restrictive covenants.

***Baker:*** Clawbacks have been used by companies for decades to provide an enforcement mechanism for post-employment restrictive covenants. Limited clawbacks became required after financial restatements under 2004 legislation. Broader 2010 clawback legislation is expected to take effect when the SEC adopts implementing regulations. Many companies have adopted policies designed to comply with the new requirements; many others are taking a wait-and-see approach. Of course, clawbacks are easier to enforce if the funds subject to clawback have a deferred payment date; some companies use that approach. If the funds have already been paid, the tax effects of the clawback are very complicated and not completely resolved, which adds to the drafting challenges. Other drafting issues currently include state wage law concerns, the general impossibility of changing the timing of payment of deferred compensation without serious tax penalties, the difficulty of defining what gets clawed back, from whom, and under what circumstances.

***FW: To what extent have the legal obligations and potential liabilities of the compensation committee changed in recent years? How can committee members ensure they discharge their responsibilities appropriately?***

***Sjostrom:*** The strongest critique we hear from investors of corporate governance is how many boards and committees fall short in their ability to discharge their responsibilities. The key to ensuring that this is not the case for the compensation committee, or any other committee, is in the composition, education and processes of the committee. The composition must be linked to experience and understanding, so continuous education is essential to keep up with specialist subjects such as reward and auditing. The processes are equally important. If the committee is not fed with the right information, assistance of independent advisors and the right governance structure – and thus able to make informed decisions – then you can't expect them to do their job.

***Gregory:*** Independence is now required for public company compensation committees and their counsel and advisors. Committee members need to attend meetings, be actively involved, review documents, ask questions, and so forth. That hasn't changed, but the consequence of 'bad governance' is to be voted out at the recommendation of the institutional investors and proxy advisory firms.

***Baker:*** When shareholders are not satisfied with a company's response to a less-than-

overwhelmingly favourable SOP vote, the next step is to vote out compensation committee members. There is a bigger risk now of being voted out than a decade ago. Compensation is very complicated, especially as companies struggle to find the right metrics to drive performance. It requires a compensation committee member's full attention to understand any one company's schemes. 'Engagement' is the name of the game. A committee member whose attention is spread too thin will not be able to focus on complicated strategic decisions required. Many compensation committees now engage independent compensation consultants to filter management recommendations with an eye for board members' – and shareholders' – interests. In my view, compensation committees also need the advice of counsel who specialises in executive compensation. I'm always amazed at how often a lawyer diverts a mistake before it happens.

***FW: How do leading organisations combine individual performance of executives with company/financial performance measures?***

*Sjostrom:* Leading companies recognise that financial performance is the outcome of critical inputs and operational outcomes, which can also be measured and incentivised, and are as important to incentivise and reward. At a high level, some organisations do this on a discretionary basis, recognising that it is a multivariate situation that will struggle to provide a fair assessment through a formula. Others are anxious to protect the objectivity and independence of decisions and reward individual performance through a predefined evaluation. Either way may be suitable and both carry clear flaws. What truly matters is whether incentives and other reward support what the company wants to do, where it wants to go and how it creates sustainable wealth. Sometimes that needs to be explicit, other times implicit – unfortunately reward design is therefore best tailored to the individual situation.

*Gregory:* Most companies recognise the need to tailor long-term performance goals with long-term strategic plans and retention needs and many companies are adopting factors including: risk adjusting payments; deferring payment to adjust payments based on actual outcomes; lengthening performance periods; and reducing sensitivity to short-term performance. Also, equity and cash long-term incentive programs are being tied to company-driven financial metrics and total shareholder return (TSR) metrics tied to peer performance. This is really more of an art than a science, although Dodd-Frank and other recent laws and regulations are imposing more objective criteria.

*Baker:* Several structures are used. Where deductibility of the bonus is not a factor – for example, because the inventive program is structured to permit discretionary adjustments while preserving deductibility – the committee, usually following the recommendation of the CEO has discretion to adjust the incentive award earned on financial performance upward or downward to reflect a subjective assessment of individual performance. In another common structure, a set percentage of the incentive – typically 25 percent or less – is earned by satisfying management objectives, which are specified individually for each position. At the end of the performance period the compensation committee, again usually following the recommendation of the CEO, determines the extent to which the objectives were met. The management objectives are often a mix of objectively determinable measures – for instance, 'divest X business unit' – and subjective measures, such as 'be a leader'. Relative metrics usually only apply to financial measures.

*Massmann:* Company or financial performance is used to determine whether a short-term incentive is warranted each year. Companies that also include individual performance as part of determining the appropriate payout will typically use individual performance to influence the allocation of the incentive created based on company or financial performance. The optimal balance is determined by the business itself, and has to be adjusted slightly and carefully to take into consideration the personalities of the executives and the culture of the company. Seldom is the amount of incentive payout determined based solely on individual performance.

***FW: What do you believe are leading practices regarding the number of performance measures in short-term and long-term incentive plans?***

*Baker:* There is a range of practices. Short term and long-term incentives should have a different mix of company and business unit measures, and may also include personal and broad relative measures. With short-term incentives, if there are more than two or three measures, the so-called 'line of sight' gets blurred. With long-term incentives, the key measure is usually stock price, because long-term incentives are typically equity-based. If a financial measure is also added – for example, as a prerequisite to vesting – it is usually a single measure and may be relative to peer company performance on the same measure. For a company with a cash long-term incentive, there are usually only one to three financial metrics, and the financial metrics are different than the ones chosen for short-term incentives.

*Massmann:* Short-term incentive plans are very often based on more than one performance measure. The most prevalent practice is the use of two performance measures and frequently you see the use of three measures. When multiple measures are used, they are aligned with the business strategy of the company. For example, high growth companies usually focus on revenue or revenue growth and cash flow, while more mature companies may focus on revenue or revenue growth and earnings. Based on a recent review of companies in the technology sector, the most prevalent measure used was operating income or operating margin with the second most prevalent measure used being revenue. When companies use multiple measures the measures are generally weighted differently depending on the business outcomes desired. For long-term incentive plans that use performance measures to determine the amount of incentive earned, companies in the US typically use only one measure. Companies outside the US more frequently use either one or two. Common measures used relate to total shareholder return, relative total shareholder return, or return measures – for example, return on equity, or return on capital or invested capital.

*Sjostrom:* The conflict is that fewer is better from a clarity point of view; whilst the more measures you use the closer you get to perfectly describing performance. However, since reward is about signalling what is most critical, clarity wins in every case. Saying that, oversimplification is a loss of signalling opportunity, just one long-term incentive plan measure is unlikely to tell you enough about the long-term ambitions you should pursue. The worst practice of all are combination measures where one tries to hide multiple measures through complex Gordian knots of metrics in a single target.

***FW: What general advice would you give to companies on designing effective compensation strategies? How important are risk and sustainability considerations in today's compensation arrangements?***

*Gregory:* The financial metrics really have to make sense and not end up being unobtainable which would discourage management. Also, TSR metrics have to be balanced against company metrics – the stock of a ▸▸

company going through a difficult cycle will lag behind its peers on a TSR basis, but management may be working hard and succeeding in 'turning the ship', and may deserve compensation recognition for doing so.

***Baker:*** Firms should stick to the basics. Be deliberative and be guided by the compensation philosophy. This usually means a significant portion of pay should be performance-based, with short-and long-term elements, using both absolute and relative performance measures and metrics. Though it's a cliché, equity compensation aligns executives' interest with shareholders'. An appropriate measure is one where the executive can see the effect of his or her behaviour on the results, but cannot – or has a disincentive to – skew the results in a way that poses a material risk to the company. An appropriate metric is one that is achievable but not easily reached. It's almost impossible to gauge right every time. Non-financial goals, such as grooming successors or improving the company's image, can be equally important. Over time, keep an eye on whether a given compensation program is achieving the desired results, and don't be afraid to change if need be.

***Massmann:*** Step one is to link the compensation strategy and programs to the company's overall business strategy. This link should be apparent to both the executives and the shareholders. Companies should actively engage their largest shareholders early in the process. They should understand how heavily those investors rely on shareholder advisory groups such as ISS and develop compensation strategies and programs that would be viewed favourably when compared to the advisory group's leading practices. Risk management continues to be an important consideration in compensation programs. Management and shareholders do not want the compensation programs to encourage excessive risk taking and therefore, continue to monitor the performance objectives and associated payouts. Sustainability is gaining in importance as shareholders and the general public become more active in promoting social and environmental efforts.

***Sjostrom:*** Risk and sustainability considerations are key, not because they are the current buzzwords but because all compensation strategies should align with the corporate strategy, culture and organisation – which in turn means ensuring a matching risk profile and that performance is sustainable over time. Building on that, executive compensation signals to your executives what you want them to do and how you want them to behave. Equally, it signals to your shareholders how you manage your business, how committed management are to the strategy, and how clear you are with regard to what needs to be done to execute the strategy. Hence, important advice in my book is that compensation is not over complicated, it fulfils its purpose and it makes good business sense. Most important is to come to terms with the purpose – it is where most companies go wrong and what most stakeholders react to when it is evidently lacking. ■

## OPINIONS ARTICLES

# Boards, compliance and reputation: diving shallow versus diving deep

BY MICHAEL GREENBERG

The corporate boardroom in 2013 is under pressure to change. That pressure is coming from multiple different directions. Basic questions have been raised about the evolving role of boards, at a time when scandal and perceptions of corporate opportunism have resulted in a loss of public trust in the business community. In a related vein, traditional notions of fiduciary duty are increasingly being questioned, both in regard to how effective boards really are in safeguarding equity shareholders, and in regard to whether boards really ought to try to balance a broader set of stakeholder interests. Meanwhile, many of the more specific facets of board responsibility are shifting as well. Compliance, reputation risk, ethical tone, and organisational culture are becoming more salient as concerns for corporate directors, even as they wrestle with how to deal effectively with any of these things. In a related vein, one question that comes up often, in conversations with directors, is what are boards actually supposed to do, in order to better address compliance and reputational risk?

On compliance in particular, there are two interesting trends in play. On one hand, there has been significant legal and regulatory movement over the past few decades, in the direction of placing more responsibility on boards to oversee the compliance function. In part, this has occurred through major appellate court cases like *Stone v. Ritter*, which have affirmed that board fiduciary duties encompass some responsibility for compliance oversight, and for making sure that the corporation has a meaningful compliance program. It has also occurred through revisions to the Federal Sentencing Guidelines on organisational crime, which provide for more lenient treatment to corporate offenders when related standards for effective compliance programs have been met (e.g., ensuring a direct channel of reporting access between compliance officer and board). Collectively, these policy developments have put pressure on boards to be more engaged in compliance oversight, while also providing a pathway for them to follow in carrying out that oversight.

On the other hand, in actually speaking with directors, a different theme sometimes emerges. This involves the sense that directors and boards are frequently overburdened in what is essentially a part-time job. They face increasingly long checklists of things that they're supposed to demonstrate that they're monitoring. And the largely ministerial act of simply checking items off of that list has come to dominate an increasing amount of time for many boards and their directors. In context, some directors describe the act of reviewing and checking off items from the list as being a 'compliance' type activity, or as involving a 'compliance' burden – by implication, something that takes the directors away from spending time on more substantive issues, such as reviewing business strategy or operations. This viewpoint on what 'compliance' means in the boardroom is almost antithetical to what policymakers and the compliance profession are seeking to accomplish when they pursue 'compliance'. *Their* aim is to achieve something much deeper than inflicting paperwork and a check-the-box mentality on boards (or on management). Instead, the ultimate aim is to try to promote honesty and adherence to the law as basic corporate values, in ways that move beyond enforcing narrow acquiescence to specific legal mandates.

Questions about what boards ought to do concretely in order to carry out their compliance responsibility have been addressed at length ▸▸

elsewhere. But an important basic insight is to recognise the intrinsic tension between 'compliance' as a superficial activity, as opposed to something more substantive and meaningful. A similar point arises in the oversight of corporate reputation, which has also become increasingly focal in boardroom conversations lately, and which also sometimes confuses boards and senior executives in terms of what they are specifically called upon to do. It has been prominently asserted by Warren Buffet and others that reputation is a tremendously valuable attribute for any going-concern business, even though it may be difficult to quantify as an intangible asset. But that still leaves open the question of what 'reputation', and reputation risk, really mean. Some view corporate reputation as being largely synonymous with public relations and marketing, and with outward facing efforts by a company to influence brand awareness and brand image with the public.

Others, however, suggest a different focus. In writing about Exxon-Mobil and its reputation for Forbes online, Jonathan Baskin recently observed that reputation is better understood as the behavioural response of key external stakeholders to the firm, in terms of their willingness to continue to engage on mutually advantageous terms. Thus, a firm has a strong reputation when its employees are willing to work on favourable terms; its customers to purchase; its creditors to lend; its suppliers to supply; etc. In turn, all of those external behaviours tend to reflect the stakeholders' beliefs about whether the firm itself is both dependable and attractive as a counterparty. Put another way, corporate reputation is about engaging external stakeholder groups, and demonstrating through one's own behaviour that one is desirable as a business partner. From this vantage point, reputation is less about managing appearance than it is about managing substance. It is primarily about influencing the expectations of others through the visible reality of one's own practice, rather than through public relations efforts.

**Reputation is less about managing appearance than it is about managing substance.**

In this sense, compliance and reputational oversight as board responsibilities present a similar basic problem. In both instances, it is possible to cast the underlying issue in superficial terms, and thereby to make board oversight responsibility similarly superficial and mechanical. But that's unlikely to be how boards will best contribute to enhancing shareholder value. In principle, boards are comprised of persons with expertise and insight into business operations, strategy and finance. By virtue of their backgrounds and knowledge, board members are uniquely positioned to ask deep and probing questions, rather than superficial ones, when it comes to overseeing an enterprise that embeds honesty, dependability and fair dealing as a cornerstone in all of its activities. Superior reputation management and superior compliance practice both demand that kind of deep attention, and deep questioning and corporate self-reflection. Figuring out how to ask and address the deep questions, given limited time and ever increasing outside scrutiny and pressure, is perhaps the greatest challenge facing corporate boards today. ■

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# Auditor independence: mandatory auditor rotation and the increased burden for audit committees

BY BILL FLOYD AND AMANDA LEECH

The role of independent committees of a board of directors, such as the audit committee, the compensation committee, the nominating and governance committee, and perhaps a risk management committee, is becoming increasingly important as significant responsibilities shift to the board of directors. As part of this evolution, the audit committee, which was the first committee whose independence was mandated, continues to be the committee whose role is evolving most rapidly and on which requirements are imposed. In addition to regulation and oversight by the SEC, public company financial statements, and thus the audit committee, are affected by rulemaking of the Public Company Accounting Oversight Board (PCAOB). The PCAOB's recent proposals and rulemaking with regard to auditor independence suggest increasing responsibility for the audit committee. Along with this increasing responsibility, increasing exposure will result, and the need for independent counsel for the audit committee will intensify.

**Background**

Since its creation, the PCAOB has conducted hundreds of inspections of registered public accounting firms, observing, in many instances, a lack of the independence, objectivity and professional scepticism required of an independent auditor. As a result of these findings, on 16 August 2011, the PCAOB issued a 'Concept Release' to solicit public comment on methods to: (i) enhance auditor independence; (ii) increase objectivity and professional scepticism; and (iii) generally increase or promote audit quality. One of the methods proposed in the Concept Release is mandatory auditor rotation.

To date, the Sarbanes-Oxley Act of 2002 has provided the bulk of the guidance of auditor independence. In drafting the Sarbanes-Oxley ▸▸

Act of 2002, Congress considered, but stopped short of implementing, mandatory auditor rotation. Most notably, Sarbanes-Oxley established the audit committee, rather than management, as the party responsible for hiring the independent auditor and overseeing the engagement. Sarbanes-Oxley also requires mandatory rotation of the lead audit partner by prohibiting the same partner from performing audit services for an issuer for more than five consecutive fiscal years. Based on the language in the Concept Release, it appears that the PCAOB believes Sarbanes-Oxley did not complete the task of assuring auditor independence.

The PCAOB is not alone. Auditor independence has become an international concern. The European Commission has proposed legislation mandating audit firm rotation every six years, which is currently before the European Parliament and Counsel of Member States, with some action expected in the near future. The Canadian Public Accountability Board is currently reviewing a requirement for a 'mandatory comprehensive review' of independent auditors to be performed by independent audit committees and the UK has proposed an auditor review process and a mandatory 'retender' on a 10 year cycle.

Despite the proposals moving forward elsewhere, the PCAOB's proposals have been the focus of significant debate. In response to the Concept Release, the PCAOB has received nearly 700 comment letters, many focused on the proposal of mandatory auditor rotation, and has conducted roundtable discussions in Washington, DC, San Francisco and Houston for the purpose of gaining additional insight from both panel members and participants. Opinions have spanned the spectrum. During the third roundtable meeting in October 2012, an academic panel introduced research suggesting that mandatory auditor rotation would enhance independence. One panel member, an associate professor of accounting at the University of Kansas, provided information indicating that long-term relationships between auditors and public companies increased the likelihood the company would receive a clean audit opinion and that auditors with longstanding relationships are less likely to raise issues the longer their tenure continues. Information was also presented reflecting that in countries where mandatory auditor rotation is in effect, earnings management is less evident.

On the other hand, the President and CEO of the National Association of Corporate Directors expressed the views of his organisation in support of an alternative to mandatory auditor rotation, suggesting that the audit committee should "own and execute" a risk process for oversight of the auditors and should communicate not only the process but also the outcome to shareholders. Along these lines, Larry Rittenberg, an Emeritus Professor of Accounting at the University of Wisconsin and former chairman of the Committee of Sponsoring Organizations (COSO), suggested that the performance of external auditors could be improved by requiring the audit committee to give more focus to accounting issues and to communicate with independent auditors, as well as requiring the auditor to rotate more frequently its non-partner staff.

**Audit committees should expect significant additional burdens and responsibilities regarding auditor independence.**

Members of the five-member PCAOB board appear to be divided in their support for the proposals, as well. While Chairman Doty has expressed support for mandatory auditor rotation, other PCAOB board members have shared concerns. At the American Institute of Certified Public Accountants (AICPA) Regulatory Conference, PCAOB board member Jay Hanson indicated that he does not believe the board has sufficient evidence to support mandatory auditor rotation, noting that the JOBS Act of 2012 requires that any PCAOB standard must be implemented with evidence that reflects the benefits of the standard justify the cost of the new standard. The cost benefit analysis would require a study that analysed the link between tenure and audit independence, audit failures and deficiencies which, according to Hanson, has not been presented. Somewhat less specific, PCAOB board member Jeanette Franzel informed the AICPA that, in her view, the PCAOB is in the process of rethinking the Concept Release and will be seeking other methods to improve independence and the quality of audits.

Given the opposition to mandatory auditor rotation, both by the public and members of the PCAOB board, it has been suggested that the PCAOB may abandon the mandatory rotation requirement and consider instead requiring audit committees (fully independent of and operating without influence of management) to periodically, and perhaps annually, prepare and furnish a formal evaluation of the functions of its existing auditor, giving effect to the quality of their audit services, the degree of scepticism and objectivity shown by the auditor, the nature of the non-audit services they provide, the influence those services could have on independence, and in general, the relationship with and involvement of management in the audit process. This evaluation will be used to justify retention or replacement of the auditor.

Given the amount of time and effort the PCAOB has exerted on the question of auditor independence, and the PCAOB's comments regarding its experience in connection with 10 years of inspections of registered public accounting firms, it appears likely that the PCAOB will propose new and additional requirements within the next six to nine months.

**What to expect**

Audit committees should expect significant additional burdens and responsibilities regarding auditor independence. Although it is possible that the PCAOB will impose mandatory auditor rotation for public issuers, it seems more likely the PCAOB will adopt the Canadian approach or portions of the UK approach (for FTSE 350 companies) and task the audit committee with detailed reporting obligations on, and formal evaluations of, the independent auditor. Such reports will likely be made part of a public company's periodic reporting requirements, and require the audit committee to provide the rationale and support for its decision either to retain or to replace the issuer's ▸▸

independent auditor.

Such a comprehensive review by the audit committee, coupled with preparing and publishing a formal evaluation, will, at a minimum, require the audit committee to probe the degree of scepticism and objectivity reflected by the auditor (independent from any management influence), the relationship between auditors or members of the audit firm and management (or board of directors), the nature of non-audit services provided by the audit firm, and the influence those services could have on auditor independence. Reviews may also be required to address any perceived issues. For example, a significant complaint that has risen to the PCAOB level, and also is being addressed by the Financial Accounting Standards Board (FASB), relates to valuations and estimates of management used in connection with financial statement preparation, and the degree and nature of the auditor's examination and analysis of such vital audit functions. By installing a comprehensive review requirement, the audit committee would be tasked with ensuring that the auditor thoroughly examined such valuations and estimates.

**What to do**

To comply with the anticipated requirements, audit committees should consider engaging independent counsel to assist and guide the audit committee, without influence from management or others. Generally, audit committees operate without a staff independent of management, but the nature of these reports would prohibit the audit committee from looking to management for assistance with the evaluation and reporting process. Engaging independent counsel to serve as the audit committee's staff for this purpose would allow the audit committee to fulfil its responsibilities, but it would also provide the audit committee with assurances that the review and report adhere to prevailing best practices. For example, the PCAOB's periodic inspection reports reflect increasing deficiencies on the part of audit firms. By monitoring the inspection reports, independent counsel could assist the audit committee with establishing an appropriate scope for the ongoing review and evaluation process, as well how the matters in recent inspection reports should be addressed in the published report.

While the impending regulations are likely to task the audit committee with reporting obligations, as the methods to ensure auditor independence continue to be debated, it is likely that the audit committee's responsibilities will be more onerous in the future. Some have suggested that audit committees will be tasked with ongoing responsibilities throughout the audit process, including the engagement of the independent audit firm, designing the scope of the audit, planning the audit process and periodically meeting with auditors and evaluating the audit, and quarterly reviews, on a continuing basis. Independent counsel to the audit committee could serve to fulfil many of these obligations.

**Conclusion**

As the role of the audit committee evolves, audit committee members should engage independent counsel to ensure the committee meets both existing and new requirements and that members meet their fiduciary obligations. The role of independent counsel to the audit committee should be tailored to fit the individual company. For example, at a minimum, independent counsel can be engaged to periodically educate the committee on new PCAOB and FASB standards. Alternatively, independent counsel can serve as the audit committee's staff, not only educating the committee on the standards, but ensuring compliance with those standards by outlining plans for approval, assisting with implementation and interfacing with the internal auditors. There are many other options in between. While the scope of an engagement will vary to meet a committee's needs, as the responsibilities and thus exposure of the audit committee continues to grow, having independent counsel will become increasingly valuable and, in many instances, necessary. ■

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# Enterprise risk management tools create shareholder value

BY LINDA CONRAD, DAVID SHLUGER AND KRISTINA NARVAEZ

Enterprise Risk Management (ERM) has received increased attention over the last decade from corporate directors and officers, perhaps due to the challenging and often inconsistent execution of business strategy at many organisations. These business leaders are looking at ERM as a way to link their strategic planning and capital allocation process with the risks that could impede the successful execution of the organisation's goals. ERM is an integrated framework for holistically managing risks to the company's strategic goals while minimising its unexpected earnings volatility. It also challenges organisations to view risk as an opportunity for creating new value.

Taking the right risks is a necessary part of growing and protecting shareholder value. Companies can't operate too cautiously and miss market opportunities that could attract the best talent and investor capital, but must also balance the growth opportunities with the reality that it is operating in a complex world economy.

To consistently achieve the right balance between risk and reward, many corporate leaders adopt ERM within their organisations.

**ERM tools deliver shareholder value**

Global businesses are increasingly focused on the challenge of mapping and managing their risk profiles, looking beyond a single dimension to understand the complex interactions between many different types of risks. In defining its risk profile, a company must determine its risk to optimise its returns. Its ERM mission is to promptly identify, measure, manage, report and monitor risks that affect the achievement of goals of the organisation.

By aligning ERM with business strategy, certain tools can be used to create new value for the organisation in a variety of areas.

While Key Performance Indicators (KPIs) help an organisation understand how well it is performing in relation to its strategic objectives, Key Risk Indicators (KRIs) are leading indicators of risk to business performance. ERM can add value by embedding KRIs within a company's operations to provide an early warning that potential risks are on the rise. Some examples of using KRIs to monitor risks are in the areas of natural catastrophe risks (percentage of group shareholder equity), asset-liability matching (duration mismatch), strategic asset allocation (mix of investments across categories) and credit risk (weighted average credit rating).

Companies may also create value through business resiliency, which addresses disruption to business operations using a combination of ▸▸

modelling software, supply chain risk assessment software and gap analysis techniques to evaluate exposure. Larger companies may, for example, appoint a supply chain risk officer who reports to the Group CRO, and is tasked with finding the appropriate balance between cost and risk reliability. Some companies are establishing a Business Continuity Planning team throughout their operating regions, and maintaining a robust network of champions within the business, trained to return the business to operation quickly and efficiently after a disruption. While anything can happen, the Business Continuity Team regularly exercises a variety of plans to ensure the company is ready for anything. Stress-testing activities take place in parallel to ensure the network is prepared to shift workload, deploy contingencies, and remain operational when customers may have suffered the same event.

With new projects or product development, a company may also use a Strategic Risk Assessment tool to evaluate risk scenarios that may prevent it from delivering on time, on budget and with the expected results. Actions are assigned to risk owners during Strategic Risk Assessment workshop sessions, and monitored regularly to ensure risk reduction. This type of tool also helps with quantifying the potential exposure and risk tolerance level. For example, a strategic risk assessment may be conducted before considering outsourcing IT services, helping to vet the solution as a viable alternative. The results should be updated regularly throughout the course of a project as risks change and new ones surface.

Finally, ERM may contribute to a company's core business through processes and procedures that review customer risks. For example, credit checks can monitor the collateral and financial viability of customers and their suppliers. In addition, a team may be tasked with scanning the horizon for new exposures that may impact customers as well as monitor customers' loss control techniques. ERM may also be used to examine a company's risk portfolio to identify areas of disproportionate exposure to a single company, industry, supplier, or geographic location.

**ERM produces value over time**

Every organisation's directors and officers will approach ERM differently in order to achieve their unique objectives. Once a company has embedded a robust program into the fabric of its business, it should not rest on its laurels. The program should be constantly scrutinised in search of better ways to identify, assess, manage and monitor key risks. The organisation's management should continuously look for opportunities to create a closer partnership between ERM and the core businesses, so that a team of consultants is ready to assist the business in understanding risk in pursuit of profit. ERM is certainly a long journey defined by many paths, but one that can yield tremendous benefits for the organisation. ■

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# 10b5-1 trading plans under the microscope

BY PRIYA CHERIAN HUSKINS

Could abuses of 10b5-1 trading plans become the next corporate governance scandal?

The fundamental principle underlying Rule 10b5-1 of the US securities laws is that an insider is not engaged in manipulating the market – even if the insider possesses material, nonpublic information at the time of a trade – if that the trade occurs automatically according to a predetermined plan established before the insider ever possessed the material inside information.

10b5-1 Trading Plans are under scrutiny by both the Department of Justice and the Securities and Exchange Commission. Their attention was drawn to the issue by a November 2012 Wall Street Journal article that suggested that some executives may have benefited from above-market returns under their Rule 10b5-1 trading plans ('Executives' Good Luck in Trading Own Stock').

This is not the first time 10b5-1 trading plans have been identified as problematic: consider the research published by Professor Alan Jagolinzer back in 2006 and the subsequent press that followed. This might, however, be the moment that regulators will seek to punish plan abusers. And, reminiscent of the options back-dating scandals of the mid-2000s, no doubt innocent users of these plans who acted in good faith will be caught up in investigations as well.

Now is the time for public companies to review their 10b5-1 trading plans, and – where needed – modify company policies to lessen the chance of abuse.

To help you calibrate and address the risk, this article provides some background on 10b5-1 trading plans, and offers recommendations for best practices related to 10b5-1 trading plans.

**Background**

Numerous public company directors and officers – 'insiders' – systematically sell stock of the companies that they serve through 10b5-1 trading plans. When properly implemented, these plans help insiders avoid three undesirable outcomes. First, never selling shares of company stock because of almost constant possession of material nonpublic information, and thus failing to sufficiently diversify their own personal portfolios.

Second, selling their shares and then being subject to charges of violating the criminal laws that prohibit trading on the basis of material non-public information.

Third, providing fodder for the civil securities class action plaintiff bar if the price of their company's stock happens to fall sharply after the insider sales of stock. In theory, because sales are scheduled well in advance of their execution date and the plans are put into place at a time when the insider holds no material, nonpublic information, 10b5-1 trading plans prevent insiders from using material, nonpublic information to time the sale of their shares.

**The popularity of 10b5-1 trading plans**

Given the affirmative defence against insider trading afforded to executives who follow the prescriptions of Rule 10b5-1, the popularity of 10b5-1 trading plans is unsurprising. In addition to enabling sales of stock by insiders, 10b5-1 trading plans may afford protection to defendants in securities class action lawsuits.

To understand the protection afforded in a securities class action, consider the typical allegations raised in a shareholder suit: the shareholder plaintiffs accuse the defendant insiders of violating Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5, with the thrust of the allegations be- ▸▸

ing that company insiders committed fraud on the market, usually through false disclosure or failure to make necessary disclosures so as to support the price of a company's stock.

To prevail in their quest to find an insider liable of a 10b-5 violation, one element that the shareholder plaintiffs must establish is that the defendant insiders acted with intent to commit fraud. The shareholder plaintiffs' job is made easier when they can point to sales of stock made by the insiders at allegedly artificial prices – sales allegedly timed to personally enrich the defendant insiders. The fact that sales made by an insider were instead made pursuant to a pre-established 10b5-1 plan may rebut the bad intent that a trade by an insider may otherwise imply.

**Press reports have made it abundantly clear that the regulators are interested in investigating instances of abuses in 10b5-1 trading plans.**

**Possible evidence of abuse**

The first systematic study of 10b5-1 trading plans was published by Professor Alan Jagolinzer, then a professor at Stanford University's Graduate School Business, in 2006.

Jagolinzer's research examined the return on trades made through 10b5-1 trading plans. His analysis of the data suggested that some insiders were using 10b5-1 trading plans so 'strategically' that the insider trading laws may have been broken.

The preliminary results of the study suggested that the timing of trades under 10b5-1 plans was not always left to chance. Based on the data compiled by the study, insiders participating in 10b5-1 plans beat the market by 6 percent over six months, while those who did not participate in such plans beat the market only by 1.9 percent. These statistically significant results were indeed surprising if 10b5-1 plans were being employed in a way that did not take advantage of material insider information. Notably, Jagolinzer's research observed that early 10b5-1 plan terminations were not implemented randomly, but rather tend to precede declines in stock prices.

Fast forwarding to November 2012, the Wall Street Journal reported that it has examined "thousands of instances since 2004" of corporate executive trades. Their conclusion? They found statistical evidence of abusive trading by insiders.

**Plan recommendations**

Press reports have made it abundantly clear that the regulators are interested in investigating instances of abuses in 10b5-1 trading plans. Public companies should consequently examine the terms and conditions of their 10b5-1 trading plans. To avoid even the appearance of impropriety, consider implementing the following practices:

*Public disclosure*. Promptly disclose the implementation of 10b5-1 trading plans on Form 8-K. Although not required by the SEC, such disclosure guarantees that the public is put on notice of a 10b5-1 plan's existence.

*Minimum 60-day gap between disclosure and trading*. Mandate that at least 60 days elapse between the public disclosure of the implementation of a new 10b5-1 plan and the first trade made under the plan. A 90-day period would be even better. This will minimise any appearance of market timing.

*Reporting plan sales on Form 4s*. Ensure that all 10b5-1 plan sales are promptly disclosed on Form 4. In addition, insiders should note on the Form 4s that the sales are being made pursuant to 10b5-1 trading plan.

*Limited modifications to 10b5-1 plans*. There should only be minimal, if any, modifications to a 10b5-1 trading plan once adopted. If changes are made to a plan, there should be a significant lag period of at least 30 days between the adoption of the plan modifications and the first trade made pursuant to the modified plan.

*Minimal terminations*. Suspensions and terminations of the 10b5-1 plans should be allowed infrequently – very infrequently. If an insider is uncomfortable with this restriction, that insider might instead consider implementing shorter duration plans such as just six or nine months, but always with significant lag periods of at least 30 days between the adoption of the new plan and the first trade made pursuant to that plan.

*Small sales over time*. Rather than just a few large sales, consider designing 10b5-1 plans to cause a number of smaller sales over time. Such a pattern will minimise inferences of exploitation of material nonpublic information.

*Isolation of trading plan broker.* Have the 10b5-1 plan administered by a broker who is not the insider's broker for the insider's other securities. As a result of isolating the broker, the insider will have many fewer reasons to communicate with the plan broker. With less need for information exchange, it is less likely that the insider will be able to convey information – advertently or inadvertently – that might help the plan broker improve the returns from the 10b5-1 plan. At the very least, isolation of the plan broker will curtail the appearance that the insider is somehow systematically conveying material nonpublic information to the broker. Furthermore, the insider should set up communication protocols with the plan broker – for example, only in writing – that would help rebut any implication that the insider is feeding material nonpublic information to a broker who may have discretion over the execution of a particular trade.

*No other trading*. Insiders who have 10b5-1 trading plans should only trade the company's stock pursuant to those plans. Not only will trades made outside of the currently-existing plan not benefit from the protection afforded by 10b5-1 plans, but such trades may call into question the claim that the 10b5-1 plan is truly a part of a preplanned diversification strategy.

Mandate that at least 60 days elapse between the public disclosure of the implementation of a new 10b5-1 plan and the first trade made under the plan.

**Out in front on the issue**

Given the advantages 10b5-1 plans offer to insiders and their companies – allowing insiders to achieve liquidity in their company's stock at a much reduced risk of being accused of illegal insider trading – it would be premature to abandon the use of these plans. Nevertheless, public companies should review their policies and possibly modify their 10b5-1 trading plan policies. ■

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# Latin America: M&A anti-corruption due diligence

BY MARTINA ROZUMBERKOVA

Rapid growth in Latin American markets present attractive business opportunities for investors, as demonstrated by significant private equity investment during 2012, up 21 percent from 2011, according to the Latin American Private Equity and Venture Capital Association. While the investment opportunities may be plentiful, so too are the countries in the region that are identified as 'corruption-prone', including Brazil, Mexico and Venezuela, which are rated low on Transparency International's 2012 Corruption Perception Index.

One thing that is certain – the investment opportunities in Latin America are not without considerable risk. Investors pursuing them without conducting anti-corruption due diligence may substantially increase their chances of enforcement actions by the Department of Justice (DOJ) or the US Securities and Exchange Commission (SEC) for violating the Foreign Corrupt Practices Act (FCPA). Since 2004, the DOJ and SEC have been aggressively enforcing the FCPA, which prohibits companies and individuals from bribing or offering bribes to foreign officials for the purpose of obtaining or retaining business. Many of the enforcement actions initiated have involved bribery activity in Latin American countries.

**Significant FCPA enforcement related to M&A transactions**

The recent 'Resource Guide to the U.S. Foreign Corrupt Practices Act' (the Guide) issued by the DOJ and the SEC in 2012 devotes substantial attention to FCPA issues regarding M&A, specifically successor liability, which deems that a purchaser of a company may be held liable for the target company's pre-acquisition FCPA violations. Accordingly, much of the FCPA's enforcement involves M&A transactions – a trend that will likely continue as foreign investment in emerging markets increases.

Understanding this risk, the DOJ and SEC emphasise the importance of pre-acquisition due diligence and post-acquisition integration of the target into the purchaser's FCPA compliance program. In summary, the Guide presents the following steps as necessary components of anti-corruption due diligence: (i) interview target management, including those in charge of the legal, sales and audit functions; (ii) review the target's sales and financial data, customer contracts, and third-party (distributor, sales representative, etc.) agreements; (iii) perform a risk-based analysis of the target's customer base; (iv) review the target's due diligence on its agents, intermediaries and other third parties; and (v) audit select high-risk transactions.

**FCPA exposure represents a significant risk, including reputational damage or even criminal charges, for the purchaser, its management and board of directors.**

As the Guide notes, robust anti-corruption due diligence will enable the purchaser to identify the enforcement risk arising from pre-transaction FCPA violations committed by the target, its employees and agents and permit the purchaser to better assess the transaction. More importantly, the Guide makes clear that the DOJ and SEC will view the failure to perform comprehensive anti-corruption due diligence as evidence that the company lacks a commitment to FCPA compliance.

Recent enforcement, including the Watts Water, Diageo and Ball Corporation cases, highlight the importance of anti-corruption due diligence in M&A transactions where the target company posed potential corruption risks. In these cases, the SEC entered settlements with companies for violations of the FCPA based on the pre-acquisition misconduct of recently acquired targets.

**Mitigating risk in M&A transactions**

Quite often due diligence is conducted within a very limited time frame. Two areas of anti-corruption due diligence that are often overlooked include a target's practices with regard to third party due diligence and an assessment of sample high-risk transactions in order to mitigate the risk that payments might be improperly recorded or lack supporting documentation. During an acquisition, the absence of these crucial steps on the part of a purchaser in conducting due diligence often leads to FCPA exposure. This represents a significant risk, including reputational damage or even criminal charges, for the purchaser, its management and board of directors.

One of the most common violations of the FCPA is the mischaracterisation of bribes in the 'books and records' of the target. Bribes are often recorded as legitimate payments; such as commissions, consulting fees, or sales, marketing and miscellaneous expenses or accounts, and may include payments to fictitious vendors or payments for nonexistent services. These payments and accounts should be reviewed as part of the M&A due diligence process. At the beginning of a review, data analytics, such as trending and variance analyses, should be performed to identify a smaller population of transactions for a more substantive review by forensics professionals. This in-depth review should identify any mischaracterised entries.

As one would expect, transactions involving bribery are often missing supporting documentation or the documentation that is available is purposefully vague. This is commonplace with respect to invoices from processing agents, such as freight forwarders or transportation and logistics providers. For example, an invoice from a freight forwarder may include a general description such as "transportation of product from A to B, custom duties and custom processing" and an invoice amount for these activities without supporting details or documentation. Frequently, such payments include corrupt payments to customs or other governmental officials to expedite the process. The purchaser should, as part of the due diligence process, request invoices from processing agents that include the appropriate level of detail and supporting documentation in order to verify that the invoiced amount does not include bribes to foreign officials.

**Challenges presented by third party representatives**

Under the FCPA, a company is responsible for the actions of its agents, intermediaries, consultants and other third parties (the 'third parties'). However, conducting due diligence on third parties is not common in Latin America and companies typically do not conduct any anti-corruption related due diligence on third parties hired to interact with government officials. Moreover, individuals are often hired specifically because of their personal relation-

ship with a governmental official, which are leveraged to obtain business for the company.

Purchasers are well-advised to scrutinise the processes that a target has utilised to retain third party representatives prior to retaining these parties themselves, and evaluate the process for overseeing and monitoring their activities and payments. Contracts and payments to the third-party representatives should also be closely reviewed to identify red flags indicating that representatives may be engaging in prohibited conduct. Red flags may include payments requested in cash or in an unrelated currency, excessive commissions, or payments made to a separate party or to a bank account in a country other than the one in which the representative operates or is domiciled.

As investments in Latin America continue to grow, private equity and venture capital firms active in this developing market are increasingly exposed to potential FCPA violations, at times unwittingly through the prior activities of their targets. Consequently, companies should expand their financial and compliance due diligence to include procedures designed to identify corruption risks. Conducting an in-depth review of the target's high-risk transactions and a target's dealings with third parties is not only prudent, but necessary to mitigate risk and potential reputational damage, or even criminal charges. ■

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# IP risks and opportunities – portfolio management and product clearance

BY GWILYM ROBERTS

Every fighter knows that you are not going to win a battle by soaking up the blows without giving a little back. Every business knows the same thing, and IP matters are no different.

Whenever you consider IP you should always be thinking about two things. For your own business, your innovations, your creations and your brand are your property – you came up with them, you don't want people to copy them and so IP is the route you pursue to protect them. On the other hand your competitors will be thinking the same way and so when you bring out your new product, or your new software, or develop a new logo, you need to be aware that they may have IP lurking ready to slow you down. In the fighting analogy, your own IP is the sword, but how do you shield yourself from your competitors?

The basic IP types are well known – patents for inventive technology; copyright for software, blurb, images; trademarks for brands. Some of these are yours automatically: your written creations probably have instant entitlement to copyright and you may also inherently own further rights in the look of a product (through short lived design right) and branding (through passing off or unfair competition) although these may be more difficult to substantiate in court. Other rights require active protection – you need to file and obtain grant of a patent at Patent Offices around the world, and to get strong trademark protection you similarly need to obtain registration.

When it comes to portfolio management – ensuring that your own IP is in good shape – it is largely a matter of a cost-benefit analysis. We patent lawyers can spend as much as you want us to and you need to weigh this against the potential benefits the IP can bring. How important is exclusivity, for example? If your competitors move into the market, will this cause significant damage? Are there licensing opportunities? Can you get royalties from the remainder of the market? Are you looking for exit? Will IP add to the valuation of your business? Once the position of IP within your company's strategy is settled then managing the portfolio is a matter of identifying subsisting rights such as copyright and perhaps technical know-how, and setting up a capture system to ensure that you at least consider whether registration or grant of additional patent and trademark rights is worth seeking, for new technical concepts, brand ideas and so on. That way you can ensure that you maximise your IP opportunities whilst staying within the financial and time constraints identified.

But one man's opportunity is another man's risk and in bringing any new concept to market you face the possibility that a third party already has IP that can stand in your way. This can be catastrophic and can lead to rebranding an entire business or withdrawing a product from the market and possibly paying back any damages suffered by your competitor as well. With patents, even if you independently developed your concept, if the patent came first and you infringe it then it has precedence.

Defending your business against this is key. The level of defence you adopt is a matter of resource, and risk management. Often, other than financial constraints, the main issue is who you answer to. If you are an independent company then as long as the board understands the risks then the clearance exercise can involve no checking at all at one extreme, which is not recommended. On the other hand if you answer to investors or shareholders then significantly higher levels of diligence are likely to be required. This can take many forms – a dedicated strategy for each product line, monitoring of specific competitors, landscaping of a technology area: there are many approaches dependent on your business model and intentions. At the very least, the risk must be understood.

Choosing where to start is sometimes very difficult. For a new venture, resources can be low in terms of cash and time and it's key to have a realistic and manageable system in place, but one that is also scalable, both for product/brand clearance and capture of your IP. Established businesses sometimes come to IP late but this is still manageable. Audits of existing IP can be carried out and in terms of product clearance one of the best indicators of safety is whether you have been sued yet, which is the odd luxury for the lucky, established company.

In either case the end game is an attractive one – a well-functioning IP capture and protection process, a well-defined and streamlined product clearance process. These are never foolproof but the business decision makers can at least take the view that they have identified and managed the risks and opportunities appropriately.

So, with all this in mind, where do your priorities lie – fight or flee? It comes as a surprise to some businesses that the most important of these two IP threads is the clearance side. If your business has one product and that product is closed down, then you have no business. But when litigation starts, most companies immediately look to what steps they can take in response, and if they additionally have their own IP position, then the game changes very quickly. In the end, like any good gladiator, you need the shield *and* the sword if you want an even fight. ■

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