WHAT DIRECTORS

A CORPORATE BOARD MEMBER/SPENCER STUART SURVEY

CORPORATE BOARD MEMBER’S 13TH ANNUAL SURVEY REVEALS DIRECTORS’ CHIEF CONCERNS AND THE CHALLENGES THEY’LL FACE IN 2016 AS THEY LOOK FOR NEW OPPORTUNITIES TO INCREASE SHAREHOLDER VALUE.
boards are constantly realigning their priorities to ensure they can fulfill their fiduciary duties while maximizing shareholder value. To better gauge board practices across industries, each year NYSE Governance Services dedicates its first quarter issue of Corporate Board Member to our flagship survey, What Directors Think. This premier research illuminates what’s on the minds of US public company directors, bringing fresh insight to the corporate governance community.

In this 13th survey edition, directors reveal their biggest worries and the challenges they believe their corporations will face in 2016. Clearly, directors feel long-term strategic planning is the primary issue they wish to spend more time on, followed by innovation/disruption and cyber risk (Figure 1). Among the various risks to tackle, cybersecurity continues as a leading concern from a regulatory, reputational, and contingency standpoint.

However, these aren’t the only issues on boards’ agendas; a waiving economy and a bumpy global market are also major preoccupations for our respondents. Adding to those worries is an avalanche of new regulations and compliance requirements, along with a surge in shareholder activism and concerns about best practices for shareholder engagement. In a year when proxy access is likely to become the norm for many companies, boards are becoming more aware of the importance of understanding their investor base. Indeed, the majority of directors surveyed feel they have a good understanding of their shareholders’ perspectives and are willing to engage with them directly on critical issues.

To address these and other concerns, boards must continually evaluate their skill sets to ensure they have the right mix of experience and perspectives. Again this year, directors say their boards are looking for members with strong industry, financial, and leadership expertise, but also realize diversity is a critical component.

To report our findings, we have organized the results into three main issue categories: challenges and risks, board/C-suite communication, and shareholder engagement. We hope this research will help you better assess the effectiveness of your board and prepare you for what’s ahead.

**CHALLENGES AND RISKS**

One of the fundamental responsibilities of the board is to oversee the universe of risk that can damage reputation or impede shareholder value. Looking forward to 2016, economic uncertainty and related market risks topped directors’ list of challenges, along with cyber risk (Figure 2). Many directors also left comments related to the challenge of dealing with a host of new regulatory compliance measures.

Sara Grootwassink Lewis, CEO of Lewis Corporate Advisors and a director with PS Business Parks, Plum Creek Timber, and Sun Life Financial, isn’t surprised by this list. “The challenge is even greater now as many companies are finding markets more difficult to navigate and easily disruptable, combined with fewer growth opportunities. Board members have many important risks to oversee, from cyber risk to compliance and accounting risk. But helping their companies step back and think strategically about risk is one of the greatest ways we can add value.”

**Economic uncertainty and market risk.** Following the first uptick in interest rates in nearly a decade, there’s mass speculation as to how quickly rates will continue to escalate. Add to that typical election year jitters, the impact of trade policies, tax issues, and a tumbling US stock market—along with Asian market volatility—and it’s no wonder directors are on edge.

As Mark Sheffert, chairman and CEO of Minneapolis-based Manchester Companies, a business management consultancy, notes, “Without a clear plan for economic growth and stability, the only thing directors and executives can do is speculate as to the impact of these variables on their company and try to prepare as much as possible using the assumptions developed.” Sheffert, who has chaired or served on more than 40 public, private, and nonprofit boards, says this makes for a difficult task. “In essence, the directors and executives will need to fire the arrows while the government is out there running around with the target, [which makes it] pretty hard to get a bull’s-eye!”

But boards don’t have to feel powerless. Even in a world that doesn’t necessarily adhere to traditional cycles, boards should consider several models to measure various outcomes. F. Daniel Siciliano, faculty director of the Rock Center for Corporate Governance
at Stanford University, says economic uncertainty makes a difficult job even harder when it comes to strategic planning for boards. He suggests board members ask management to create economic/financial performance models wherever possible so the board can engage in genuine scenario analysis by manipulating and exploring what happens as economic circumstances change.

“This is a great way to generate discussion and better understand the company’s position under a wider variety of economic situations,” Siciliano says, noting that financial modeling is generally much less onerous than even a few years ago because of readily available online tools.

Siciliano recommends the board use the models along with detailed discussion to explore ways in which the company can be made more resilient. “A fruitful board discussion will often involve understanding vulnerabilities and then discussing with management what steps can be taken to improve the ability of the company to respond to sudden changes.”

He says adaptations might include improving the balance sheet by reconfiguring or reducing debt, hedging to reduce exposure to currency or energy shocks, containing or reducing costs by entering into (or terminating) long-term contracts, and many more actions. “The main goal,” Siciliano explains, “is for boards to insist that management engage in a more thorough evaluation of potential company performance possibilities in this new, more volatile economic reality.”

It should be noted that our respondents were polled last fall; on a slightly positive note, the Consumer Confidence Index took a small bump upward at the close of 2015, raising hopes that 2016 may see more of an upturn. Time will tell whether meaningful changes will alleviate economic concerns at the board and executive level or whether these issues will simply morph into different ones.

Cyber risk. Given the plethora of recent high-profile breaches, it’s no surprise directors named cybersecurity as one of the biggest challenges they’ll face in 2016, as well as one of the top three issues they believe their board is not addressing adequately. In fact, more than a third of our respondents (38%) believe that while they are doing all they can to protect the company’s data, cyber risk is really out of their hands.

“I don’t believe that cybersecurity is out of the board’s hands at all,” says Jim Hunt, a director with Brown & Brown Inc. “While it may be true that many individual board members do not have specific expertise in areas of technology, I believe we have the ability to work with the senior management team...to develop strong plans, policies, and procedures in this area.”

31% OF BOARD MEMBERS BELIEVE SHAREHOLDERS CREATE UNDUE RISK

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Adam Sodowick, president, NYSE Governance Services, agrees. “Board members realize they have an extraordinary challenge ahead of them to wrap their arms around all the issues related to cyber governance,” says Sodowick. “It is a pervasive challenge for every public company, and directors must ensure they are continually asking the right questions about their cyber culture, training, and crisis preparedness.”

For many companies, it’s difficult to even know where to start. Some of the directors we surveyed believe an outside adviser would help the board improve its
oversight of cyber risk and others believe more experience within the board itself is needed. When questioned about attributes directors would most like to add to their current board composition, 83% said it is important to bring on a board member with IT/cyber expertise, which aligns with similar findings from our survey in the last four years.

“As ‘digital’ grows as a business imperative, we have worked with an increasing number of companies to recruit a director who brings technology expertise to the board,” observes Ben Holzemer, co-leader, Spencer Stuart North America.

“To address escalating cybersecurity risk,” Holzemer continues, “some boards have brought in a director who comes from a security background. Typically, these companies are at high risk for cyberattacks in industries like financial services and healthcare or conduct significant business online. The cybersecurity board member can help the management team make difficult risk management decisions as well as increase the general level of cybersecurity knowledge and awareness on the board.” However, he cautions, the board should not isolate cybersecurity responsibility with just this one board member, but continue to view cybersecurity as a full-board priority.

Boards also need to make sure their company has a comprehensive crisis communications plan in the event a breach occurs and that it is tested regularly. While 52% of respondents are confident their current plan would run successfully, 13% are not at all confident in their plan’s effectiveness, and more than half of the directors we surveyed (57%) say they have not vetted such a plan in the past 12 months—which is a red flag for cyber governance.

The recently released *Navigating the Digital Age: The Definitive Cybersecurity Guide for Directors and Officers*, a collaboration of the New York Stock Exchange and Palo Alto Networks, reports that a delayed, bumbling response to a security breach often leads to increased data loss, exposure to regulatory action, and reputational damage. Conversely, a good incident response plan defines the roles and responsibilities of the response team and establishes clear initial action items, including notifications to internal and external resources who will lead an investigation or manage communications.

Bottom line, the issue of cybersecurity is not a tech issue anymore—it involves a wide array of risks that fall squarely in the board’s purview. “When a breach occurs, there will be pressure to move quickly. You will have to make a series of decisions in a matter of hours. Therefore, it is vital to have policies and procedures in place,” according to Spencer Stuart CEO Kevin Connelly. “It is critical that the management team and the board have a detailed plan in place and have identified a dedicated team ready to act to help ensure that your response goes smoothly.”
constant feedback and monitoring. As one respondent explained, “Even if I am confident, I still strongly feel the need for policies and training and the ability for employees to report possible issues.” Another director said, “Training on compliance matters needs to be followed up with periodic reminders and annual certifications. An open-door policy at all levels encourages employees to talk about their concerns about compliance and conduct matters.”

In which compliance areas do directors believe their companies are most and least successful? Nearly half of the directors surveyed (45%) say they lack confidence employees are complying with corporate social media policies. According to Mary Beth Vitale, a director at CoBiz Financial, “The board’s role in the matter of corporate responsibility in the use of all social media is to ask management [about] their plans to educate employees on the appropriate use [of social media]; the status of any issues in respect to the inappropriate use of social media that have an impact on shareholder value; and how to handle any crisis that could result.”

In contrast, directors are more confident in employees’ understanding, training, and compliance with regard to insider trading (92%), internal controls (92%), and antibribery rules (87%).

**BOARD/C-SUITE COMMUNICATION**

One of the most crucial lines of communication is the one between the board and the C-suite. Though company officers are responsible for day-to-day operations, the board has a mandate for due diligence and oversight and must therefore maintain a strong working relationship with the CEO and executive team.

**Internal communications.** According to our survey respondents, the board/C-suite pipeline is in good order. The majority of respondents say they are satisfied with the level of information and in-person reporting they receive from their CFO (94%), CEO (93%), GC (90%), internal audit (88%), CCO (84%), and CIO/CISO (65%) (Figure 3). In comparing these differences, the latter percentage may be lower due to the level of complexity and uncertainty associated with IT and cyber risk.

“Directors want to productively use the time they are together in formal board meetings and are looking to management for background materials and presentations that are comprehensive and bring commentary, analysis, and perspective to foster useful discussions,” observes George Anderson, Spencer Stuart Board Effectiveness Services leader. “By [reviewing] pre-reads and prep material, directors can enter into less scripted or controlled conversations with management in the boardroom.”

At least a third of respondents feel information flow between their board and management could be improved through a higher frequency of updates (36%), more concise reporting (31%), or in the time allotted to review materials prior to a meeting (34%). Other communication components directors believe could be of benefit include additional onsite visits with managers (44%) and more time allotted to discussing critical agenda items (47%).

Bearing out these mostly positive numbers, our survey reveals that major conflicts between the board and the CEO seldom arise. From their comments, respondents indicate that working with management is a team effort toward the common goal of maximizing shareholder value, with communication the key to a positive outcome. Of course, boards do need to stand up to management on certain issues, but as one director noted, “When the board is clear with its expectations, conflicts with management are less likely to arise.”

“Our board sticks to the role of strategic oversight and leaves management to manage,” added another director. “We are deeply involved, but do not cross the line into management territory. The relationship is one of respect for each other’s roles, and [we aim to find] a way to resolve differences in a positive way.”

Indeed, directors we surveyed seem to agree that opposing views are welcome in the boardroom. “Many conflicts are relative; it isn’t a matter of ‘giving in’ or ‘standing up’ but often entails discussion to understand both viewpoints. Most conflict issues are not an us vs. them situation but involve gray areas where more knowledge and perspective provide resolution,” answered one of our respondents.

Furthermore, in looking specifically at their relationship with the CEO, nine out of 10 survey respondents say they are pleased with their CEO’s ability to listen to issues raised by board members, think strategically about the future of the company, work as part of a complementary team with the board, communicate frequently with board members, and offer strategic analysis for initiatives and proposals.
One of the few areas that sparked some degree of dissatisfaction among directors was the CEO’s ability to manage senior executive development, which a quarter of respondents rated as fair or poor. This raises the issue of succession planning, which, along with board composition, is our next area of focus.

**CEO succession and board composition.**

With regard to succession, it appears that most CEOs are involved in planning their own succession, at least in the early stages of the process. More than 70% of directors indicated their CEO is involved in a periodic plan review, development of internal talent, and a determination of the desired skill set. As the search continues, just over half (53%) take part in the identification of finalists, though only 17% are involved in the management of external searches, which is primarily a board responsibility.

“The CEO is a very important player in CEO succession planning, both in an of-counsel role to the board or the committee responsible for the process and in overseeing the company’s overall management succession,” states Cathy Anterasian, North American CEO Succession Services leader for Spencer Stuart. “However, as the time for a transition nears and the process turns toward the board’s selection of finalist candidates and, potentially, an external search, the CEO’s participation diminishes.”

In terms of their own succession and restocking the board, we asked directors which attributes they value most in the selection of a new board member. Industry expertise and financial experience were the two attributes garnering the highest ratings, ahead of gender diversity and CEO experience (Figure 4).

“The effectiveness of any director depends in large part on the relevance of the expertise he or she is bringing to the board,” comments Julie Hembrock Daum, Spencer Stuart North American Board Practice leader. “Industry expertise and financial experience are critical to board service as they provide the foundation for overseeing the business, so it is no surprise they continue to rank high year-over-year.”

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**FIGURE 3**

DIRECTORS’ SATISFACTION LEVELS WITH IN-PERSON REPORTING FROM THE FOLLOWING:

- CFO: **94%** Satisfied
- CEO: **93%**
- GC: **90%**
- INTERNAL AUDIT: **88%**
- CHIEF COMPLIANCE OFFICER: **84%**
- CIO/CISO: **65%**

**VETTED A CRISIS COMMUNICATIONS**

A DATA BREACH.
SHAREHOLDER ENGAGEMENT

In last year’s survey, directors revealed that shareholder engagement is becoming a more exigent issue for boards, which also aligns with the wave of proxy access proposals expected this year. Two-thirds (65%) of the directors surveyed say they view direct engagement with shareholders as a way to open meaningful dialogue before critical issues come to a head.

Many directors, however, still prefer to refrain from engaging with investors outside the boardroom, regardless of the topic. Although some governance experts suggest boards should have more accountability toward shareholders, nearly a third (31%) of our respondents worry that direct shareholder engagement carries undue risk of board and individual director liability. Moreover, 28% say it elevates the risk of violating Reg FD, 21% think it creates a wedge between the CEO and the board, and 14% feel direct engagement creates undue influence on the board.

Veteran director Mark Sheffert disagrees. “Directors sometimes forget that their shareholders are the owners of their companies and the ones who elect the directors to serve as their fiduciary representatives. Therefore, investors have a right to engage with directors and to expect transparency in the execution of the directors’ service,” he explains, adding that “the so-called risks claimed by some of the respondents are manageable with an understanding between the board of directors and the investors.”

More governance advisers are giving the green light to board and investor communications, provided there’s a well-defined policy guiding the circumstances and nature of the communications. Two-thirds of board members (63%) we surveyed say they have such a protocol in place.

Those in the investor space are also on board. A June 2015 article published by F. William McNabb III on the Harvard Law School Forum on Corporate Governance and Financial Regulation website asserts, “Corporate governance should not be a mystery. For corporate boards, the way large investors vote their shares should not be a mystery. And for investors, the way corporate boards govern their companies should not be a mystery.”

In his remarks, McNabb, chairman and CEO of investment management behemoth Vanguard, lists accountability as the second most important principle on governance—accountability to the board on management’s part and accountability to shareholders for directors. He also refers to engagement as the be-all strategy to accomplish this, placing an emphasis on quality over quantity, including knowing your shareholder base, a criteria about which, as our survey indicates, the great majority of directors (86%) believe their board has a good to excellent understanding.

When it comes to shareholder activism, however, directors—even those that support engagement—have a markedly different viewpoint.

Specifically, our study found that while half of the directors surveyed believe the recent wave of hedge fund activism has created more awareness for the need for good governance, 62% believe it has reinforced and rewarded short-termism, which can short-circuit decisions that directors believe will provide more sustainable, long-term growth.

One board member explains, “Shareholder activism has created an environment whereby the board and management often pay too much attention to the wants and needs of a few significant shareholders, potentially at the detriment of the vast majority. Also, activists tend to have general knowledge but rarely the specific knowledge required to recommend positive improvements for the company and its other shareholders.”

“Investor interest in corporate governance has continued to grow, driving expectations that boards will embrace more rigorous practices, first in areas such as financial reporting, risk assessment, CEO compensation, and succession and more recently in board composition and refreshment,” states Daum.

FIGURE 4
IMPORTANCE OF ATTRIBUTES IN A NEW BOARD MEMBER

INDUSTRY EXPERTISE
83% IMPORTANT

FINANCIAL EXPERIENCE
78%

GENDER DIVERSITY
59%

CEO EXPERIENCE
55%

“IN ESSENCE, THE DIRECTORS AND ARROWS WHILE THE GOVERNMENT TARGET, [WHICH MAKES IT] PRETTY...
“While boards have taken notice, a gap still exists. Directors want to ensure that their boards contribute at the highest level, aligning with shareholder interests and expectations, and setting a positive tone at the top for the organization by holding themselves to a high standard.”

And yet, the activists aren’t going away, so boards must think strategically about this challenge. Adds NYSE Governance Services’ Sodowick, “Rather than putting their heads in the sand, boards could benefit from employing ‘think like an activist’ scenarios, examining vulnerabilities that may put them in the crosshairs. As is so often the case, the best defense is a good offense.”

SURVIVING AND THRIVING IN 2016

Given the macro conditions in place, the economic climate and market fluctuation may indeed prove to be the biggest challenges of 2016. The precipitous drop in the crude oil market, geopolitical tensions, and the potential for interest rate increases will continue to challenge the stability of the US stock market. Therefore, experts say that to maneuver through these headwinds, public corporations can either set their strategy and stay the course, hoping it is the right one, or prepare for various scenarios and be ready to deploy the best strategy at a moment’s notice.

“Are there new opportunities the company is uniquely positioned to capitalize upon, where it can earn an outsized risk-adjusted return? What are the risks of pursuing those opportunities, and what are the risks of not pursuing those opportunities? These are the questions that can really help a company move forward in a rapidly changing business environment,” explains Grootwassink Lewis, the director and corporate adviser.

Regardless of the approach taken, considering the increasing complexity of issues on directors’ plates, boards need to evaluate their current communications, reporting, and information flow with management and be more attuned to their shareholders’ barometer as they address future agenda topics.

And on those agendas, given what we’ve gleaned from respondents this year, risk oversight will stay front and center as the overarching challenge. According to a recent posting by Martin Lipton on the Harvard Law School Forum on Corporate Governance and Financial Regulation, “Boards, along with their risk and audit committees, must be diligent in ensuring that comprehensive risk management is neither an impediment to the conduct of business nor a mere supplement to a firm’s overall compliance program, but is instead an integral component of strategy, culture, and business operations.”

In 2016, corporate boards will undoubtedly be conducting long-term planning to better mitigate risk from cyberattack, manage the threat of shareholder activism, and respond to macroeconomic conditions to ensure ongoing shareholder value and financial performance. Along the way, most boards will also take a healthy gut check to make sure they have the appropriate skill sets to promote diversity of experience and thought. Finally, the need to develop better communication strategies, both internally and externally, will be top of mind.

It is our hope that the information and comments shared by fellow directors and the potential areas for improvement uncovered during the course of this research offer meaningful opportunities for directors and their boards to stay ahead of the curve.