BI Boardroom INSIDER January 2013

The online newsletter for better boards and better directors *Ralph Ward, Publisher/Editor*

- **NEW YEAR'S RESOLUTIONS FOR BOARD LEADERSHIP**
- **5 WAYS BOARDS CAN HELP SMALL-CAP FINANCING**
- **ASK THESE 4 QUESTIONS ON YOUR WHISTLEBLOWER PLAN**
- **HOW DO YOU JUDGE DIRECTOR "UNFITNESS?"**
- **MIKE MYATT ON HOW CEOS "MANAGE" THE BOARD**
- **Q&A: Selling Our Pay Plan to Investors**
- **Upcoming in B.I……**

NEW YEAR'S RESOLUTIONS FOR BOARD LEADERSHIP

A new year can trigger any number of business or personal resolutions. But in the corporate boardroom requires smaller, more tactical new year's resolutions. The board of directors, whether that of a smaller, family-owned company, or one at the Fortune 500 level, will always be a means to an end. It is a tool that assures legalities are enforced, shareowners represented, and a coherent company strategy is in place and being properly pursued. The first element in doing this job is solid board leadership. What leadership resolutions should your board set for the year ahead?

To define and assure independent board leadership. The largest corporations today are legally boxed in to having some form of an independent leader on the board. Yet the powers this leader exerts still vary widely, usually depending on the personality of the person holding the role, whether an independent chair, a lead director, or a presiding director. At mid-cap, venture, or family corporations, the role is even more vague. For 2013, why not designate a strong, independent board leader role, write up an actionable job description for it, and then find someone on your board (or even a new member) who best fills the role?

Give your board leader a real job to do. A huge, but little-discussed change has come to corporate boards over the past decade – they now have a real job. Rather than being a legal rubber stamp, the board needs a practical framework to review and assure financial filings, disclosures, controls, risk management, executive pay, and a dozen other matters that bring real-world consequences if fumbled. Boards, meanwhile, groan under the paperwork and approval burdens they now face. Much of this comes from CC'ing them on everything managers and counsel wants the board to see – rather than what they need to see to do their job. How about putting your board leader in charge of designing a system of reports, agendas, and board packs driven by actual board demand?

A board leader with a budget. What if the independent leader determines the board needs to tap outside resources to do its job best? Maybe get an opinion from a banker, or outside counsel, or bring in a trainer for some board education? Would the CEO groan about how expensive the board is getting? Probably. But for the new year, how about board leaders who can say that a board worth having is worth a modest investment in better governance? And leaders who have the power to make these calls stick?

-- RDW

5 WAYS BOARDS CAN HELP SMALL-CAP FINANCING

For small cap and venture company governance, Adam Epstein is a guy you want to know. As a board member, capital market authority, and VC, Epstein has worked with a hedge fund involved with over 500 small cap financings, and he currently heads Third Creek Advisors.

Epstein's strong suit is the governance and funding needs of younger and smaller corporations. While those of us who work in governance can find plenty of info and stats on Fortune 500-level firms, there is far too little good advice for small-cap, mid-cap and venture companies. Yet, in the U.S. alone, 70% of public companies have under $500 million in market cap.

Epstein has just published a book with the eye-catching title "***The Perfect Corporate Board***" that I urge you to add to your post-Christmas shopping list. Although the title seems all encompassing, this new gem of a book actually focuses on the part a young company's board can play in teaching, prepping and selling when it comes to capital and finance. I asked Adam Epstein to boil down his advice for how the board of a new company can help in whipping the firm into shape to face the capital markets:

- "Directors need to be brutally realistic (as opposed to optimistic) about their company's strengths and weaknesses, and the overall financing market for similarly situated companies."
- "Because many small-cap CEOs/CFOs are new to public company stewardship, directors of companies with less experienced management teams should consider setting up special committees to closely monitor all elements of the financing."
- "Directors should confirm that management/service providers have identified all legal, financial or regulatory impediments to a prospective financing before the company hires bankers or meets with investors."
- "Many small-cap financings are characterized by highly specialized legal issues -- directors should make sure their company has retained legal counsel with extensive, recent, relevant experience.
- "Upon receipt of deal terms and recommendations from investment bankers, directors should consult recent deal data to confirm that the financing terms are, indeed 'market' terms."

ASK THESE 4 QUESTIONS ON YOUR WHISTLEBLOWER PLAN

The past year was a boom one for the corporate whistleblower market in the U.S. In November, the SEC's new Whistleblower Office reported more than 3000 tips in its first year in operation, and it also reported the biggest whistleblower bounty yet, a whopping $104 million paid out to a whistleblower on illegal offshore banking by UBS.

The top long-term news of 2012, however, was formal SEC rulemaking that confirms potential rewards for corporate insiders who bypass internal reporting to take their concerns straight to regulators and outside attorneys. ("whistleblower" attorneys are already advertising themselves like personal injury law firms).

Despite the possible payday, surveys find that most employees still prefer to take their concerns with potential fraud, tax mischief, securities violations, etc. through inside channels. This route can nip wrongdoing far earlier, and with fewer financial and legal consequences – if employees use it. Corporate whistleblower systems have swiftly evolved from a necessary evil to become a venue that you must *sell* to employees. What questions can your board ask to assure that your company's whistleblower program competes?:

- Prove to us that you've learned (and covered) our major compliance dangers. Legal, audit and compliance staff should have given your company a full review of where your most serious compliance landmines lie. A public chemical processing company, a private global trading firm, and a community bank will have wildly differing compliance vulnerabilities. Profile yours, with particular attention to which internal offices are the most likely "flash points." Also, which outside suppliers, contractors, advisors, or customers would be in positions to tip you off on misdoings? Will they have access?
- How easy (and safe) is it for a whistleblower to sound off? Though it can become costly, there are growing numbers of outside providers who offer confidential, third-party whistleblower services. Making clear that the informant's call will be handled anonymously by pros outside your company HR, legal or compliance structure can tempt a nervous witness to speak out. Whether you contract out or stay inside, though, your board should ask how easily anyone can tap into the system. If you use a toll-free number, is it staffed at *all hours* by someone who knows how to handle the call? Do you also offer anonymous reporting via the internet, email, text messaging, and even old-fashioned drop box and postal mail options?
- How well are we telling employees about the program? Are posters with whistleblower info everywhere employees go? Are you sending the message through employee newsletters and other communications? Do your computer network communications advertise it?
- How well are front-line managers trained to handle whistleblower queries? While formal whistleblower programs are crucial, most employee reports on wrongdoing actually begin through an informal comment or query to their supervisors. Too often, though, supervisors blow it by telling employees to keep quiet, covering the matter up, or even retaliating. In short, the whistleblower's first stop may destroy all your carefully laid plans -- unless those supervisors are trained and evaluated as part of the system.

HOW DO YOU JUDGE DIRECTOR “UNFITNESS?”

Mike Peregrine, a partner with the law firm McDermott Will & Emery, specializes in advising corporations on sticky legal and ethical issues. In December, he penned an intriguing piece for *The New York Times*' ***Dealbook*** blog on how boards can (and should) deal with director “unfitness” issues.

Boards tend to avoid laying out rules for judging when a member should resign (or be pushed) from the board even for solid legal grounds (“Hey, he’s just been *indicted*, not found guilty yet!”), so it’s no wonder they stay away from greyer areas, like public policy, or how things look to shareholders.

Peregrine cites 3 areas a director “unfitness” policy should address:

- “No brainer” offenses, such as criminal convictions, or a proven breach of fiduciary duty. SEC or judicial sanctions in these case may make the call for you, by mandating the offender not serve as director of a public company (and if yours is a *private* company, how much difference should that really make to your board?)
- Regulatory penalties, professional ethics sanctions, service as an officer or director of another company that has faced similar corporate spanking. This includes allegations or investigations of wrongdoing. This director may taint your D&O insurance rates or eligibility, or count against your company if it competes in a highly regulated industry.
- The third level of “unfitness” hell is the trickiest. Board members may face messy divorces, relationships with subordinates, personal legal problems. They may be caught up in a public ethical firestorm (Peregrine cites the example of Lance Armstrong resigning from the board of the Livestrong charity). Or they or their companies may be identified with controversial issues or stands, drawing pressure from activist groups or the media.

Peregrine offers some sound advice on how boards should cope with such issues by developing advance “unfitness to serve” protocols. The simplest may be for all directors, on election, to submit a resignation letter to your board’s governance committee, which can they vote to act on it should an “if and when” problem arise.

Yet how many boards will actually consider this problem in advance, much less lay out solid procedures? Most boards strongly try to avoid tying themselves down with objective governance rules (look at how many board bylaws include the waffle-phrase “as seems in the best interest of the company at the time.”). I suspect boards shy away from “unfitness” language because A: they may not want to lose someone who falls under its clauses; and B: they may want the freedom to oust a director who hasn’t technically violated a rule.

Beyond this, the 3rd level cases (more “unseemliness” than “unfitness”) raise their own subjectiveness dangers. If a director is identified with a strong public stand on a controversial issue, he or she may indeed be a pariah to some interest groups -- but a hero to others.

MIKE MYATT ON HOW CEOS “MANAGE” THE BOARD

Mike Myatt is a name familiar to many of our readers. Leadership consultant, author, and contributor to *Forbes* magazine, Myatt offers real-world insights on how leaders perform (and too often underperform). He recently provided some good thoughts at ***CEO.com*** on the provocative theme “Managing the Board – What Every CEO Must Know. Sample thought: “CEOs who fail in their attempts to coalesce with the board usually do so as a result of being either arrogant or naïve.”

Check it out, but here are a few high points (with editorial kibitzing):

- *Understand the Landscape*. “Board members have egos, and will go to great lengths to help you if they perceive you respect and value their position.” The people on your board *got* on your board by being VIP’s, proven leaders, or major sources of investment or advice. Savvy CEOs realize that these are not people to be ignored or treated as obstacles. Aside from technically being your bosses, they are also at least as heavy hitters as yourself.
- *Be Proactive* (OK, as an editor, I hate that word, but here it’s useful). “The number one rule of board management is not to hold the meeting *at* the board meeting.” Long-lived CEOs chat up their directors individually before the actual board meeting, review board materials with committee chairs in advance, and (perhaps most important) give directors a heads-up on any bad news before the meeting is called to order. The meeting itself is for thoughtful discussion, agenda business, and legal votes – not surprises.
- *Manage the Trickle Down*. Yea yea, we all know that board members have a fiduciary duty not to blab board business, but “what happens in the board room rarely stays in the board room.” Myatt notes that VC, private equity or other investor directors are going to report back on what they’ve learned on your company (and their take

on management). Other outsiders are also going to let slip with their take to their connected friends (see item #1). No, this doesn't mean they're giving insider trading tips or strategic dish – but they *will* be sharing their views on how they think the CEO is doing his or her job.

- *The Environment*. "If your board members dread attending your meeting, they will be predisposed to show up with a bad attitude." Making sure that meetings are well planned and led, info is concise and useful, and that a staffer doesn't spend half an hour reading off PowerPoints is more than just common courtesy. It tells the directors how effective *you* are as the CEO who ultimately steers the meeting, and determines how agreeable they will be. Board meetings may never be fun, but if directors find yours to be the most valuable they attend, they'll probably consider you valuable too.

Q&A: Selling Our Pay Plan to Investors

Q: "*I serve on the board compensation committee of a technology and consulting company, and I'm not looking forward to this year's proxy voting. We've faced a couple of strategic setbacks in recent years, a couple of key investor funds have been grumbling about our management. We reached a new compensation contract with our CEO just before the recent setbacks. Though we still think it's fair and effective, I suspect that investors might show their unhappiness through their say-on-pay vote. While the CEO and our IR team have been reaching out to our major investors, I'm wondering what our board (and, specifically, comp committee) can or should be doing to help sell our pay plan.*"

A: It sounds like management needs to call in the boardroom big guns to sell your pay plans. "It's very powerful for shareholders to hear from directors," says Kristine Bhalla, a senior associate with Clearbridge Consulting Group. "What they're looking for is an overall, rational compensation philosophy."

First, though, carefully coordinate your outreach with Investor Relations. What messages have they been giving investors thus far? What sort of feedback are they receiving? Are there specific concerns with comp elements, or disconnects between pay and performance (any "hot button issues like perks or gross ups?" suggests Bhalla)? Or, as you suspect, are there broader complaints on results?

Coordinate your messages, and do some cramming before reaching out. Comp committees are expected to have a solid pay rationale now, so put that research to good use. Review the pay and equity elements involved, schedules, and various scenarios. Know how your team's "realizable" pay figures compare with numbers from proxy advisory sources (such as ISS), and be able to defend any differences. "Make sure you know where the 'problem' areas are, and be prepared to hit these items head-on with rationale for each" Bhalla concludes.

COMING IN BOARDROOM INSIDER --

- *VENTURE BOARD TRENDS FOR 2013*
- *PRIVATE COMPANIES AS YOUR STEP TO PUBLIC COMPANY BOARDS*

RALPH WARD'S BOARDROOM INSIDER is published monthly for directors, CEOs, those who work with corporate and nonprofit boards (corporate secretaries, corporate counsel, support staff, and consultants), and those who are board prospects.
Ralph D. Ward is author of the books *BOARDROOM Q&A*, *THE NEW BOARDROOM LEADERS*, *SAVING THE CORPORATE BOARD*, *IMPROVING THE CORPORATE BOARD* and *21st CENTURY CORPORATE BOARD*, and a speaker on corporate board issues. Keep up with us on Twitter at ***@boardroominside***.
Our address is P.O. Box 196, Riverdale, MI USA 48877. Telephone/fax (989) 833-7615. Our website is at www.boardroominsider.com