C-SUITE

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Risk Issue

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Safeguarding against cyber attacks

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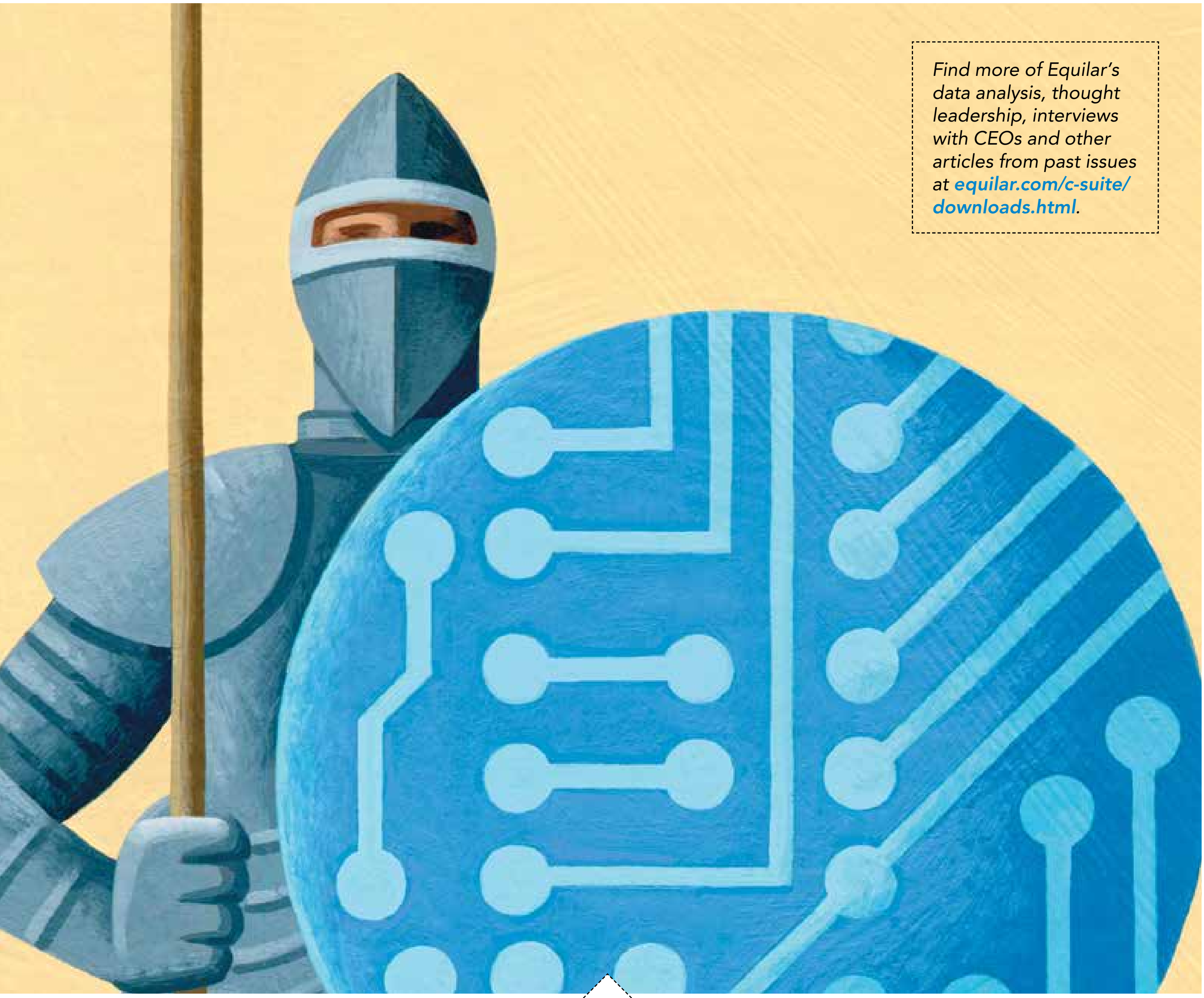

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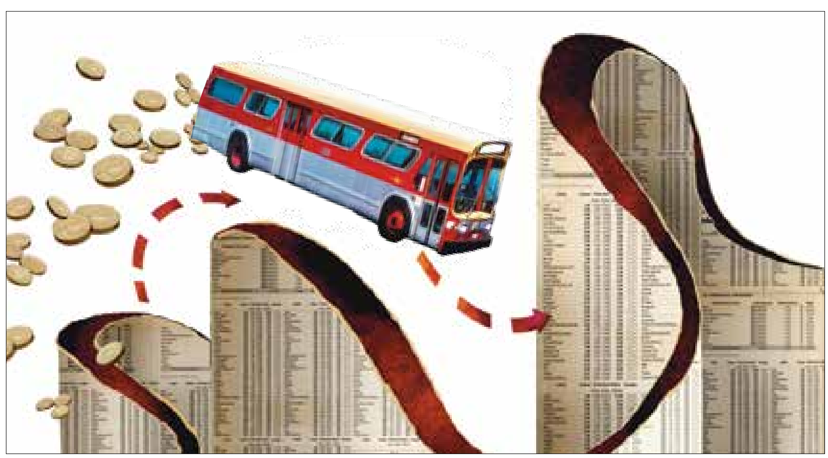

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Risk and Reward

It's hard to believe we're approaching the end of 2015, an eventful year here at Equilar. We've made several significant enhancements to our core executive compensation and shareholder engagement solutions. Earlier this year, we introduced TrueView to seamlessly integrate our Top 5 SEC data with our proprietary Top 25 Executive Compensation Survey to provide the most robust benchmarking solution in the industry. In September, we launched BoardEdge, a new board succession planning tool with in-depth information on over 135,000 board members and executives. BoardEdge not only helps companies assess their boards against their peers in an easy-to-use interface but also discover and connect with potential board candidates.

This issue of *C-SUITE* focuses on risks executives and boards face going into 2016. Our one-on-one interviews include Sabastian Niles of Wachtell Lipton, who discusses the many ways shareholder activism manifests—and some may surprise you. Suzanne Vautrinot, a retired Major General of the U.S. Air Force and now a director on multiple boards (including Ecolab, Symantec and Wells Fargo), discusses the cybersecurity risks that all companies face. "Ask the Experts" features input from a range of professionals on the biggest risk for boards in 2016, and it's telling that they all came up with different answers.

TK Kerstetter lends his governance expertise in a discussion about a universal ballot proposal from the SEC. Ron Schneider of RR Donnelley looks at emerging trends in proxy disclosures. And finally, Seymour Cash takes Pay for Performance head on, and, in typical fashion, offers up a unique way to turn a challenge into an opportunity.

Please enjoy this issue and feel free to reach out to me directly with any feedback.

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

Taking on Risk

Smarter boardrooms turn new challenges into potential rewards

By Dan Marcec

The stock market recently hit an all-time high, but a correction in summer 2015 reminded us that a well-performing market is not immune to outside pressures. Oil prices continue to decline, and economic concerns in both China and Europe weigh on the U.S. markets, in spite of unprecedented success in certain sectors stateside. With outside forces influencing potential returns for the largest U.S. public companies, executives and boards face significant risks going into 2016. (And that's before even considering potential political upheaval in the U.S. government next year.)

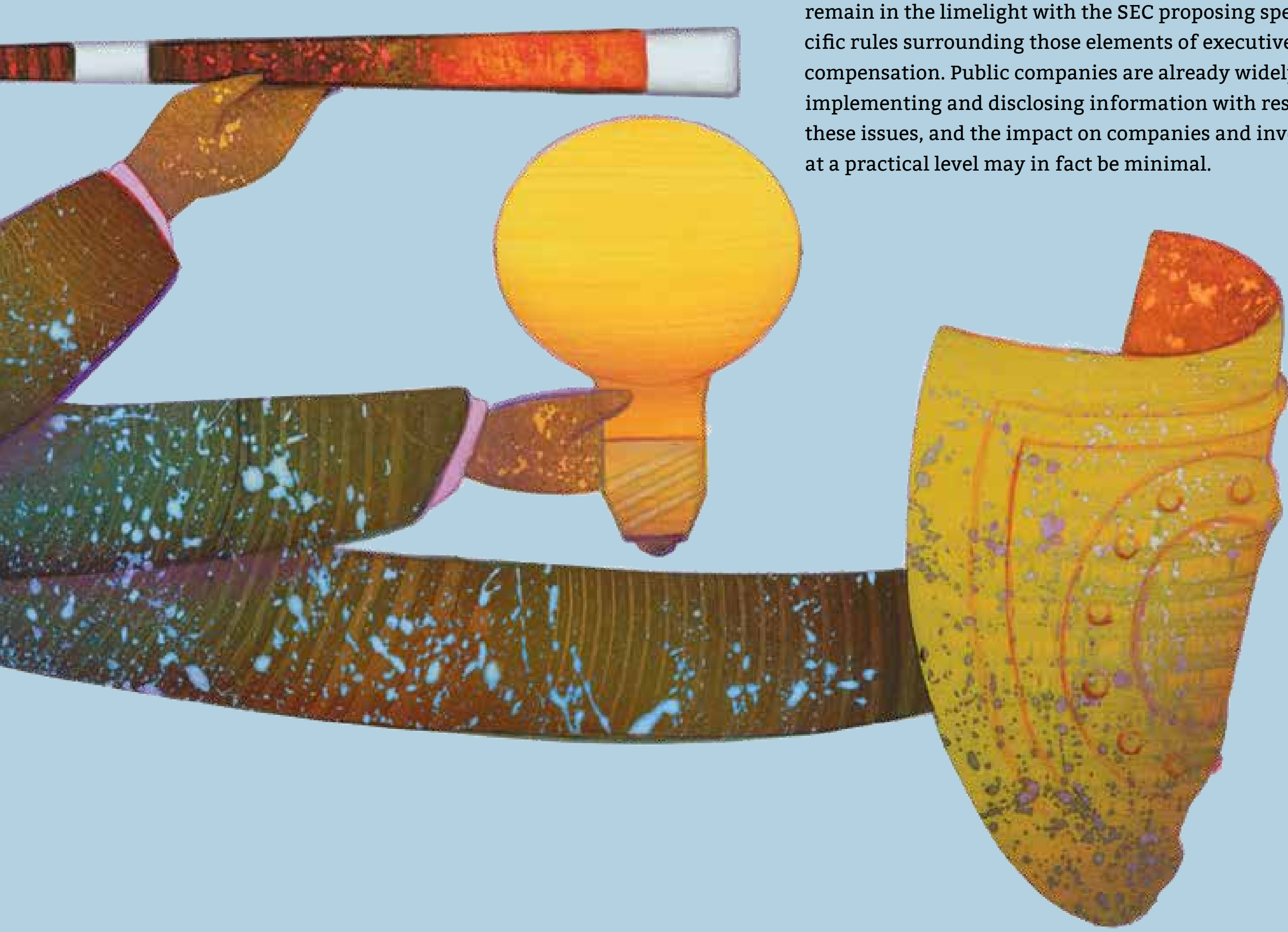
Certainly, the country's most successful companies are well versed in raising stock value and increasing shareholder return. They're no strangers to rules, regulations and legislation that complicate the ways they do business and communicate information to stakeholders. However, two major themes have emerged in recent years that are changing the conversation in the boardroom, and many of the topics discussed in this month's issue relate to these risks: the rise of shareholder activism and high demand for technology solutions.

Rules and Regulations Open Doors for Activists

Initially focused primarily on reform in the financial sector, Dodd-Frank has had lasting influence on public companies in the U.S. at large. Celebrating its five-year anniversary this summer, mandates from Dodd-Frank continue to alter the way public companies operate. As a result of new rules and regulations, boards and executives are facing new risks to consider in strategic planning.

In early August, the SEC made waves by mandating disclosure of the CEO-employee pay ratio. While there's not much evidence that this will directly influence investors' decision making, companies must report an easily understandable, public-facing issue they may have to contend. A few companies had already set forth disclosure practices in anticipation of this ruling, but they remain a very small minority. Though reporting CEO pay ratios is not mandatory until 2017, the public eye will be focused on companies during the 2016 proxy season to see who is willing to step out in front and volunteer this information.

Furthermore, clawbacks and pay for performance remain in the limelight with the SEC proposing specific rules surrounding those elements of executive compensation. Public companies are already widely implementing and disclosing information with respect to these issues, and the impact on companies and investors at a practical level may in fact be minimal.



However, public discourse surrounding any perceived “slip-ups” remains an imminent risk for companies. Though not their stated intentions, many of the rules and regulations passed down from Dodd-Frank have created risk for companies and their governing bodies. The goal of governance is to create a transparent framework for all stakeholders—whether they’re board members, executives, employees or investors. Indeed, there’s little debate that clear disclosure from companies to promote active engagement with sophisticated and passionate investors is a good thing. At the same time, these changes in corporate governance have put high demands on boards and executives while also opening doors for activist shareholders to exploit difficult situations.

The solution to these issues is simple on paper, and companies are taking additional steps to carefully assess and address shareholder activism. But clearly, the application is much more complicated. For example, activists are not only targeting underperforming companies. In an ironic twist, some activists are actually taking advantage of the swelling economy to push well-performing companies to higher returns, and in many cases, toward M&A.

Yet despite all the attention on activism, shareholder relationships are not inherently challenging. Disclosures and other communications—mandated or voluntary—have led to wider understanding of company performance goals among all stakeholders. After all, many if not most investors are aligned with companies in seeking long-term gains, not just quick returns. As a result, transparent engagement with allied shareholders can help mitigate new risks posed by disruptive forces.

Boardroom 2.0: Technology Takes Over

The ever-rapid rate of change in technology means that falling behind in tech expertise has become one of the biggest risks a company faces. Even just a decade ago, most cyber attacks were more inconveniences than inherent risks to operation of the company. However, we’ve started to see a dramatic increase in criminal behaviors—hacking, espionage, theft of intellectual property—that have brought cybersecurity to the forefront of conversations in the boardroom.

Of course, risk related to technology is not limited to the damage incurred by nefarious hackers. A much more innocuous risk factor—but an equally critical one—is the use of digital tools inside the boardroom.

From composition to compensation, shareholder scrutiny isn’t limited to executives. Shareholders are demanding increased transparency from directors when it comes to what they pay themselves, and in addition, how and why a board is composed. These issues are requiring unprecedented responsiveness and disclosure on the part of boards, which will remain a challenge in the year to come.

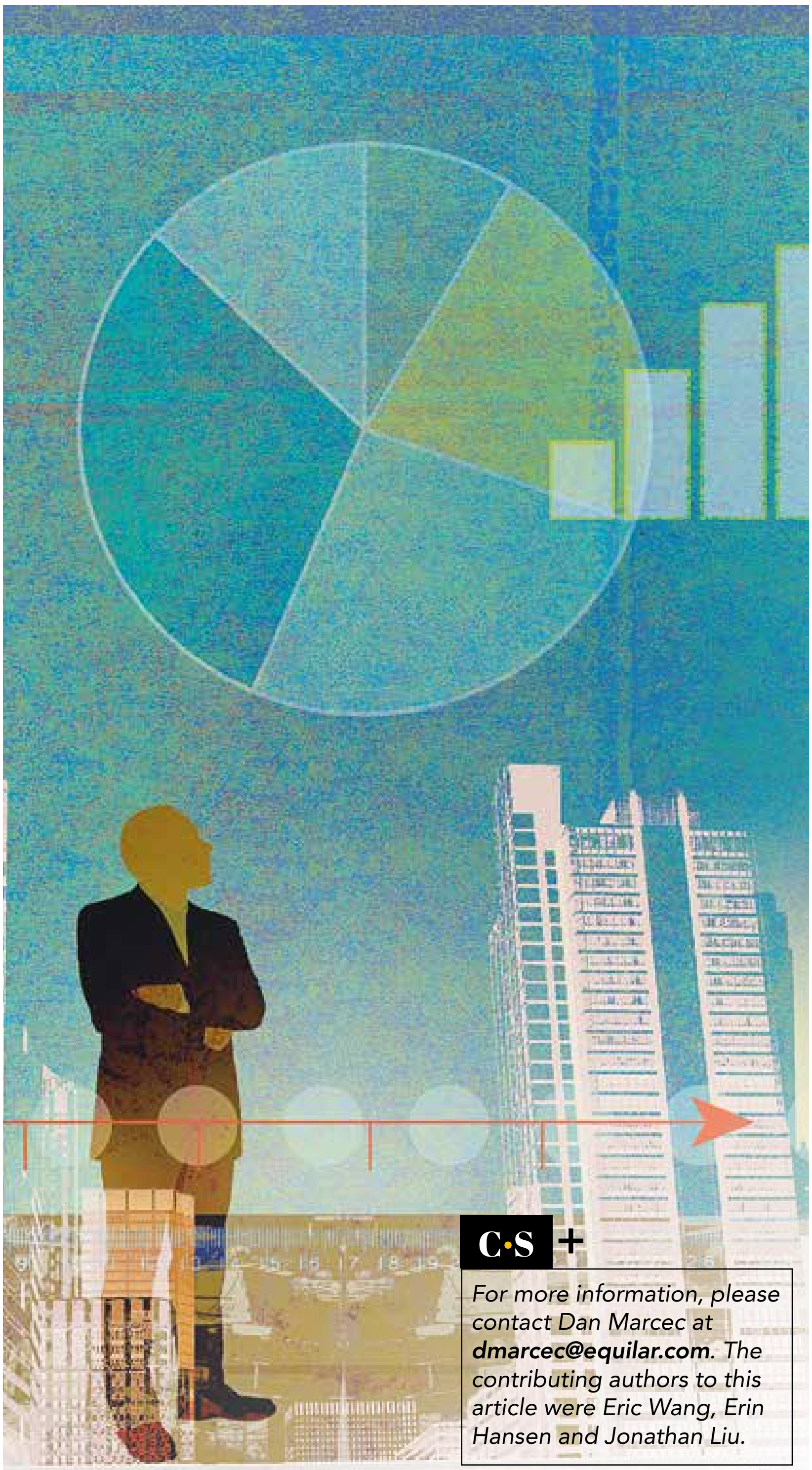
Institutional investors regularly evaluate board composition—including age, tenure, gender, share ownership and industry experience—and they already have tools to access and analyze these elements across their portfolios. In response, boards are turning to technology solutions to help boards address issues that influence company performance and shareholder expectations.

Companies consistently prepare to face unpredictable elements in the economy and from legislature, financial investment and technology. New elements such as activism, cybersecurity and technology certainly mean new challenges, but they also create new opportunities for companies to set themselves apart from their competitors. To mitigate these risks, upfront and clear engagement regarding goals and expectations among all stakeholders—directors, executives, investors and employees—is more critical than ever. CS

A critical risk factor is the use of digital tools inside the boardroom.

Playing the Long Game

Equity compensation shifts away from options and short-term incentives



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For more information, please contact Dan Marcec at ***dmarcec@equilar.com****. The contributing authors to this article were Eric Wang, Erin Hansen and Jonathan Liu.*

Dodd-Frank remains in the spotlight five years following its inception, and scrutiny regarding executive compensation continues to increase as more guidelines and regulations emerge. Specifically, pay for performance has remained a hot topic, and equity, the cornerstone of executive compensation, continues to play an essential role in governance matters for companies and their boards, proxy advisors, and shareholders.

Although changes in equity mix across the S&P 1500 were less drastic in 2014 relative to previous years, the overarching trends from the past five years have continued. Because shareholders are pushing hard for a more direct link between company performance and executive compensation, companies continue to increase their usage of performance equity. In addition, they are trending toward using restricted stock as the premier equity vehicle, which has caused options awards to lose favor as part of equity packages.

Equity Compensation Trends

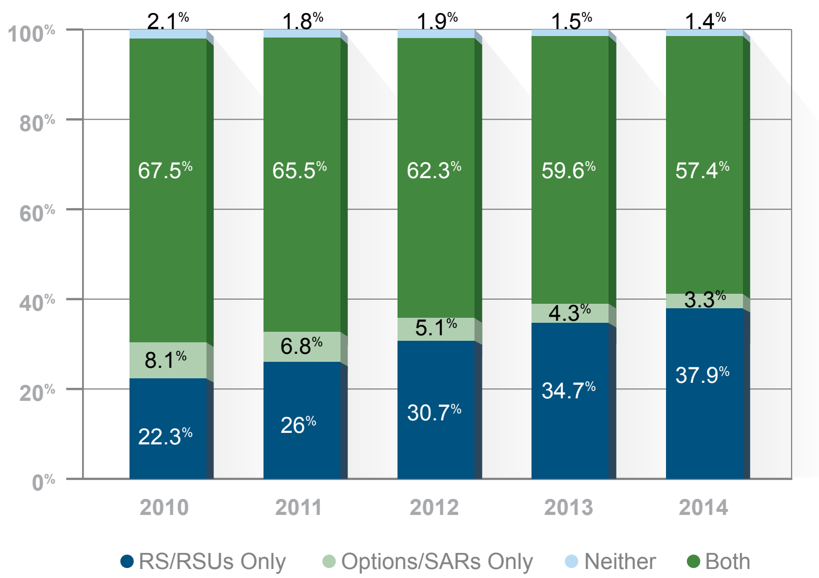
At a broad level, equity grant practices have evolved considerably over the past five years. A majority of companies in the S&P 1500 continue to offer a mix of both restricted stock and options, however, that figure is diminishing, falling from 67.5% in 2010 to 57.4% in 2014. Meanwhile, companies that offer restricted stock exclusively as an equity benefit have become an increasing subset of the S&P 1500, increasing to nearly 38% of companies in 2014. Accordingly, the number of companies that granted no equity, only options or a mix of options and restricted stock decreased.

The trends show a decrease in options awards, and the percentage of companies providing options as a method of equity grants has diminished significantly over the past five years. In 2010, 75.6% of S&P 1500 companies offered options as part of equity packages, and by 2014, that figure had fallen to 60.7%.

Whether or not options are effectively linking pay to performance is still under debate, so the decrease in options awards could partially be due to the fact that investors tend to view options as a time-based and not a performance-based equity vehicle.

*The data and analysis contained in this publication has been prepared by Equilar and is an excerpt from the Equilar 2015 Equity Trends Report. The commentary, where noted, has been provided by E*TRADE Financial Corporate Services, Inc. Equilar is not affiliated with E*TRADE Financial Corporate Services, Inc. or the E*TRADE Financial Family of companies.*

Graph 1
Equity Mix Among Companies in the S&P 1500



E*TRADE Corporate Services Commentary

As seen in the chart above, the popularity of issuing RS or RSUs as the only form of equity grant has steadily increased since 2010. While companies that issue options and Stock Appreciation Rights (SARs) by themselves or along with RS/RSUs are still a significant percentage (60.7%) of the population researched, the rise of RS/RSU grants as the primary means of equity compensation is undeniable. This shift seems to correlate with three key catalysts:

- The adoption of FAS 123(R) by the Financial Accounting Standards Board, which required a fair value to be calculated and expensed for options, effectively eliminating one of the benefits of options.
- The financial crisis of 2008–2009, which put many employees' options or SARs "underwater," reducing the value perceived by employees who received this form of equity.
- Lastly, the growing concerns over corporate governance and dilution, which disadvantage options since one needs to issue more options to achieve the same "monetary value" of a grant.

These factors have likely all played a role in the rise in RS/RSU popularity. However, this is not the end of the story. It is hard to reject the relative simplicity of RS/RSU grants compared to other forms of equity compensation. E*TRADE Corporate Services' research and participant commentary indicate employees tend to understand this form of equity more easily[1]. If a goal of granting equity is to attract and retain top talent, there is a definite benefit if employees have an easier time understanding and valuing the grant. Furthermore, there is a benefit to employees not having to take any further action once the grant is vested, unlike options which can expire if an employee does not exercise his or her vested grant, which may create unnecessary complexity for the issuing company.

*[1]Results are from the 2015 Stock Plan Participant Survey conducted by E*TRADE Securities LLC in February 2015.*

How Performance Is Paid

With options continuing to disappear from incentive plans and the recent focus on pay for performance from shareholders, performance equity awards—which have payout values dependent on predefined metrics—have become the vehicle of choice for incentivizing leaders at many companies. Since 2010, the percentage of companies in the S&P 1500 granting performance equity has risen significantly, reaching 69.3% of that group in 2014, up from 51.7% in 2010.

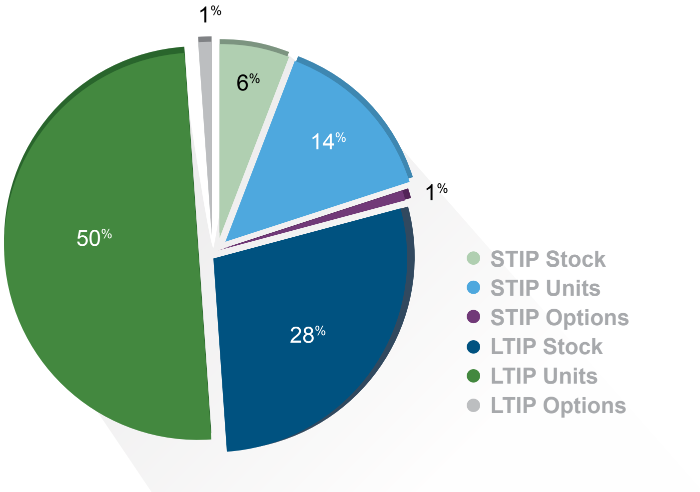
The overall rise in performance equity has introduced a variety of equity plan structures, composed of stock, units and options, and divided into long-term incentive plans (with performance periods of multiple years) and short-term incentive plans (with performance periods of one year or less). Long-term performance awards comprised the vast majority of performance awards granted to named executive officers (NEOs) among S&P 1500 companies in 2014, totaling nearly 80% of all performance equity plans.

Overall, graded stock vesting schedules among S&P 1500 companies were the most prevalent in 2014, with more than 40% of schedules offered in that form. On a sector-by-sector basis, however, vesting schedules varied significantly. For example, S&P 1500 companies in the financial and technology sectors exhibited the highest proportion of graded stock awards in 2014. Just over 55% of all equity vesting schedules among financial companies came via graded stock awards in 2014, and 54% of all such schedules in the technology sector were based on graded stock. Indeed, these were the highest proportions of any vesting schedule across all sectors, and the only ones to command a majority.

E*TRADE Corporate Services Commentary

Institutional investor advisory companies appear to be playing a significant role in issuers' decisions to add performance equity grants to their compensation strategies, especially in the more senior ranks of the company. This pay for performance push is having an impact on public companies that now regularly include performance awards in the compensation mix granted to employees, sometimes making performance equity the only non-cash long-term incentive for executives within those firms.

Graph 2
Performance Equity by Vehicle and Plan Type



Given the increased popularity of performance-based equity grants, companies are left with the task of determining how they will choose to measure the performance of their executives. Relative total shareholder return (TSR) is far and away the most prevalent metric to which companies prefer to tie performance equity, with nearly half of the S&P 1500 using it in at least one of their performance awards. Notably, it is also the most popular performance metric among every industry sector. In 2014, almost half of all companies in the S&P 1500 utilized TSR as a performance indicator. Earnings per share (EPS) and company revenue were the next most popular metrics at an index level, showing 25.3% and 22.1% prevalence, respectively, across the S&P 1500 as a whole.

Ultimately, executive pay is determined by factors very specific to a company (and to those of its peer group), and there is no one-size-fits-all equity mix. The landscape for equity compensation is varied, and companies within different sectors often show distinct, even opposite, compensation packages and equity vehicles. However, in an era of increased government regulation and shareholder scrutiny, universally companies are under mandate to align performance directly to their executives' rewards, to disclose those performance metrics openly, and will be compensated accordingly if they do not meet those expectations. CS

E*TRADE Corporate Services Commentary

The inclusion of secondary metrics into the performance metric calculation seems to be more closely tied to the desire to fairly compensate executives for the broad influence they have over the company. Beyond total shareholder return, companies are looking at other areas that are key to mid- and long-term value creation. These areas can be easily measured, the influence executives have on the measurement is clear, and over time they are a reasonable measure of the impact an executive has had on the company's value.

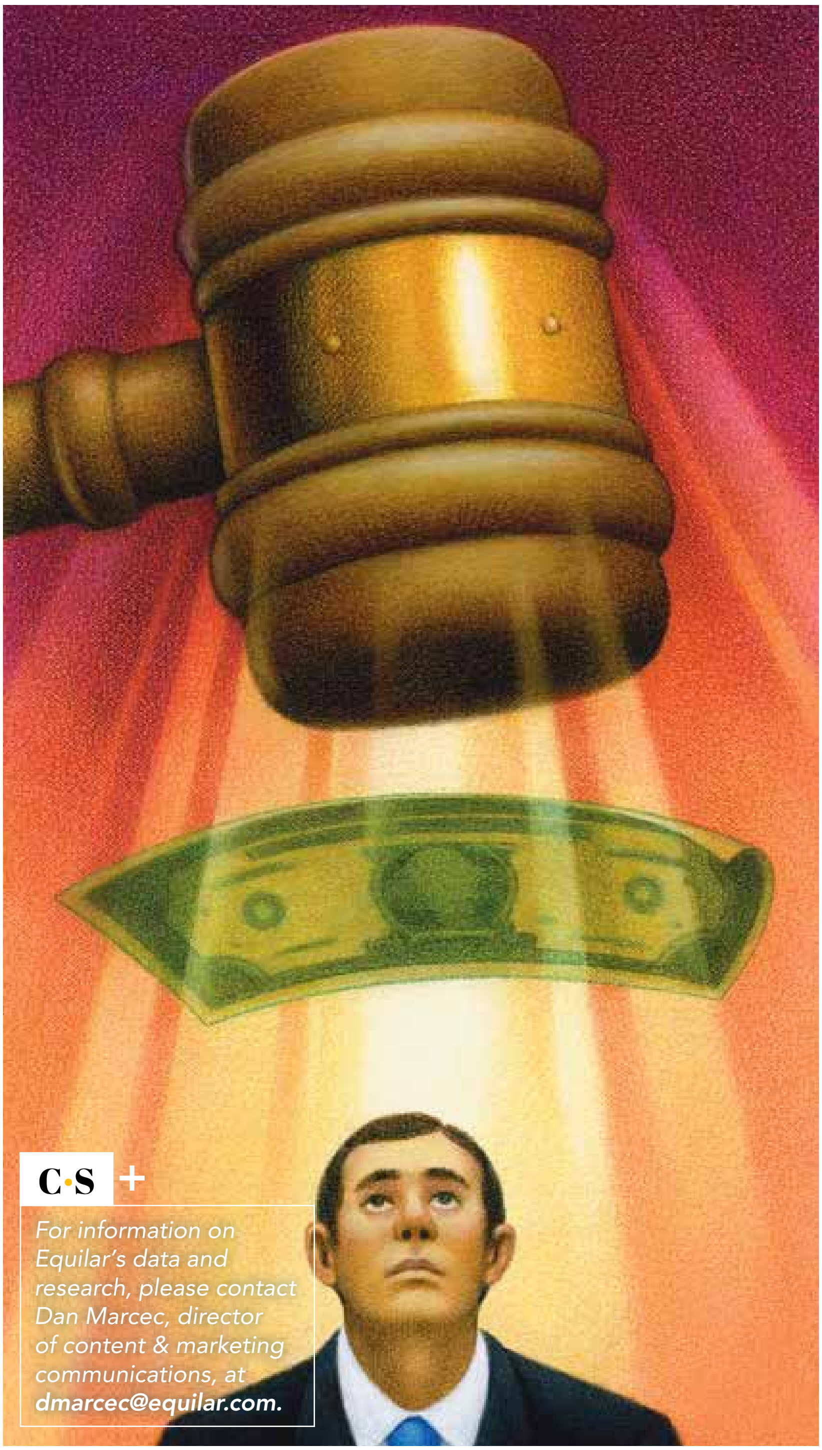
Ultimately these plans, just like broad-based equity plans, are designed to attract and retain top talent. Creating a performance metric that can be driven by the employee and also tie to the goals and values of the company is more likely to motivate and attract talent than simply tying the performance equity to TSR.

Table 1
Most Prevalent Metrics by Sector

SECTOR	METRIC	PREVALENCE
S&P 1500	Relative TSR	47.8%
	EPS	25.3%
	Revenue	22.1%
Basic Materials	Relative TSR	68.1%
	ROC/ROIC	33.6%
	Cash Flow	10.6%
	EBITDA	10.6%
Consumer Goods	Relative TSR	38.0%
	EPS	32.4%
	Revenue	31.5%
Financial	Relative TSR	50.0%
	ROE	28.4%
	EPS	25.3%
Healthcare	Relative TSR	48.0%
	EPS	37.3%
	Revenue	30.7%
Industrial Goods	Relative TSR	45.3%
	ROC/ROIC	27.4%
	EPS	25.5%
Services	Relative TSR	30.5%
	Revenue	28.6%
	Operating Income	27.7%
Technology	Relative TSR	45.9%
	EPS	43.9%
	Operating Income	27.7%
Utilities	Relative TSR	93.0%
	EPS	33.3%
	Net Income	14.0%
	ROE	14.0%

From the Boardroom to the Courtroom

How director compensation can cause legal risk



Median director pay among S&P 500 companies has increased significantly in recent years. According to the latest Equilar research, director retainers among companies reached a median $235,000 in 2014, up from $215,000 two years prior. In response, shareholders see the amounts board members pay themselves and are asking whether this compensation is justified.

"Looking at macro stats, I expect we should see modest increases in total value provided to directors based on their service," said Barry Sullivan, managing director at Semler Brossy Consulting Group. "It's interesting to dig into the company-by-company information, where we see many are managing director pay on an every-other-year, or even every third-year, basis."

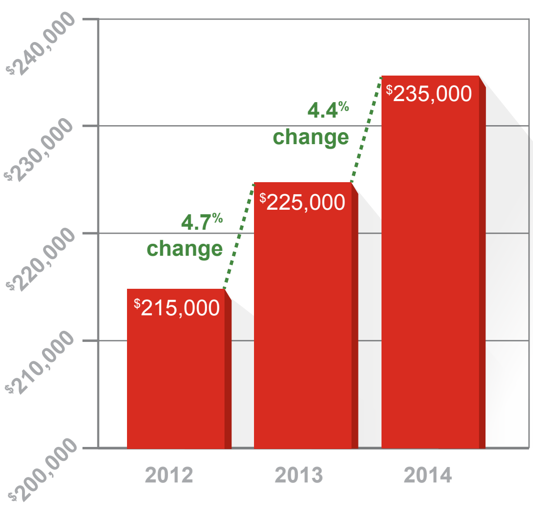
While each company's case is individual unto itself, a few general trends in determining director pay have emerged.

Directors are taking on a combination of increased risk and increased responsibility, especially in light of Dodd-Frank and its subsequent regulatory changes. Board directors are now facing more disclosures, regulations, guidelines and a more complex business environment, and are accountable for communicating their companies' strategic and financial goals.

Then you have the risks: Aside from shareholder scrutiny on pay, other forms of shareholder activism leave boards vulnerable to restructuring or even replacement. Ironically, activism often manifests because of good performance and pressure to outperform, in contrast to a common conception that activists come in to takeover and overhaul poorly running companies. These responsibilities or risks aren't inherently "bad" for boards, and increased transparency and communication has led to greater shareholder engagement. But they also command greater shareholder scrutiny.

In a few cases, shareholders have gone as far as the courtroom, suing companies on the grounds of excessive pay and lack of compensation caps.

Graph 1
Median Director Pay Among S&P 500 Companies 2012-2014



Plaintiffs are drawing comparisons to lesser paid board members at peer companies, alleging that the defendants are benchmarking to "aspirational peers," i.e. justifying their pay by cherry-picking peer groups instead of aligning their pay with companies that are reflective of their actual market position. These were key themes in cases involving Goldman Sachs, Facebook, Citrix and Republic Services.

"Plaintiffs are alleging that boards have breached fiduciary duties in connection with comp they pay themselves, and the essence is that directors are acting out of self-interest," said Joe Yaffe, partner at Skadden, Arps, Slate, Meagher & Flom. "This is a large risk for boards because they are not protected by the same corporate law rules as when they are setting another person's compensation."

How Director Pay Maps to Performance

Director compensation, like executive pay, is also increasingly being tied into shareholder interest. This has manifested in a rise in equity awards for directors. In 2014, the median director retainer package was 56% equity vs. 44% cash.

But unlike executive pay, where we've seen pay for performance and realized pay being tied to short-term goals, experts say it's important that director pay has less volatility.

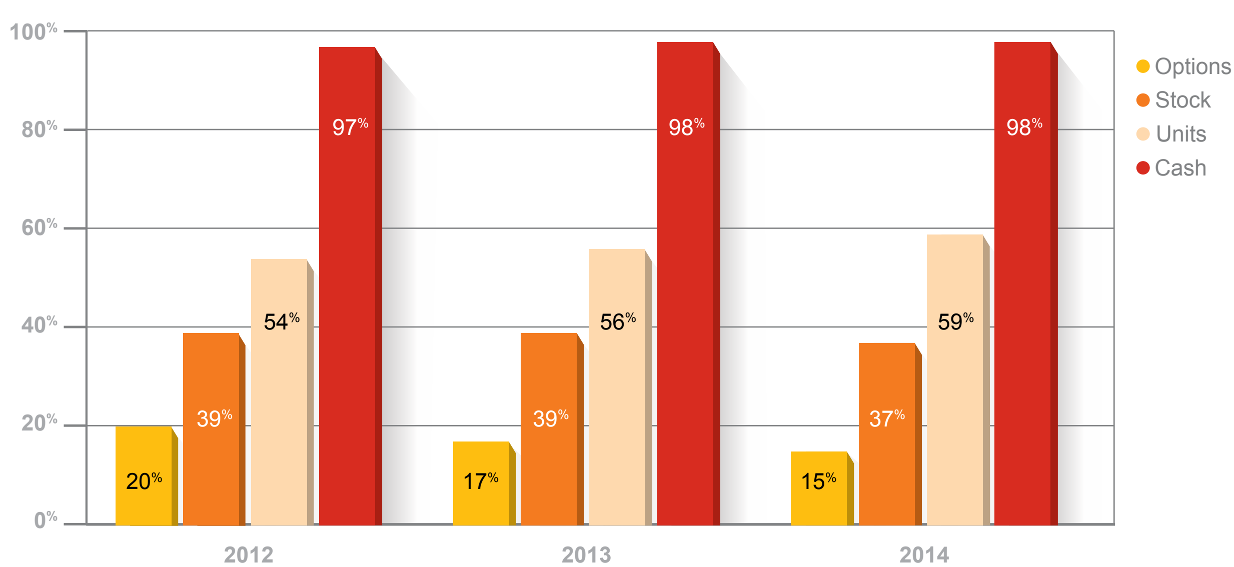
"Companies are hesitant to wade into pay for performance water with boards because they want to be very careful to protect the board's overall stewardship role, which is different than active management," said Sullivan. "Direct active management lends itself to performance pay, but something like share price over time is more appropriate for boards who provide more of an advisory and fiduciary role."

Yaffe agreed. "It's important to remember director duties as fiduciaries, and there's a challenge when you run into pressure for performance-based pay," he said. "A lot of times there's overlap, but board members should not be put in conflict with those duties."

Indeed, the data shows that nearly all director packages among S&P 500 companies include some cash element, and the prevalence of units has risen while stock and options are decreasingly part of packages.

The question is how boards adjust to added levels of scrutiny and the perception of conflict of interest, and appropriately set their own compensation. Identifying the right peer group is getting as much scrutiny as on the executive side, but it's not always an apples-to-apples comparison. For some companies that might even mean distinct peer groups for director pay where

Graph 2
Director Pay Component Prevalence Among S&P 500 Companies 2012-2014



pool for director talent might be deeper and broader than executive talent.

"Looking toward the future, I wouldn't be surprised if we see more and different thinking about whether peer groups for executive pay carrying over to director pay is the right approach," said Sullivan. "In some sense you need specific industry experience and potentially specific skills to that industry on the executive side, and on the board, skills may be more portable industry to industry, so you might think about the peer set more broadly, or more narrowly—maybe by geography, for example."

Many boards are already taking protective measures, said Sullivan. He noted his firm's recent analysis of the S&P 100 since 2013 to look at boards in the new era of heightened governance. And of those companies, 77 had gone back to shareholders for new equity authorizations, and of those two-thirds have taken explicit protective measures in setting equity limits for director grants. About 40 of those companies have set meaningful limits and given them dollar values—typically ranging from $500,000 to $1 million for that group of the largest U.S. public companies.

There are other areas where director compensation will differ materially from executive pay in the near- to mid-term, said Yaffe. One is mandated pay limits, which are very similar to meaningful limits on director pay under shareholder-approved plans.

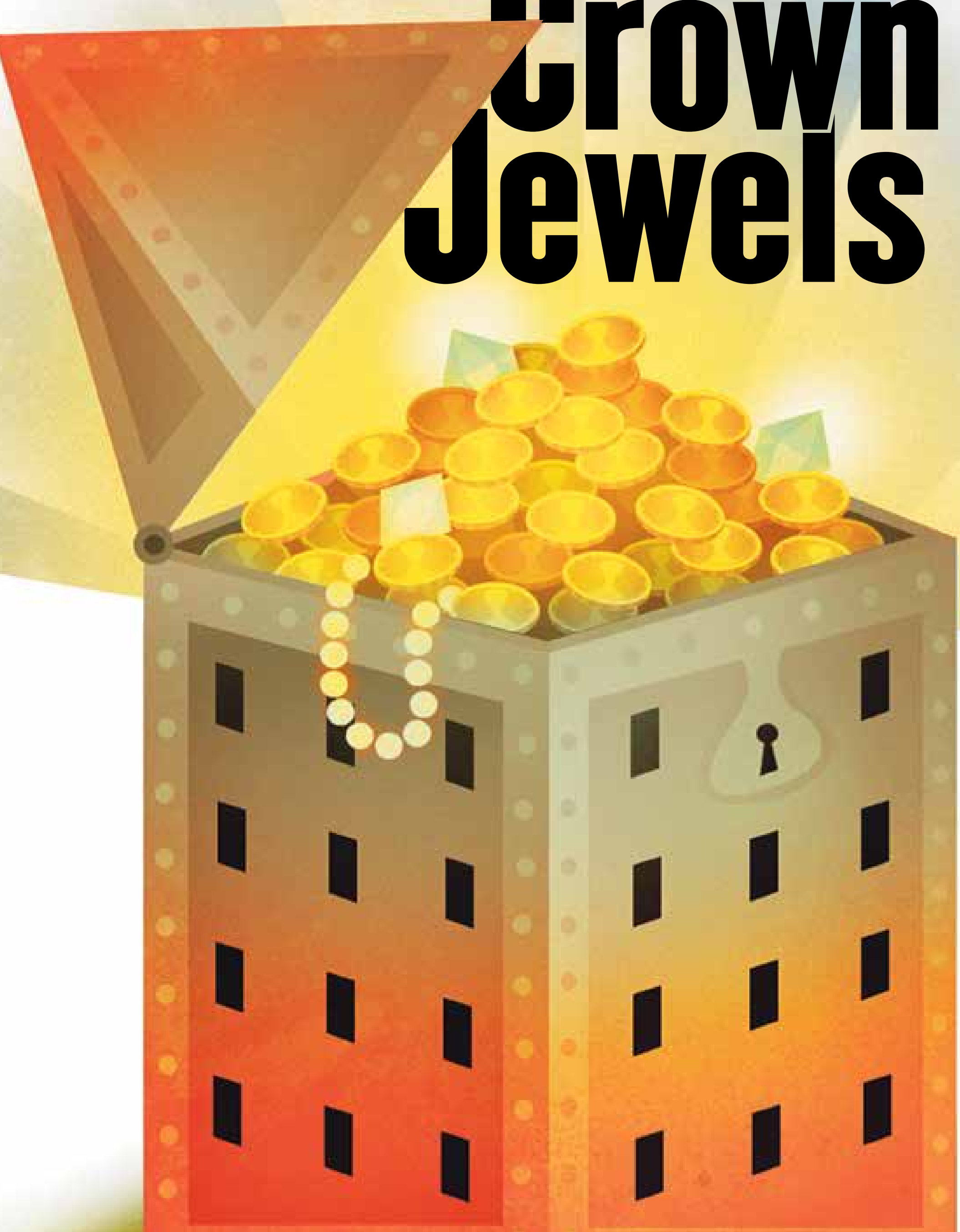
"I would not be surprised to see this, but once approved by shareholders, that is very difficult to overcome, and granting an excess of that limit creates a host of issues," he said.

In addition, he says that director Say on Pay would be "striking, if not shocking." While it's mandatory for executives, it's still not binding, and even that required an act of Congress. Since there isn't even a drumbeat for it, shareholders having control of director pay seems further afield.

Ultimately, as organizational complexity has increased, so too has director compensation. Directors are earning more in accordance with new responsibilities and heightened company performance, but with that comes distinct risks if they are not deliberate and transparent about what they choose to award themselves. CS

"Directors are taking on a combination of increased risk and increased responsibility, especially in light of Dodd-Frank and its subsequent regulatory changes."

Safeguarding the Crown Jewels



Cyber attacks can expose a company's most important assets. How can boards manage this risk?

By Blake Stephenson

NASDAQ

Cybersecurity has entered the mainstream, touching the lives of individuals, organizations and entire nations. Today, society relies on interconnectedness and collaboration, and cloud storage is commonplace. To this end, vulnerability to a cyber incident and the potential consequences are increasing.

For companies, the board is responsible for defining risk tolerance, and executive management implements policies to manage risk within that tolerance. Risk management is typically delegated to the CTO or CIO and during each board meeting, they update to the board to ensure the directors understand the nature, impact and probability of a breach, as well as the mitigation actions.

Boards usually maintain a risk register to aid in monitoring changes in risk and how effectively they are managing and mitigating potential threats. This information—together with other mission critical data pertaining to topics such as product strategy, long-range financial planning, HR policies and potential candidates for key positions—is often shared over a secure electronic portal because "these content items can be market moving," said Jim Konz, Nasdaq's Head of Mobile and Security and Principal Product Manager of Directors Desk. "A leaked document could have a significant impact on their share price."

The sources of risk are broad, but a number of external actors dominate the threat landscape across sectors. Nation states want access to intellectual property, trade secrets and government information, cyber criminals seek credit card data to commit fraud or compromise user accounts, and hacktivists act against specific targets, sometimes on behalf of nation states. A further group of actors often overlooked are company employees with privileged access to assets.

Ultimately, the degree of risk assumed by the board varies depending on the type of company, and generally the bigger the company, the more customer data it has and the greater the potential cost of any breach. A recent credit card data theft at one U.S. retailer cost the company more than $160 million. The organization struggled to recover from the reputational damage and revenue loss as consumers' loyalty shifted to competitors. In the aftermath of the news release, its share price experienced a double-digit decline. Although it recovered later that year, the negative consequence to stakeholders is palpable.

Blake Stephenson is Head of Business Development–Governance Solutions at Nasdaq, and has held many governance, risk and compliance roles, with a particular focus in regulatory compliance and good governance in UK markets infrastructure.

Because of global on-demand access to media, brands can be tarnished overnight. In scenarios where client data is stolen or manipulated, companies may have to pay losses to compensate for damages, and moreover, regulatory fines for failure to implement sufficient controls might be incurred. Cybersecurity breaches are usually high-profile events and the reputational and regulatory risk associated with them should not be underestimated. Risk management arrangements need to be robust and appropriate for the company in question, and be sufficient to maintain the confidence of all stakeholders, including regulators.

Employees are often the frontline defense and therefore usually complete security awareness training annually. To strengthen this frontline defense, companies also establish transparent, thorough, streamlined and tested processes that are communicated to all levels of the organization. Software developers usually undergo secure coding training, too.

Hackers use various 'vectors' to achieve their goals such as targeting application vulnerabilities and sending phishing emails to internal employees. Product developers and managers should be aware of these and take steps to educate employees and minimize possible gaps. Further, information security teams regularly monitor lists, such as the Open Web Application Security Project, so they are aware of the top ten most common and exploitable vulnerabilities, and make sure they can safeguard applications against them.

It is important to subject applications to third party penetration tests, where the source code of each major release is examined to identify vulnerabilities. A full security stack including encryption, multi-factor authentication, firewalls, intrusion detection systems and intrusion prevention systems should be implemented. Data centers are locked down and controls reviewed at least annually.

Ultimately, companies assume a certain level of risk to deliver financial performance. If a company is excessively risk averse, the business may not perform as expected by its shareholders. So, boards are taking a much more active role in wrapping risk management into corporate strategy, which is having an impact on corporate culture.

"Boards need to know what assets they're protecting—what are the crown jewels of their organization—and then put appropriate protections in place," said Colleen Valentine, Information Security Project Manager at Nasdaq. "Identifying critical assets may not be clear-cut in a diversified business, so they have to conduct that analysis."

Cybersecurity is mistakenly perceived as primarily a technology issue instead of a regulatory compliance issue and a core business risk that must be managed. Ultimately, the board must be held accountable for asking the right questions, adopting policies and procedures, and communicating the risks.

A key takeaway following recent attacks is that companies have traditionally invested millions of dollars in security after the breach. That investment needs to be made well before any incident is on the horizon. Every company is a potential target, so now is the time to prepare. CS

Cybersecurity best practices

- Develop a risk culture and a fit-for-purpose enterprise risk management policy.
- Establish an enterprise risk management and reporting framework, with accountability flowing to various parts of the organization.
- Implement real-time processes to manage and communicate information securely about the types of risks, the level of risks and how they are being mitigated.
- Foster resiliency by identifying and categorizing all risks, determining their severity and then implementing measures to counter them.

Vote of Confidence

An SEC vote for universal ballot may cause unintended consequences

By TK Kerstetter

BOARDROOM RESOURCES LLC

Remember this day: Thursday, June 25, 2015. It was then that U.S. Securities & Exchange Commission (SEC) Chairman, Mary Jo White, informed attendees at the Society of Corporate Secretaries & Governance Professionals Annual Conference in Chicago that she favored the concept of a universal ballot, or a single voting form in contested corporate elections. She said a universal ballot would make it easier for shareholders to vote for individual board candidates offered by both investors and management, versus the traditional proxy voting rules that require shareholders to choose entire slates of director nominees proposed by either group. She also said, "While I agree that the devil will be in the details, I have asked the staff to bring appropriate rule-making recommendations before the Commission."

As you might imagine, this created quite a buzz in the crowd. Most of the attendees were corporate secretaries responsible for working with the board of directors on both structure and process to ensure their board operates as effectively as possible. While there was no audible cheering in the ballroom that day, there was undoubtedly some proverbial back-slapping and cork-popping in the backrooms of institutional investor, proxy

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advisor and hedge fund offices. If universal ballot is passed, those interested activist shareholder groups would potentially gain the muscle and tools to become the driving force in future contested board competitions.

SEC critics were quick to identify potential problems like shareholder confusion and activists' short-term earnings agendas that may or may not have much validity. A potential rule change is pretty big governance news in itself, but Chairman White didn't stop there. She encouraged companies not to wait for rulemaking, but rather to just bite the bullet and make the change to a universal ballot today. Frankly, this advice probably won't be encouraged by companies' corporate lawyers or governance experts, and I expect this will be one hotly contested issue—particularly with the U.S. Chamber of Commerce, which has a pretty good track record battling both sound and shaky regulator rulemaking.

Flip-flopping back and forth on the pros and cons of a universal ballot, I quickly recognized I have a lot to learn as the smarter and higher-paid experts continue to sort out the right balance of power for both companies and shareholders to maximize shareholder value in the United States. Fortunately, I am smart enough to think through the ramifications for existing publicly held boards, and I do feel there is a troubling aspect of the universal ballot.

I have spent a good part of the last 15 years working to ensure that boards meet several key success factors: Good leadership through a strong outside chairman or lead director, a board succession program that will ensure the right composition of board members to prudently fill out committees and, most importantly, board committee chairs, and meaningful board evaluations to guarantee that all board members are contributors qualified to protect and grow shareholder value.

With that backdrop, here's my concern. Take, for example, a strong outside chairman and nominating/governance committee chair of a company who has done a good job recruiting directors who contribute to committees and provide both key industry and risk management knowledge. Then say a very clever activist with a witty proxy solicitation team gets four candidates from a slate of potential directors elected on the universal ballot at the annual meeting. If that happened, in one annual meeting this company's board would have lost its current audit committee chair, audit chair in waiting, and compensation committee chair, not to mention the only person on the board that understands the right questions to ask related to cyber risk. None of the new directors are qualified to be the audit committee chair, but the company has no flexibility under current bylaws to recruit anyone to fill this critical board committee chair position—unless they expand the board, however the new directors will likely vote against that if it dilutes their influence.

This is a worst-case scenario, but my question is simple: How is a board supposed to plan effectively to represent shareholders if they don't even know what skill sets they will have on the board until after the annual meeting, and if the existing nominating/governance committee has played no role in recruiting the skill sets needed? It is an extreme example that several key committee chairs might all be among those directors defeated in the election, but it is certainly not out of the question. Consider the potential consequences if an activist is successful in electing four new directors who have been placed on the board slate more for their allegiance to the activist than for their skills as a contributing director. As a shareholder who understands the dynamics of a success board and boardroom process, this definitely concerns me.

In closing, I need to be clear. As a practical matter, I'm not against shareholders having more say in who represents their interests in the boardroom. I think that is a healthy process. I also have personally witnessed plenty of examples where activists, both on and off the board, have helped companies get their act together and significantly improve both short- and long-term shareholder value. My issue is that the SEC really needs to think through this proposal so that we don't erase the progress that has been made since Sarbanes-Oxley. Since then, a majority of boards have stepped up, owned their boardroom, provided needed leadership and planned for the future. We still have some less than stellar boards for sure, but there has been great improvement overall, and we need to keep moving forward rather than taking a step back. If universal ballot passes, will the devil be in the unintended details? CS

"If universal ballot is passed, interested activist shareholder groups would potentially gain the muscle and tools to become the driving force in future contested board competitions."

Thoughtful Transparency

Examining detailed and open proxy disclosure of Board Oversight of Risk

By Ron Schneider

RR DONNELLEY

Company proxy statements continue to evolve from SEC 14A compliance documents to more investor-friendly, visually inviting and compelling communications pieces. This transformation encompasses both required proxy disclosures, such as a discussion of Board Oversight of Risk, as well as the increasing amount of non-required, or voluntary, discussion many companies are incorporating into their proxies. Risk is broadly defined, including but not limited to financial, regulatory, strategic, operational, compensation, reputational, environmental/sustainability, and increasingly, cybersecurity risks.

Today, many companies' proxies contain more information about the board than ever before. In addition to required sections such as director nominee bios, skills and qualifications, composition and roles of key committees and board oversight of risk, the CD&A is intended as a window into the "why" of compensation committee pay decisions, in addition to merely the "what."

Additional voluntary board-related disclosures include the increasing inclusion of director skills matrices, often depicting graphically the key skills possessed by the board in total, with others attributing specific skills to particular directors. In addition, there have been increasing disclosures including graphics highlighting director diversity, including age, tenure, turnover/refreshment and geographic experience, as well as expanded discussion of director and CEO evaluation processes and related succession planning.

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In the current environment of heightened investor activism and related calls for proxy access, it is critically important for companies to use all available means to build confidence in the board—its independence, skills and qualifications, and its related ability to provide effective oversight of, and support to, senior management in their efforts to increase shareholder value.

Recent Research Into Investor Use of Proxy Information

In late 2014 and early 2015, RR Donnelley, Equilar and Stanford University's Rock Center for Corporate Governance collaborated on a survey of institutional investors about proxy statements and how they utilize them, supplementing an earlier RR Donnelley survey. These results, which included responses from 64 institutional investors with a combined $17 trillion in assets under management, were made public earlier this year, in a report titled "Deconstructing Proxy Statements — What Matters to Investors."

The more recent survey primarily focused on how proxy disclosures are used by institutional investors in evaluating and voting on company proxy proposals. In addition, it addressed how certain proxy disclosures may also be used in making investing decisions. Here are some highlights:

- **Voting decisions:** Disclosure of risk oversight was ranked 8th out of 20 topics investors indicated they review carefully in proxies, with 43% of respondents indicating this was an important topic in making voting decisions. Most of the top seven topics were related to the board, and to executive compensation.
- **Application of proxy statement information to investing decisions:** Disclosure of risk oversight ranked even higher, at 4th out of 20 topics, with 29% of respondents indicating this was an important topic in making investing decisions. The three higher-rated topics related to compensation and governance profile/shareholder rights.

In reviewing how hundreds of leading companies treat the topic of board oversight of risk, it is important to recognize that investors generally do not have a direct line of sight into the board and its activities, other than what companies may disclose. As such, we see three primary types of disclosure:

1. Fairly generic discussions of board on oversight of risk, without going into great detail about which risks are of most concern, or who (full board, particular committee(s)) focuses on these risks. While these boards may be highly focused on risk oversight, it does not come through in what may appear to be boilerplate discussions. Generic discussions will not generate confidence that the board takes this important issue seriously and is actively focused on particular risks facing the company, given its industry and stage of growth.
2. More thoughtful, company-specific discussions of risks, including indications of which risks are discussed by the full board, and which are handled by specific committees of the board. These detailed disclosures should generate more confidence that the board has a handle on the key issue of board oversight of risk. But if appearing only in narrative format, given the increasingly visual nature of many proxies, this discussion may be overlooked, in which case the company is not getting the credit it deserves for its effective risk focus and oversight.
3. Similar thoughtful, company-specific discussions, initially in narrative, and then supplemented by a graphical summary that draws the eye to which risks are within the purview of the full board, versus which are attended to by which committee(s). This third type of disclosure is most likely to be noticed, digested and appreciated, thus engendering the most confidence that the board is appropriately attending to risk.

Where and how information is located also matters. Since investors need to locate key information quickly, companies are encouraged to improve navigation to and viewing of this disclosure both by placing it under its own specific section heading or sub-heading, such as "Board Oversight of Risk," and tying this back to its own entry in the Table of Contents. Doing so works far better than requiring readers to locate the information they're seeking within a broader category such as "board leadership structure" or "corporate governance."

In the end, it's clear that risk matters to investors, both in voting, as well as in investing. As with other key proxy disclosure topics, each year many companies are "upping their game" in this area, improving both the content and the ease of location of key information. For this reason, it's important not just to re-confirm the continued accuracy of your past disclosure annually. Proxy time presents an excellent opportunity to review what your peer companies are doing, and consider how your treatment of this topic stacks up to other companies with which you compete for investor capital.

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The investor survey referenced herein is available at: ***info.rrd.com/2015_Investor_Survey****. RR Donnelley's proxy guide, which is a searchable catalog of best practices disclosures including board oversight of risk, is available at:* ***info.rrd.com/Guide_to_Proxy_Design****.*

Examining New Perspectives

Why companies should go beyond benchmarking when evaluating CEO pay

By Irv Becker

HAY GROUP

Faced with increasingly active investors and a tense shareholder environment, boards are under more pressure than ever before to make informed and business case-driven CEO pay decisions that are seen as "fair" by an expanding pool of stakeholders—from investors and employees to the CEO and the general public.

While peer-group benchmarking is still the most common tool for determining CEO pay, this approach has faced increased scrutiny from critics, serving as a catalyst for risk for boards across industries.

The critical eye on CEO pay is an outcome of the financial crisis, which exposed the shortcomings of the benchmarking process and simultaneously put pressure on organizations to find new and better ways to reward their top executives. Today, critics continue to blame benchmarking for ratcheting up pay to higher levels and decoupling compensation from CEO and organizational performance.

Shareholders' and investors' focus on capital returns, desire for top-line growth and pressure on profits are forcing boards to reconsider not only what they pay CEOs, but also how they structure that compensation. At the end of the day, while benchmarking has its place, it is important for boards to think more broadly and peel back more layers of the onion to determine executive compensation.

Going Beyond Benchmarking

Especially as CEO pay remains a front-page news item, boards must use multiple lenses to evaluate compensation via a more complex and rigorous assessment of both internal and external factors. This will create the context for decision making that goes beyond the numbers and creates a business case for CEO pay.

Externally, this process considers the relative scope, complexities, challenges and expectations of the chief executive role. Looking inward, boards must examine the culture, leadership style, pay differentials between CEO and direct reports, and how well the internal talent pool has been developed for a successor.

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In evaluating each criterion, boards must ask themselves, "What do we want to achieve as a business?," "What are the unique expectations of the CEO's role?," "How will the way we compensate our CEO support those goals?" and finally, "How will we measure the return on our investment?"

The end goal is to establish "internal equity," or the perception that the organization is paying people according to the relative size and the impact of their roles on the organization. This will diminish the risk associated with CEO pay by leading boards to create an executive compensation program that balances fairness and competitiveness with the responsibilities and complexities of the chief executive role.

Building the Business Case

Fairness is the current buzzword in executive compensation—and understandably so. As CEO pay transparency is required and the pay ratio disclosure is looming for all public companies, the compensation conundrum has spread beyond the boardroom and into mainstream conversation. This has resulted in an ever-expanding pool of people who have an opinion on how fair (or not) CEO pay is at an organization. Boards must take all of these often competing views seriously when making pay decisions.

> "As CEO pay remains a front-page news item, boards must use multiple lenses to evaluate compensation."

To establish internal equity and determine the most effective level of CEO pay, boards must weigh compensation against the company's overall strategy and objectives, considering external factors, including:

- **CEO role, responsibilities & complexities.** Determining the goals the board has for the CEO role and how it will measure and reward that person for achieving those milestones is important. Factoring in any challenges associated with the role and evaluating the differences and expectations of the CEO's role relative to the market—such as needing to turn around a struggling business—is also key. Ultimately, mapping these answers against the CEO job requirements and expectations will, in turn, foster a holistic view of pay that is both "fair" and effective.
- **CEO expectations.** The CEO needs to perceive the compensation that the board is offering as being of equal value to a pay package with a different structure elsewhere. The chief executive should also understand what needs to happen in order for the incentives of the package to pay out.

To glean a more complete picture, boards must also look inward to evaluate CEO pay, examining the following criteria:

- **The CEO as an individual.** Taking a close look at the CEO's experience, skill set, leadership style, motivators and appetite for risk is critical. Boards must determine whether the chief executive will thrive on a low-base salary, with high potential pay-outs from incentives, or whether a more balanced pay program would be more compelling.
- **Corporate culture.** What the board pays the CEO sets the tone for the culture of the organization, so it's important that his or her pay reflects the company's overall compensation philosophy and corporate culture. Comparing pay levels between the CEO and his or her direct reports can reveal important perspectives on internal equity and help the board ensure that the people at the layer below feel appropriately rewarded for their work.
- **Succession planning.** Determining whether there are CEO successors standing in the wings will inevitably impact CEO pay. Internal candidates will generally not require a marketplace premium to assume the role for which they have been groomed, whereas recruiting from the outside often requires a premium in addition to award buyouts, while also incurring the associated risks of bringing in an outside executive to run the organization.

The Result? Reduced Risk

The pending implementation of the CEO pay ratio disclosure, looming decisions on pay for performance disclosures, and constant debate surrounding pay and income inequality ensure that CEO pay will stay at the forefront of discussions in the media and politics, as well as among shareholders and active investors. As a result, using multiple perspectives to evaluate CEO pay, rather than solely relying on benchmarking, will help to protect boards and create a solid foundation for accurate and effective CEO pay decisions.

Ultimately, CEO pay analysis doesn't stop when compensation has been determined. For maximum effectiveness, boards must continue watching how changes in viewpoints and the business environment affect the business case for pay and tailor CEO compensation accordingly. CS

Roundtable:

Overcoming Risk on Critical Company Projects

We've often heard that there's no substitute for experience, and indeed, there's no better learning environment than one's own successes and failures as a manager. Feedback and reflection present us with several opportunities to learn from others, and one of those areas that can define one's career—and more importantly, bring value to a company—is successfully launching critical company projects.

TK Kerstetter, CEO of Boardroom Resources LLC, conducted a roundtable for *C-SUITE* with Steve Wilson, CEO of CF Industries (retired) and a director at both Ameren Corporation and GATX Corporation, Jennifer Scanlon, Senior Vice President, USG Corporation and President of USG International, and Tom Lebamoff, Managing Partner for Liberty Advisor Group, to discuss how great companies guided by effective leaders manage critical company projects—which can range from major technology upgrades to bet-the-company strategic mergers. With this issue of *C-SUITE* focused on risk, this roundtable defines several ways in which leaders manage difficult issues and lead their companies to positive outcomes.

Kerstetter: Let's start by defining what we mean by critical company projects and programs.

Steve Wilson: Critical projects have outcomes with significant impact on the company's success—for example, essential IT projects that impact the operating platform, integration of a transformational strategic merger or construction of a major manufacturing facility. Executed successfully, critical projects will create sustained value, while critical projects that are poorly executed can result in large cost and time overruns or even put the company's viability at risk.

Jennifer Scanlon: A project is critical when it solves a strategic issue, requires a visible percentage of available capital, requires multiple functions to work together and will improve the bottom line meaningfully.

Tom Lebamoff: It might be argued any customer-facing project is critical, but I would also add cross-functional projects where divisional silos, competing priorities and executive incentives can conflict with overall company goals.

Kerstetter: What are the essential leadership controls for a company to be successful with critical projects?

Lebamoff: Put your best people on the project, make it a number one or top two priority, and position executive incentives to achieve executive alignment.

Scanlon: First, the executive team has to agree upon what problem(s) they believe this project will solve, and use that clarity to set simple metrics as the project's goals. Second, you have to assign your best people—usually full time. This is painful, but without your best performers, you are almost guaranteed a poor solution—delivered late and over budget—which is not a winning proposition. Third, you need to follow a process that encourages honest evaluation of progress, milestones, budget and contingencies.

Steve Wilson, CEO of CF Industries (retired) and a director at both Ameren Corporation and GATX Corporation

Jennifer Scanlon, Senior Vice President, USG Corporation and President of USG International

Tom Lebamoff, Managing Partner for Liberty Advisor Group

Wilson: Leadership controls are the foundation for a successful project. That includes developing a set of metrics to monitor the activities, establishing clear accountability by appointing an appropriate project sponsor who has a vested interest in a successful outcome and providing a direct line from the sponsor who is empowered by a very senior officer, often the CEO.

Kerstetter: What is your approach to managing critical projects successfully?

Scanlon: First, set a compelling shared vision. Our USG team always develops a vision statement immediately, supported by a clear list of project objectives. We review the list at every executive committee meeting and board update.

Second, push for aggressive deadlines, while balancing risks. The faster we launch USG's technology in the markets, the better our return will be. We push our technical teams to accelerate the original plan, and this requires us to take some calculated risks about working in new, unfamiliar geographies.

Finally, assign seasoned project managers. The larger the project, the greater the need for project management experience. You need seasoned project managers who are not afraid to deliver bad news and have the experience to know what to do about it.

Kerstetter: What experiences helped shape your approach to managing critical projects successfully?

Wilson: About 15 years into my career, my business unit implemented an IT project designed to integrate almost all phases of the business. The lessons I learned ranged from contract writing, to how to allocate tasks between employees and consultants, to how to design a system testing and rollout approach that would maximize the chances of success and minimize the consequences of failure.

Kerstetter: Can you give an example of a project that required skills outside of your company's talent pool to ensure success?

Wilson: We undertook an SAP system installation. Most executives have either experienced or heard horror stories about poorly executed SAP projects. In this case, I knew that we didn't have the skill set in-house to handle the technical side of this project. So we hired a major consulting firm to co-manage the project and to provide technical staff to handle much of the workload and to transfer knowledge to our in-house team. That level of outside assistance is needed in most companies for major IT initiatives. However, in this case, I also wasn't sure that we had the technical ability at the executive level to ensure that we would detect issues and problems early enough to address them without delaying the project or increasing cost. Although this was somewhat counterintuitive, I retained a consultant to monitor the consultant. This consultant team had experience with many SAP installations and with the main consulting firm. Their role was to make sure that we stayed within scope, schedule and budget. Their accountability was to me directly, and we met on a scheduled basis. That gave me line of sight to the project on an unfiltered basis and provided the information I needed to keep the board of directors informed of project progress.

Scanlon: We at USG frequently bring in outside experts to supplement critical projects. For example, many of our large IT projects used external program managers, who were independent of software vendors and systems integrators. These program managers play the role of "honest broker," which accelerates the pace and speed of decision making. There is a big difference between external resources that are supplemental staff versus experienced experts who provide real leadership. I bring this up because the latter is expensive, and many inexperienced executives believe they can minimize this budget item without consequence. One of the biggest mistakes I've seen is spending little to nothing on program leadership resources because they "hate consultants." It's a shortsighted view.

Kerstetter: What one important piece of advice would you offer senior managements teams and boards to ensure their critical projects have the best odds of being successful?

Wilson: Insist on clear delineation of accountability for the project and avoid, or at least minimize, "scope creep" which adds to budgets and timelines.

Scanlon: You need at least one high-ranking leader who understands the business, will roll up their sleeves to learn the expectations and limitations of the new solution, all while paying close attention at every stage. Early indicators and adjustments can prevent a project from going off the rails.

Lebamoff: Software never works out of the box as communicated in the sales process, and integrators are never aligned to the company outcomes, no matter what type of contract is in place. CS

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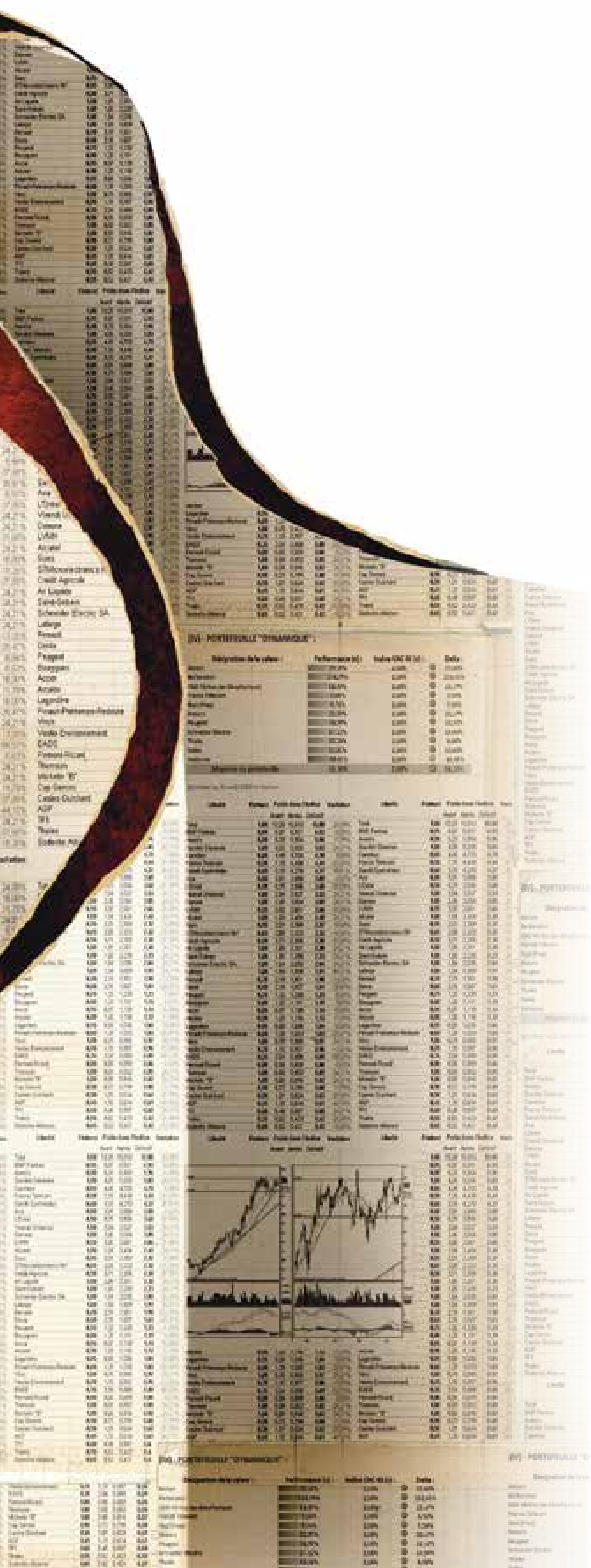
TK Kerstetter is the host of the popular webshow titled "Inside America's Boardrooms," available at boardroomresources.com.

What Will Be the Biggest Risk Facing Boards in 2016?



KELLY WATSON
Partner and National Service Group Leader
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Kelly Watson is a Partner and the National Service Group Leader of KPMG LLP's Risk Consulting Services, which helps organizations to transform risk and compliance efforts into competitive advantage by applying a risk lens to corporate strategy to improve risk intelligence and decision making, protect financial and reputational assets, and enhance business value. Kelly previously served as Office Managing Partner of KPMG's Short Hills, N.J. office, where she was responsible for leading market development efforts across all functions in New Jersey. She has over 27 years of global auditing and advisory experience serving the pharmaceutical, biotechnology and industrial product industries.

Boards are facing an unprecedented number of new risks, in addition to those already crowding their agenda. The specific risk factors fall into three primary categories—strategic, operational and external risks or "signals of change." Boards have always been very focused on strategic risk as they evaluate threats to corporate strategy. For operational risk, which entails known risks such as compliance, information security and supply chain risk, boards heavily rely on management to prioritize and report those requiring board attention. Given the severity of some operational risks, boards challenge management to ensure that these risks are appropriately managed.

Board members seem to feel the most angst over unknown risks. Some of the largest risk factors often are found in external risks, with which most boards are intuitively familiar. However, based on the complexity, inter-relationships and speed at which some signals of change impact the organization, this evaluation often requires additional scrutiny and formalization to ensure management and board alignment. These risks could include disintermediation, geopolitical factors, demographics, changing customer behavior, etc., and can greatly impact the company's strategy, business model and operations, let alone its reputation and/or ultimate survival. Boards are challenging management to evaluate the impactful signals of change and isolate them from the noise through deep and ongoing analysis.

How are these external risks being addressed and monitored given that the exact nature of those risks constantly change? And, is the company culture one that understands and respects these risk such that there is timely identification and escalation of issues? With the intense scrutiny and personal liability that boards face, the "what we don't know and therefore can't have oversight of" are top of mind.

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DAVIS POLK

Joseph Hall is a member of Davis Polk's Corporate Department and head of the firm's corporate governance practice. He works on the full range of capital markets transactions, and advises public companies and regulated entities on corporate governance and financial regulatory compliance. He is a frequent speaker on topics of corporate governance and SEC compliance.

Mr. Hall began his career at Davis Polk in 1989. Between 2003 and 2005 he served at the U.S. Securities and Exchange Commission, ultimately as Managing Executive for Policy under Chairman William H. Donaldson. As a member of Chairman Donaldson's senior management team, Mr. Hall assisted in directing the Commission's policy-making and enforcement activities.

We recently had another reminder—as if one were needed—about the threat companies face from data security breaches and other cyber threats, whether targeted at their own networks and products or those of companies they do business with. In August, prosecutors in New York and New Jersey joined the SEC in announcing insider trading charges against hackers inside and outside the United States who broke into computer servers at widely-used wire services, and used the embargoed information to trade ahead of market-moving corporate announcements. The damage caused by the 2014 Sony and 2013 Target data breaches—not to mention more recent revelations about the hacking of personnel records at the U.S. Office of Personnel Management, or the 1.4 million vehicles recalled after exposure of an entertainment system security flaw that may have left the vehicles vulnerable to remote commandeering—underscores both the scale and the pervasiveness of this multifaceted threat.

The spate of alarming news has directors asking what the board's role should be in protecting the company from cyber threats, and many boards have arrived at the conclusion that cybersecurity risk oversight is a fundamental component of the board's oversight of risk management generally. There are good reasons for this view. No matter the industry, a company touched by a cybersecurity breach or flaw can be exposed to heavy liabilities—spanning public relations nightmares, loss of customers, product recalls, shareholder litigation and regulatory investigations. And we have seen enough widely-publicized examples of these consequences in the last five years that corporate boards are on notice of the rapidly metastasizing risk facing their companies.

While large numbers of boards don't appear to be setting up standalone committees to handle cybersecurity oversight, boards are thinking about where in the existing committee structure these risks should be addressed—for example, whether the audit committee, which often has initial responsibility for risk oversight, should be tasked with cybersecurity risk oversight as well. Different companies will take different approaches, but most boards will want to understand:

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CEO
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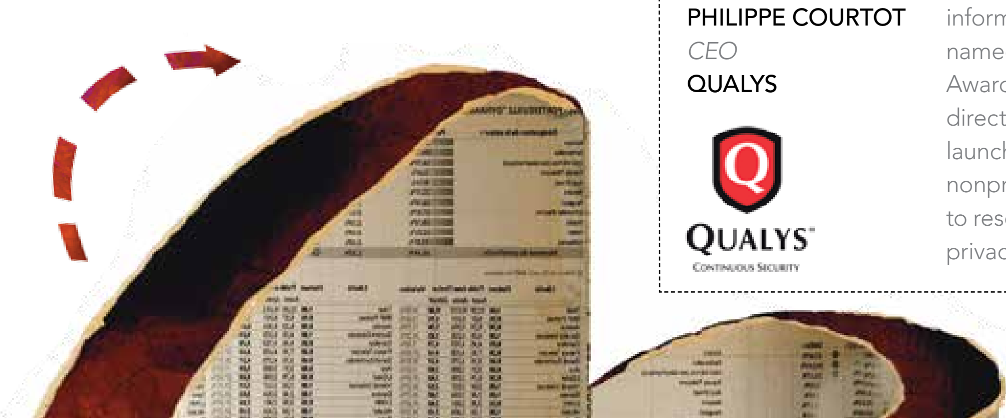
As CEO of Qualys, Philippe Courtot has worked with thousands of companies to improve their IT security and compliance postures. Philippe received the SC Magazine Editor's Award in 2004 for bringing cloud-based technology to the network security industry and for co-founding the CSO Interchange to provide a forum for sharing information in the security industry. He was also named the 2011 CEO of the Year by SC Magazine Awards Europe. He is a member of the board of directors for StopBadware.org, and in 2012, he launched the Trustworthy Internet Movement, a nonprofit, vendor-neutral organization committed to resolving the problems of Internet security, privacy and reliability.



- Which members of the management team own cybersecurity risk
- What is being done to identify and scope cybersecurity risks; for example, whether management is using the National Institute of Standards and Technology (NIST) Cybersecurity Framework, or another industry-specific framework
- How management ranks the various cyber threats faced by the company
- What financial and employee resources and insurance coverage are available to mitigate cybersecurity risk
- What policies and training have been instituted around cybersecurity risk
- What testing and other programs are employed to assess and mitigate cybersecurity risk
- The details of management's game plans if the company is exposed to a cybersecurity event

PATRICK HAGGERTY
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Patrick Haggerty is a Partner in the New York office of Pay Governance. He has over 18 years of experience working with companies on a wide range of executive compensation issues. Clients for whom Patrick serves as the Board or Management advisor include major U.S. companies in the energy, healthcare, financial services, medical devices and pharmaceutical industries. His experience extends to working with public and private companies as well as assisting companies with transactions such as acquisitions, spin-offs and IPOs.

Among the biggest compensation-related risk factors facing corporate boards in 2016 will be establishing short- and long-term incentive goals that are selected and calibrated to motivate behavior while driving corporate results and company total shareholder return (TSR). This issue will be more transparent in 2016 due to the SEC's proposed pay for performance (P4P) disclosure rules.

At a high level, the proposed P4P disclosure rules require that registrants include:

- A standardized table in proxy statements that includes a new calculation of compensation actually paid (CAP), compensation from the current summary compensation table, and TSR for the company and a peer group.
- A narrative description and/or graph to describe relationship between CAP and company TSR, and also between company and peer TSR.

Unfortunately, as proposed, the P4P disclosure rules measure executive equity awards at vesting, where any alignment or misalignment with end-of-year TSR is inherently coincidental, or even false. This mismatch may provide a hazy or even coincidental understanding of pay for performance linkage at best. We expect that many companies will not show alignment of pay and performance in the P4P disclosure table.

Since executive compensation disclosure is subject to close scrutiny by media, proxy advisory firms, investors and regulators, it will be critical that the narrative and/or graphic explanation clarify pay for performance alignment.

Cybersecurity continues to be an imminent risk for large companies. Hackers have become more sophisticated in terms of gaining remote access through networks, luring people to give them credentials or even targeting individuals. Furthermore, the needs of the business to communicate more and more electronically have enhanced, and the attack surface has exponentially increased.

The truth is that large corporations have much bigger challenges than smaller companies because they've already invested in larger infrastructure. Small businesses—and even medium-sized businesses—can easily outsource to a security provider. Meanwhile, many large companies don't have a good idea of how many web locations they have, how many servers, how many portals. They have to do the cartography of their enterprise, put in firewalls and they need a lot of security products to cover everything. Actors just need to compromise one thing to enter into the network, and companies have to defend every door.

Even two years ago, the board was not very involved in cybersecurity measures. There was no real technical understanding coming out of the era that the cloud was "dangerous." But when they saw $100 million security breaches, lawsuits and brand issues, the board got concerned.

It's going to take some time for large companies to migrate to the cloud, and they need a security network that is compatible. But the main thing for the board is to be aware of it, and take it very seriously to ensure that the company can describe what the strategy is to secure the enterprise. The other thing is that you cannot look at cybersecurity independently of IT. They are absolutely together, and at some point the CIO should be responsible for security and provide metrics to roadmap what the company is doing to measure improvement.

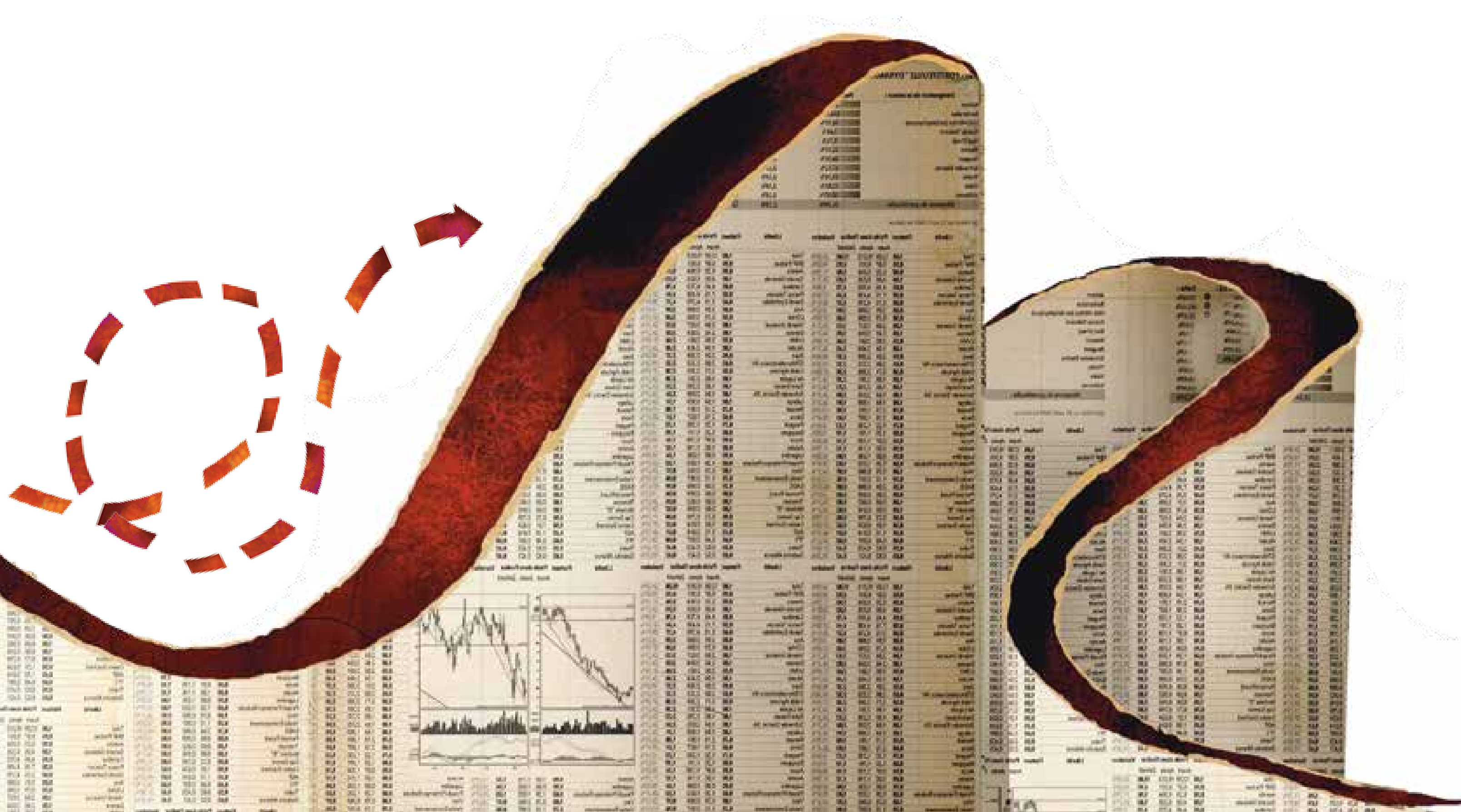
RAJEEV KUMAR
Senior Managing Director
GEORGESON

Rajeev Kumar is a senior managing director of research at Georgeson. His extensive knowledge of and research on complex corporate governance issues are quintessential components of Georgeson's service offering. Rajeev specializes in advising clients on issues of executive compensation, proxy contests, M&A transactions and complicated shareholder proposals, among other proxy matters. Using his in-depth knowledge of corporate governance issues and the policies of proxy advisory firms and institutional investors, he advises Georgeson clients on their investor engagement strategies and shareholder outreach efforts.

In his more than 20 years of experience, Rajeev has held various positions in the areas of corporate governance, mergers and acquisitions, corporate development and strategic business planning and analysis at Pegasus Communications, Teligent and Sprint, among others.

In 2016, we will see a continuation of challenges, with activist threats, cybersecurity, proxy access and regulatory developments representing some of the major issues. While the main risk factor a board might face in 2016 will be unique based on a company's situation, if speaking generally, then the biggest governance risk would be the failure to recognize and address the deficits in its board composition. As companies evolve and new challenges in the changing landscape emerge, the boards may get stale. Board changes resulting from replacement of a departing director are not enough. The boards must proactively examine their composition to eliminate any potential vulnerabilities, fill any skill gaps and enhance the expertise and experience required for the many challenges that a board will likely face. Among the likely challenges, long-tenured directors are frequently targeted by activist shareholders. There is an increased focus and demand for greater board diversity. Companies with board composition-related concerns are more likely to be targeted with the proxy access proposal. Shareholders have increased expectations from the boards and are looking for greater direct engagement to understand how the directors think, interact and the skills they bring to the table.

The boards need to view the issue of board composition not just with the perspective of risk but also one of opportunity. By establishing a regular process of board refreshment, the boards would be better able to manage risks and allow themselves greater opportunity to focus on the more important task of creating shareholder value.



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An Interview with Sabastian V. Niles

The State of Shareholder Activism

WACHTELL LIPTON ROSEN & KATZ

Cited in *The Wall Street Journal* and *The American Lawyer* for his "activist defense" work, Sabastian V. Niles focuses on rapid response shareholder activism & preparedness, takeover defense and corporate governance at Wachtell, Lipton, Rosen & Katz in New York, in addition to M&A and special situations.

He advises worldwide and across industries, and has counseled boards of directors and management teams on self-assessments, engagement with institutional investors and proxy advisory firms and navigating activist situations involving Barry Rosenstein/JANA Partners, Bill Ackman/Pershing Square, Carl Icahn, Daniel Loeb/Third Point, David Einhorn/Greenlight Capital, Glenn Welling/Engaged Capital, Jeff Smith/Starboard Value, Jeffrey Ubben/ValueAct, Jonathan Litt/Land & Buildings, Keith Meister/Corvex, Mick McGuire/Marcato, Nelson Peltz/Trian, Scott Ferguson/Sachem Head, Paul Singer/Elliott Management, Ralph Whitworth-David Batchelder/Relational Investors and Tom Sandell/Sandell Asset Management, among many other activist hedge funds.

In addition to serving as Consulting Editor for the NYSE's Corporate Governance Guide, Sabastian's writings have been widely published and he has been a featured speaker at corporate strategy and investor forums like CCMC's Capital Markets Summit, the Council for Institutional Investors, The Conference Board, Europe's Activism Rising, the Gabelli Capital Allocation Symposium, the Harvard Law and Business Symposium on Governance and Activist Investing and the Society of Corporate Secretaries.

Sabastian received his law degree from Harvard Law School, where he co-founded the Harvard Association of Law and Business, and his finance, economics and information science degrees from the University of Maryland at College Park, where he won two national championships and four regional championships in intercollegiate trial advocacy.

You and Wachtell Lipton are a recognized leader in corporate law on activism issues, but "shareholder activism" is a broad term. How would you define it, and how does activism manifest?

Sabastian Niles: Shareholder activism used to consist of one-off, isolated approaches that might happen now and again to someone else. Activism now is a permanent environment of scrutiny and potential second-guessing, in which public companies and their long-term strategies may be aggressively targeted and challenged. The challenge is led by sophisticated, well-advised hedge funds, some of whom are laser-focused on boosting the stock price as quickly as possible and by any means necessary, including through escalating pressure and scorched-earth tactics, and others of whom may pursue more constructive, open-minded, behind-the-scenes approaches. I would also distinguish the economic activism sponsored by hedge funds from the governance activism driven by some pension funds, labor unions and other groups. In some cases, that latter kind of activism can inadvertently pave the way for increased vulnerability to hedge fund activism and short-term pressures.

We are in a transformed corporate governance and shareholder engagement environment, in which major institutional investors, mainstream asset managers and even some pension funds are pursing enhanced stewardship and deep engagement and reducing reliance on proxy advisory firms in sincere furtherance of long-term value creation. On the other hand, there are still many in the financial community who need fast returns and are eager to enlist the "aid" of an activist when their portfolio needs a boost and share "hit lists."

In this new environment, companies can either lead and adapt from a position of strength or be caught off-guard and flat-footed in the face of an activist challenge.

What kind of demands do economic activists make? Are underperformers more at risk?

Niles: Demands vary, and we often see the "asks" evolve over time or be extreme at the outset, perhaps with the implicit understanding (or hope!) that they might be scaled back in negotiations. Specific objectives can include engineering a sale of the company, a breakup of its businesses (perhaps with the resulting pieces to be separately sold off) or other fundamental restructuring; blocking or sweetening an announced M&A deal; changing capital allocation strategies to boost or accelerate buybacks or other distribution of cash to shareholders, which might be funded by increasing leverage, monetizing company assets or reducing reinvestment in the business; improving margins by cutting costs or capital expenditures; changing the business strategy or operations; or even replacing the CEO and the Board through a proxy fight or withhold campaign. Companies should also understand more nuanced activist critiques that involve disputes over a company's pacing, priorities or sequencing of business decisions.

As for who gets targeted, some undervaluation in the current stock price (note, I did not say underperformance!) is necessary. But sometimes the better performing a company is, the more vulnerable it is to serious activism.

That's an interesting point, since many public activist campaigns have been positioned as a sort of kick-start for a poorly performing business.

Niles: Each activist and situation is different, and a lot of it depends on the objective in play. It's fashionable to say that activists only target underperformers, but the data and experience shows that's not the case. Ironically, sometimes the stronger the stock price and the company's potential, the more the company appears on the screens of sophisticated activists. Surprisingly, doing "too well" can drive long-term supportive shareholders out of the stock when they trade out and remaining investors may conclude that the only way to move the needle further is a sale or breakup of the company. And if a company is performing well, that caps the activist's downside, and if the activist has an approach for increasing the stock price even more, then it's all fair game in their minds.

Activism now is a permanent environment of scrutiny and potential second-guessing.

Empirical studies have shown that the biggest driver of hedge fund profits from activism is forcing a sale and capturing the immediate premium. So with M&A booming and the debt markets attractive, it's no surprise there are cases where there's an extremely strong performer, and an activist will come in with a hostile bidder wanting to buy the company. Alternatively, where an activist is concerned about an M&A or low interest rate window closing and sees a company in the midst of a turnaround, there may be pressure to sell or lever up and buyback now rather than wait for the strategy to bear fruit. Sometimes a company wonders why an activist suddenly starts pushing for a sale or other immediate action, and it later turns out that the activist was under pressure from its own investors for returns and fending off potential redemption requests.

What is the media's role in contributing to activism? Is this being over-reported?

Niles: The media amplifies activism, sometimes aggressively so, and is not a preferred forum by companies for sober debate and analysis of complex situations. The public dialogue is asymmetrical, with activists becoming personal in their attacks and issuers rightly reluctant to respond in kind. Companies often complain that activists co-opt the financial press, getting both airtime and coverage with a snap of their fingers (or a tweet) and that the press propels activist arguments and attacks without any real pushback or pressure. This media dynamic is one of many reasons why we work with companies to keep activism situations private and out of the public eye to the extent possible. But in fairness, there are reporters who will work constructively with companies and experienced advisors to provide even-handed, merits-based coverage. Smart companies refresh media relationships, prepare statements for potential contingencies and cultivate respected third-party voices who can knowledgeably speak on their behalf, all well in advance of an activist challenge.

In the past few years, it seems that activism campaigns have increased. Is there truth to that perception?

Niles: Yes. I am seeing more aggressive activism of all types in recent years as capital rushes into activist funds in record amounts, filling their war chests, and "wolf packs" assemble against companies. Indeed, activist challenges have accelerated across industries and sectors, at small-caps through mega-caps, from single-product pure-play firms to multinational conglomerates, in developed countries as well as in emerging markets and across company life cycles, hitting newly public companies as well as later-stage growth and long-lived mature businesses. "Next generation" and other new activists are crowding the field alongside well-established funds and sometimes stepping on each other's toes as they hunt for targets. So it's true that no company is too big, too successful, too well-known or even too new to be a target. And the tactics and themes continue to change too.

Given all the activity, shareholder activism is a clear and present business risk and should be dealt with as such. In other words, understand the risk, prevent the risk, and mitigate the risk.

What are some red flags that boards and company management should identify as they evaluate their risk for activist campaigns?

Niles: It's a good question, and companies ask us to review with them our evolving "screening" criteria that activists use, both from an economic and governance standpoint, as well as the key early warning signs. Certainly, if a shareholder or analyst tells you that an activist has been in to see them, that's an obvious flag. So is a warning from a sophisticated stock surveillance and market intelligence firm of unusual trading activity or that an activist is building a position. Different industries also have unique characteristics to take into account, and companies should be consistently evaluating what hedge funds evaluate, such as absolute and relative valuation, performance against peers and research analysts' perspectives. Activists can be opportunistic and quick to seize upon a temporary moment of vulnerability.

When assessing the takeover and activist environment, look for significant transactions in the industry and activist activity at peers or at companies that could be a potential acquirer or target of yours. We are seeing activists encourage M&A not only by publicly calling for a sale or engaging directly with private equity and strategic counterparties, but also by taking positions on both sides of a potential business combination and trying to forcibly bring the parties together or create a new target to be sold by forcing a breakup. Being an "outlier" without a clear rationale versus peers or the market on key metrics, stock price, capital efficiency or operational and performance measures also attracts attention.

Are there any particular areas that activists are focused on these days?

Niles: In addition to M&A opportunities, heightened scrutiny of business portfolios and cost structures, and discovering "hidden" assets whose value is "waiting to be unlocked," capital allocation and structure is a huge topic in the financial community. "Excess" cash on the balance sheet and conservative leverage ratios are always attractive to activists, and companies that have a lot of cash or strong investment grade credit ratings have to articulate why they are smart to have and keep it, what their strategy is for it and, with respect to credit ratings or low levels of leverage, why they are conservative. Investors are looking for more transparency as to how companies think about deploying capital throughout various cycles, and companies should not take for granted that the market understands the rationale behind the company's choices of what to do or not do.

What about with respect to compensation?

Niles: Would I expect an economic activist without a thesis to attack a company because of a low "say-on-pay" vote or because proxy advisory firms think the newest "best practice" is missing or that compensation practices are "excessive" or "egregious"? No. But can unaddressed executive compensation issues and misperceptions provide pressure points to be opportunistically exploited by activists as "wedge" issues? Certainly. And can well-designed compensation programs that align with long-term strategy, incentivize the right behaviors and use thoughtful targets provide a buffer against claims that a company is mismanaged and poorly governed? Absolutely.

How can boards and executives mitigate risk from potential activist campaigns? Can you walk us through the types of things a company might do?

Niles: Each activist challenge is unique. The issues, tactics, team and approaches will vary depending on the company, the country, the industry, the activist and the substantive business and governance issues at play, among other factors. In all situations, however, there is no substitute for preparation and readiness. Companies should leverage a core team of experienced company-side advisors and study the approaches that have been developed to prepare for and deal effectively with activists. Companies are wise to have "state of the art" practices for:

- Ensuring that the company's board and management receive regular updates on the activist, takeover and governance environment within the industry, understand their duties, implement true "best practices" and are well-positioned to respond and handle an activist situation without making missteps;
- Preparing the CEO and other directors to deal with direct takeover and activist approaches and handling requests by institutional investors and activists to meet directly with senior management and independent directors;
- Conducting an objective self-assessment to identify opportunities for strengthening the company and increasing value for investors and other stakeholders, mitigating potential vulnerabilities and responding to investor concerns, and ensuring that the company's strategy is well-articulated and understood;
- Executing an advance, year-round program of tailored shareholder engagement that reaches portfolio managers, governance teams and proxy voting professionals, involves in select cases director(s) alongside management where appropriate and gives the company a strong sense of investor priorities, perceptions of the company and how investors would evaluate the company and vote in the case of an activist challenge;
- Attracting investors who will support the company's strategies and have investment theses that line up with the board and management's strategic vision and time horizons;
- Anticipating activist tactics and approaches and putting "early warning" systems in place;
- Reviewing the company's governance and structural profile, including the shareholder base, board composition, relevant charter and bylaw provisions, technology that might be kept "on the shelf" (such as a rights plan) and legal developments;
- Staying abreast of emerging governance expectations and norms;
- Engaging with proxy advisory firms and responding to their recommendations;
- Engaging constructively and prudently with an activist and evaluating their views and proposals with the assistance of outside advisors;
- Anticipating public relations and media dynamics in an activist situation, including by refreshing media relationships, preparing statements for potential contingencies and cultivating

respected third-party voices who can knowledgeably speak on the company's behalf;
- Providing compelling evidence of a company's progress and performance and rebutting misleading or incomplete analyses or criticism; and
- Preparing for potential litigation and attempts by the activist to obtain non-public books and records of the company, including board minutes and sensitive analyses.

"It's fashionable to say that activists only target underperformers, but the data and experience shows that's not the case."

In our readiness engagements and when counseling clients in live activist defense representations, we review more granular guidance for preparing for or dealing with activist hedge funds.

Any internal controls or procedures for activism that you want to mention here?

Niles: A surprisingly overlooked item is ensuring that the General Counsel/Corporate Secretary's office is kept apprised on a current basis of buy-side and sell-side sentiment, and what investor relations personnel and others at the company who deal with the financial community are hearing. Any questions that indicate a shareholder or an analyst believes there are structural, business or governance changes that would increase value should be brought to the attention of the general counsel, so that a team can decide how best to deal with it, including evaluating what may be in the investor or analyst's mind and how to correct errors or flawed assumptions before they become more widely disseminated. This is especially important with sell-side analysts, as activist hedge funds are increasingly crediting analysts for their ideas. Once a report gets out there and is published, other people are off and running and the issue can become a self-fulfilling prophecy. Good internal communication may be the single most important aspect of this. The investor relations team should also have a robust list of known and occasional "activists" to check against, so that appropriate advice can be given before rather than after the fact for handling activist requests for a call or meeting, understanding with whom they are dealing and managing the discussion effectively without missteps. With respect to shareholder engagement generally, companies need procedures to track—and escalate internally as appropriate—messages conveyed, feedback received and follow-up carried out.

What are the most important considerations for boards with respect to shareholder scrutiny and activism?

Niles: First, true readiness is the foundation for a favorable outcome. The board should expect periodic updates on steps the company is taking to maintain a state of preparedness for an activist approach, shareholder perspectives and sentiment, and as to options and alternatives that have been analyzed by management and the company's outside advisors. Failure to prepare for an activist's demands or a takeover bid exposes the board to pressure tactics and reduces the company's ability to control its own destiny. The psychological elements of activist attacks, proxy contests and takeover battles are, in many cases, as significant as the financial, legal and business elements.

Second, Boards and CEOs need to be their own toughest critics. In addition to robust business reviews, meaningful director evaluation is a key expectation of institutional investors, and a corporation is well advised to have it, demonstrate it, and talk to investors about it. However, board trust and confidentiality are crucial, and boardroom debates over business strategy, direction and other matters should be open and vigorous but kept within the boardroom. Activists constantly seek to drive a wedge between the board and the management team and between the company and its stockholders, and board consensus in the event of an attack is extremely important. That means that internal clarity and alignment among the Board and management should be developed before an activist surfaces. Directors must guard against subversion of the responsibilities of the full board by activists or related parties and know to refer all approaches in the first instance to the CEO.

Third, every activist and situation is different, and each board must consider, and regularly revise, its plans and strategies as needed. Intense director involvement in key investor meetings and proxy advisory firm engagements may be necessary as circumstances warrant, and directors are increasingly involved in "peacetime" shareholder engagement efforts too. In a live activist situation, well-advised companies continuously gauge whether or not the best outcome is to make strategic business or other change, perhaps even including recruitment of new director(s) or possible board representation, in order to avoid or resolve a proxy fight. Keeping the board fully apprised of the evolving situation and alternatives and avoiding surprises best positions the company to achieve success, which can include a negotiated resolution where appropriate, on favorable terms. But, after carefully and objectively evaluating an activist's proposals, boards should be prepared to show backbone if confronted with demands that are ill-advised, misguided or would undermine long-term value or the health of the company.

Lastly, and particularly when in the throes of an activist challenge, boards should help management remain focused on the business and maintain the confidence and morale of employees, partners and other stakeholders. Activist approaches can be all-consuming, but continued strong performance, though not an absolute defense, is one of the best defenses. And when business challenges inevitably arise, opting for candor and acting in a manner that preserves and builds credibility with shareholders and other stakeholders is critical.

Any thoughts specifically from a risk oversight angle?

Niles: From the broader risk oversight perspective, boards are wise to identify external pressures that can push a company to take excessive risks and consider how best to address those pressures. An example would be pressures from certain hedge funds and activist shareholders to produce short-term results, often at the expense of longer-term goals, in ways that might increase a company's risk profile, such as on account of taking on excessive leverage to repurchase shares or payout special dividends or undertaking imprudent spinoffs that leave the resulting companies with inadvisably small capitalizations. While such actions may certainly be right for a specific company under a specific set of circumstances, the board should focus on the risk impact, too, and be ready to resist pressures to take steps that the board determines are not in the company's or shareholders' best interest. No matter how active or activist shareholders may become, directors cannot not outsource their own judgment and must not lose sight of their fundamental fiduciary duties.

I know you represent companies and boards, but do you have any advice for activists?

Niles: I think activists will get better results and earn more respect if they are open-minded about how best to create medium-to-long-term value, avoid grandstanding or worrying about getting special credit, recognize that board and management may have superior information and expertise about the business, and resist the urge to publicly threaten, attack or embarrass a company or its management and board in order to get their way. In many cases, we have had productive engagements and, yes, negotiations with activists where we obtain favorable settlement terms or otherwise help to guide a situation to a mutually beneficial outcome, including many that never become public battles or where the activist concludes they would be better served by moving on to another target or even where, thanks to the company's own initiatives, the board maintaining internal alignment and consensus and the right kind of engagement with shareholders, our client's shareholders encourage the activist to stand down.

How is activism affecting the broader governance landscape and the economy at large?

Niles: Corporate governance changes have made it harder for boards and management teams to discharge their fiduciary duties without undue pressure to prioritize short-term stock prices. But the pendulum may be shifting, and there's a strengthening view that short-termist pressures on companies are exacerbated by the excesses of shareholder activism and prioritizing shareholder power. Promoting sustainable value creation and making our capital markets attractive to those who wish to thrive as long-term oriented public companies rather than go or stay private are now priorities. A very healthy debate is under way as to whether we have gone too far in increasing shareholder power and moved

> Boards should be prepared to show backbone if confronted with demands that are ill-advised, misguided or would undermine long-term value or the health of the company.

too far away from a "retain and invest" corporate mindset to a "downsize and distribute" mentality. For example, a strong consensus of concern has emerged about activist attacks that target R&D investment and innovation, demand excessive risk or cost-cutting at the expense of sustained employment and reinvesting in top-line growth or disrupt well-conceived turnaround plans that simply need time to bear fruit. Although expectations of boards are at an all-time high and will only increase, particularly regarding board renewal, self-assessment and shareholder engagement, mainstream institutions and even some of the most prominent pension funds are increasingly willing to defend and protect boards and management teams from short-termist pressures if they are satisfied with a company's long-term plans and governance practices. In short, we may be moving toward a new paradigm of corporate governance in which major institutional investors abandon rote reliance on proxy advisory firm recommendations, decline to outsource oversight of their portfolios to activist hedge funds and ultimately champion and ally themselves with, rather than against, companies. CS

Cyber Risk in the Boardroom

Suzanne "Zan" Vautrinot is President of Kilovolt Consulting Inc. and a retired Major General of the U.S. Air Force, with three decades of experience in space and cyber operations. She retired as Commander, 24th Air Force and Air Forces Cyber Command where she oversaw a multi-billion dollar cyber enterprise, leading a workforce of 14,000 military, civilian and contractor personnel, while supporting 850,000 customers and conducting cyber operations worldwide. Zan previously served as Deputy Commander for the nation's Network Warfare Command and was instrumental in the establishment and early operation of U.S. Cyber Command. She is universally respected as a motivational leader and change agent. As a cyber subject matter expert, she addresses technical, business and university forums, guides key task forces, and has testified before Congress. She currently advises industry, academia as well as government agencies and laboratories on cybersecurity strategy, technology innovation and workforce development.

Zan presently serves on the Boards of Directors for Wells Fargo, Symantec Corporation, ECOLAB Inc., and Parsons Corporation. She is also an advisor to the Air Force Doctrine Advisory Group, America300, the University of Texas Pre-Freshman Engineering Program, and serves on the Board of Directors for the Uniformed Services Benefit Association.

She earned her Bachelor of Science degree from the U.S. Air Force Academy and Master of Science degree from the University of Southern California. She also graduated from the Air Command and Staff College and Air War College, and was a National Security Fellow at the Kennedy School of Government at Harvard University.

You have an extensive background in security and technology, how did you develop an expertise in cybersecurity?

Suzanne Vautrinot: "Expertise" might be a stretch, but let's say I'm passionate about cybersecurity. I was privileged to serve, and my military background focused on national security and the technologies that helped defend us. After graduating from the Air Force Academy, I was assigned to the National Reconnaissance Office, which developed and operated the nation's spy satellites. This was before the Internet, but these systems had a strong dependence on computer networks and security of data.

Fast-forward through many years operating satellites and running global networks for critical command and control systems, I was selected as the Deputy Commander for a new organization called Network Warfare, the precursor to United States Cyber Command. Network warfare was what one might call "offensive" cyber operations, which also gives you a great understanding of what's needed to defend your own networks. That led to my selection to the Commander of the Air Force's cyber component and 24th Air Force.

In that capacity, we had multiple jobs: establishing, sustaining and operating a network, leveraging that network to execute offensive missions, and defending our own networks and systems. Ultimately, we executed whatever actions the President, Secretary of Defense, and Commander of U.S. Cyber Command asked us to do ... but instead of land, sea, air or space, our operations were in cyberspace.

It certainly makes sense why network security is so important from a national defense standpoint. Why is this such a crucial topic for corporate leaders today, and what technology changes have contributed to this becoming a more pressing issue in recent years?

Vautrinot: The implications, and especially the vulnerabilities, that were a National Security concern are the same for the private sector, a reality we now see far too frequently in the press.

Having access to that military infrastructure, seeing what it takes to defend and what can be leveraged to your own advantage gave me a unique perspective. Cyber isn't a uniquely military capability, but technology shared by all—individuals, corporations and nations. We're all riding the same networks and using the same technologies.

> If you stop communication, you stop or severely slow the business.

The government figured it out first, and while certainly that didn't mean that every agency and department acted on the lessons, there was considerable effort to work collectively, to partner with industry and academia, to better understand, and to re-design to defend.

Now you see that dynamic in the private sector. Corporations and individuals clearly see the implications, and are responding in the same way the nation did … discussing strategy and risk. Cyber technology is a business opportunity, and cybersecurity is a corporate risk consideration.

So the government, because of its particular needs, kind of figured this out first. At what point did it become clear to corporations that cybersecurity was something they needed to articulately strategize in the course of everyday operations?

Vautrinot: It's less a "point" and more a continuum. Since computers, software and networks were originally designed for open communication, automation and global connectivity, it was hard to see the soft underbelly of "vulnerability." About 10 to 12 years ago, cyber threats went from defacement, to disruption, to deception, to destruction. Cyber attacks were defacing websites—annoying but not critical except perhaps to reputation. This was followed by viruses, worms and other malicious software designed to disrupt computer and network-based operations and/or extract key information, i.e., espionage (largely focused on government sectors).

Some of those same techniques were then used to disrupt trusted computer-based financial transactions, and we saw ever-increasing criminal activity in the financial sector. Then we started to see a dramatic increase in criminal behaviors aimed at companies and individuals—hacking, theft of intellectual property, financial theft. That progressed to the disruption or destruction of physical systems, for example, power grids, transportation systems, dams, etc., with implications to both public and private sectors.

Add to that an inability to distinguish government, criminal, corporate, hacktivist and other actors, and sometimes active collaboration between them, and now we see cybersecurity is at the forefront of public discourse for government, companies and individuals.

What are some different types of cybersecurity breaches, and how they can harm a company?

Vautrinot: Let's put them in three categories: interdiction, direct attacks on computers and data, and attacks on physical systems.

Interdiction in this sense is to stop the ability for two things to connect—denial of service, in other words. It's not hurting the computer or the network per se, but perturbs it in a way that doesn't allow the connection. Jamming is a simplified way of describing it. For corporations, the ability to communicate to conduct business is critical. Everything that travels through the network is the business. In particular, financial systems or stock exchanges are built on transfer of information that allows movement of money. If you stop communication, you stop or severely slow the business.

> "Cyber technology is a business opportunity, and cybersecurity is a corporate risk consideration."

Direct attacks go after the computers and the data itself. These alter the ability for basic business operations—which are now dependent on computers—correlation of data, and the movement of data between locations. The loss of the computer or data can prevent ongoing business operations, as well as the ability to restore and resume operations. It's also the way to lose key data, intellectual property, pricing, M&A and other elements of your corporate competitive advantage. And finally, from a reputational and regulatory standpoint, this type of breach puts protected customer and partner data at risk.

Finally, there's the attack on physical systems. It is a similar methodology to an attack on computer/data systems, but requires a detailed understanding of the system operations, man-in-the-loop and feedback mechanisms. For efficiency, sometimes safety and to reduce manpower, we implemented automation in industrial control systems. The raising and lowering of dams, switching of rail lines, operation of aircraft or power grids—all of these are inherently dependent on computers and networks to do physical operations. Making a "cyber" change can break something in those physical operations. This kind of breach is intended to perturb or even cause physical destruction. The implications for businesses include power loss, production shutdown, security system shutdown, destruction of critical equipment and shutdown of transportation or supply chain.

Are any particular industry sectors most at risk? What are some key examples?

Vautrinot: Cybersecurity covers a lot of ground, and while some solutions are the same for all sectors, it's not cookie cutter—R&D, manufacturers, financial, retail and critical utilities would all have different considerations. It's a question of what are you accomplishing and protecting as a business, and how to make it viable and resilient to this kind of risk? Informed risk assessment and management is a dialogue for boards at a strategy level. Boards and management evaluate risk elements across all aspects of the business, and that evaluation process is equally applicable to cybersecurity.

That said, there are some special considerations. For example:

- Global operations, a large customer base, conglomeration of many diverse business elements, etc., all add to the vulnerability (think bigger attack surface, more points of entry means easier to breach).
- Extensive financial interactions, well-known innovation capability or specialty technologies (as in defense or security) increase the interest, which means increased attempts, and more skilled and persistent attacks.

On the private side, you need to protect your competitive advantage. But, if you share what you're seeing, you have a better chance of thwarting the attacks.

What is the board's role in overseeing cybersecurity and the general principles of risk oversight? How can boards better prepare for cybersecurity risks?

Vautrinot: You've actually answered the question. The board's role is to apply the principles of risk oversight, to advise on strategy and help push to overcome challenges—in this case, cybersecurity gaps and challenges.

There are a couple nuances or "front-end" considerations, most importantly, whether the company should build and sustain cybersecurity expertise internally or rely on external experts. Cyber is either a consideration or it is a core competency for that business. If cyber is core, then certainly that competency is important throughout its management and operations as well as on the board, not unlike finance, transportation, mining, or oil and gas expertise would be to companies in those sectors. If it's not part of core competency, then you might consider looking to consultant or partner expertise. Again, it's not cookie-cutter.

"Cyber isn't a uniquely military capability, but technology shared by all—individuals, corporations and nations."

Have any recent guidelines and regulations addressed cyber risk? How will those affect and influence board decisions?

Vautrinot: You're seeing both guidelines and regulations. Cybersecurity is not about checking the boxes and saying, "I met the letter of the law and I'm safe." In most systems, you're compliant until the point you aren't. There are great guides to help you ask the questions, and allow you to look beyond what's comfortable.

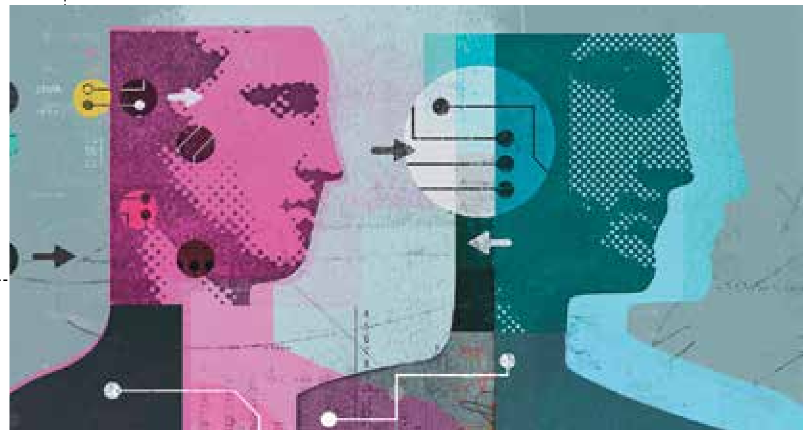
Some examples are an NACD (National Association of Corporate Directors) document, with key questions directors can ask. SANS has continued to publish and update a "top 20" list. Homeland Security released guidelines in the NIST framework, with significant input from industries. The Federal Financial Institutions Examination Council also recently put out a set of considerations. It would be onerous to simply layer them all, and they shouldn't be used as a simple checklist. However, they are helpful in making the discussion more fulsome, providing a more consistent framework for assessment (to management, the board and external entities), and helping to articulate and address gaps.

That's a good point. What are some of the main gaps between boards and IT security teams, and in what ways can those gaps cause risk to the board, the company and its shareholders?

Vautrinot: Communications, access, organizational dynamics and aligning strategic priorities with ongoing activity.

Number one is communications, and making sure that it is constructive in the sense that

> "A better practice is to accept that the adversary is inside, then your team is always looking for it."



everyone understands the dialogue with candor, without jargon or technical shorthand. It's not about technologies, but being able to apply those technologies to work for your business.

Access is the result of focus and keen interest expressed by the board, a norm among directors I know and serve with. I've seen it demonstrated through assignment to a specific committee, adding cybersecurity discussion to the agenda, special updates on new or needed capabilities, or visits to key parts of the organization.

Organizational dynamics are tougher. The responsibilities for various aspects of cyber security, or decisions that ultimately affect security, are often spread throughout a company. If responsibilities are subordinated to a level where the risk decision or tradeoff never rises to C-suite of board level, then gaps occur.

Aligning strategic priorities requires a differentiation between the long term, "what we want to be," with immediate risks that must be addressed. It also requires an upfront assessment of whether new business capabilities (or apps) contribute or add risk to that strategy. In other words, baking security in versus bolting it on.

There's a great thing I've learned about cybersecurity folks, which is unlike other areas of business. Instead of being competitive, they are extraordinarily collaborative with each other. What is a threat to one is a threat to all. On the private side, you need to protect your competitive advantage. But, if you share what you're seeing, you have a better chance of thwarting the attacks.

What advice would you give boards when identifying best practices for long-term security planning?

Vautrinot: Companies need to clearly articulate where they are going in making enterprise and architecture more secure. You can think you have 1,000 different attacks, or with better visibility to your own systems, you can see that it's actually the same single attack coming at you 1,000 times ... requiring only one response. Companies that say, "I want to understand what's in my network," are able to assess and deal with the risk at a much more effective level. You want a way to decipher what they're after and how they're trying to achieve it, because it lets you know (and proactively defend) where they want to go next.

Even five years ago, most organizations were looking to prevent something from getting in, the moat approach. Perimeter protection is necessary, but it's not sufficient. A better practice is to accept that the adversary is inside, then your team is always looking for it.

Strong policies and architectures with visibility enable your pros to constantly analyze and differentiate the normal/acceptable behaviors of software, hardware, networks and people, identifying and responding when the system indicates an "out of bounds." Your team (whether you have them internally or use external professionals with that competence) can now decide what is normal, and more quickly respond to or even preclude, the abnormal.

Best practices for this include creating a more homogeneous or unified security architecture, simplifying the myriad of extraordinary but often unconnected capabilities, and automating as much of the identification, analysis, and response as possible, which frees your specialists to focus on new or future threats. Definitely a best and certainly more efficient practice.

What do you think is the greatest challenge for cybersecurity protection?

Vautrinot: Individual behavior has to be part of the solution. You can design the best systems in the world, but it's a little like safety. If you don't wear the seatbelt or a helmet, the technology can't protect you. Ask cultural and policy questions: Do employees send messages or use apps that create unprotected paths into the system? Do they use and change passwords? Do you carefully limit and specially train employees with special/administrator level privileges? Do you exercise, test and enforce security policies? How fast and how automatically can you implement a fix? Those are just scratching the surface, but there are so many things that count on behaviors of everyone in the organization. Building in a cultural change allows you to move forward. If we make it someone else's (usually the "IT guys") problem, there won't be a solution.

Shared risk, shared responsibility, shared solutions. If the World Wide Web is now a dangerous neighborhood, then we're all needed for neighborhood watch. CS

CFOs Are in the Money

In late September, Equilar released its annual report on Chief Financial Officer compensation at the largest U.S. public companies. Recent trends have shifted more responsibility and strategic power into the hands of CFOs, and this increased scope is reflected in the growing levels of compensation, specifically tied into company performance.

CFOs Get Paid to Perform

In the past five years, CFO pay has grown along the same trajectory as the S&P 500 stock index value.

- In 2013, the S&P 500 stock index grew 29.6%, and CFO pay was up 5.8%.
- A more modest gain in 2014, 11.4% in the stock index correlated to a 3.8% increase in CFO pay.

CFO > CEO

For the first time since 2010, CFO pay at S&P 500 companies grew faster than CEO pay.

- In 2014, CFO pay went up 3.8% to reach $3.3 million.
- Meanwhile, CEO pay at S&P 500 companies increased just 0.9%, reaching $10.3 million.
- The percentage change might not look like much, especially since CEO pay is so much higher. But CFO pay grew more in real dollars $119,237 in 2014, while median CEO pay increased just $95,135 year over year.

CFO pay growth percentage in 2014

CEO pay growth percentage in 2014

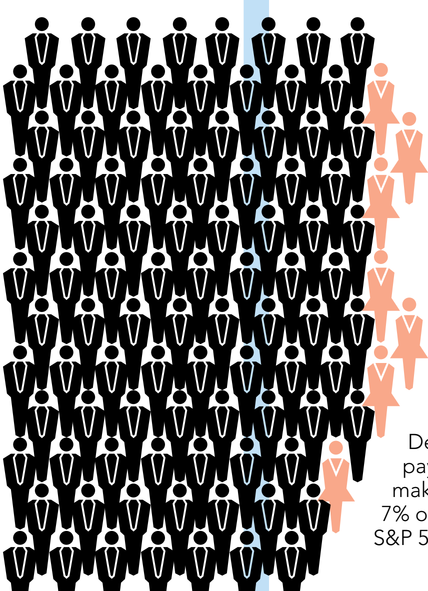
C·S +

*To learn more about the report, see **info.equilar.com/CFO_Pay_Strategies_2015.html**.*

Female CFOs on the Rise

Though still a small fraction of CFOs in the S&P 500, female finance chiefs are outperforming.

- Median pay for female CFOs in the S&P 500 was $3.4 million in 2014, a 13.1% increase from $3.0 million the prior year.
- Unlike 2013, women in chief finance positions made more than the median in 2014.
- Still, less than 7% of all CFOs were women—only 34 females were CFOs at S&P 500 companies for the two consecutive years in our study.



Despite increasing pay, women still make up less than 7% of CFOs at S&P 500 companies

Compared to 2013, median pay for female CFOs

increased 13.1%.

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