TOP 10 TOPICS
For Directors in 2015

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contents

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U.S. public companies face a host of challenges as they enter 2015. Here is our list of hot topics for the boardroom in the coming year:

1. Oversee strategic planning in the face of uneven economic growth and rising geopolitical tensions
2. Oversee cybersecurity as hackers seek to infiltrate even the most sophisticated information security systems
3. Assess the impact of advances in technology and big data on the company's business plans
4. Cultivate shareholder relations and assess company vulnerabilities as activist investors target more companies
5. Consider the impact of M&A opportunities
6. Oversee risk management as newer and more complex risks emerge
7. Ensure appropriate board composition in light of increasing focus on diversity, director tenure and board size
8. Explore new trends in reducing corporate health care costs
9. Set appropriate executive compensation
10. Ensure the company has a robust compliance program as the SEC steps up its enforcement efforts and whistleblowers earn huge bounties

1. Strategic Planning Challenges

Strategic planning again tops the list of topics to which directors want to devote more time.[1] Overseeing the company's direction is one of the core responsibilities of directors. It often requires directors to step back and look at the company's business from the "20,000 foot level" by considering the major factors that will likely impact their company's business and ensuring that management has formulated a strategic direction for the company that takes these factors into account. Depending on a company's international exposure and line of business, management and directors face particular challenges from uneven economic growth and rising geopolitical tensions as they craft their company's plans for 2015 and beyond.

Despite a resurgent U.S. economy, the global economic outlook remains tenuous. Growth in China, the world's second largest economy, dipped to a five-year low in the third quarter of 2014. Japan, the world's No. 3 economy, has slipped back into recession, and most of the Eurozone is battling high unemployment, stagnation and fears of deflation. The United States, however, is on the upswing, having enjoyed three percent growth in four of the last five quarters, and many analysts foresee this level of growth continuing through 2015.[2] However, there are growing concerns that the economic malaise being experienced in other parts of the world will eventually slow the U.S. economic engine.

Rising geopolitical tensions are also contributing to worries about the global economic outlook. Russia's incursion into Ukraine and the resulting economic sanctions imposed by the West are impacting the Russian and European economies, as well as many U.S. companies doing business there. The ongoing Syrian conflict, increasing Arab-Israeli hostilities and the startling rise of the Islamic State are further destabilizing that area of the globe. Growing apprehension about the spread of Islamic terrorism, as well as fear of the spread of the Ebola virus or the next unknown crisis, are also casting a shadow over the world economic picture.

Uneven economic growth is not limited to the international stage. On the domestic front, the precipitous drop in oil prices is boosting many sectors of the U.S. economy and leaving more money in consumer pocketbooks. At the same time, however, the low prices are causing oil and gas stocks to drop as energy companies consider ways to delay investments, cut costs and reduce capital spending for 2015. The cheaper valuations will also have some companies seeking out synergistic acquisition opportunities, while others will be looking for buyers or other lifelines to save them from this rough patch.

Management and boards also need to assess the divergent impact that the U.S. recovery has had on the American consumer. While the top percentile of American households have seen their wealth return to pre-financial crisis levels, due in large part to the long-running bull market, most Americans have experienced flat wages and many struggle to make ends meet.

Another factor adding to the domestic equation is the Federal Reserve's shift in fiscal policy. In light of an improving economy and lower unemployment rates, the Federal Reserve has ended its quantitative easing (QE) bond buying program and many predict that the Federal Reserve will raise the federal funds rate, which is currently near zero, by mid-2015. While the rampant inflation and financial bubbles predicted by critics of the Fed's QE program did not materialize, many economists expect market turbulence as the QE program comes to an end and the Fed moves closer to its first rate hike since 2006.[3]

In light of the economic uncertainty, U.S. companies have grown their cash stockpiles to a record $1.63 billion as of mid-2014.[4] Ultimately, companies will need to make important strategic decisions on whether and when to deploy these funds, particularly as shareholders demand more return on their investment. Since the financial crisis, companies have been creating shareholder value by cutting costs, improving operations and buying back stock. So far this year, more than 80 percent of S&P 500 companies have engaged in stock buybacks, which will likely top $568 billion for the year.[5] While stock buybacks create shareholder value, directors need to consider whether choosing to buy back stock in lieu of other investment and growth opportunities is the best use of corporate funds. One of the biggest challenges facing companies is finding ways to drive top-line growth, preferably through organic growth, which is often the toughest to achieve. Many companies are pursuing growth through acquisitions, taking advantage of ample cash and the ability to borrow money at record low rates. As discussed more fully below, 2014 is on track to be the biggest year for M&A activity since 2007.

In addition to economic and geopolitical uncertainties, management and boards face a host of other challenges as they plot their company's long-term strategic direction. As discussed in this alert, these challenges include understanding and anticipating the impact that technology will have on the company's business and understanding and managing the company's risks, particularly as they relate to cybersecurity.

2. Cybersecurity

"Boards that choose to ignore, or minimize, the importance of cybersecurity oversight responsibility, do so at their own peril." SEC Commissioner Luis A. Aguilar, June 10, 2014.[6]

Cybersecurity has become a risky business and boards need to be prepared. At least 3,000 U.S. companies were the victim of some kind of hack last year, and the annual cost of cyber crime to the global economy is estimated to exceed $445 billion.[7] In the wake of prominent breaches, the CEO and CIO of Target resigned, boards of directors of Target and Wyndham Hotels were sued for breach of fiduciary duty, and Institutional Shareholder Services Inc. (ISS) openly campaigned against members of Target's audit and corporate responsibility committees because "these committees should have been aware of, and more closely monitoring, the possibility of theft of sensitive information."

These tangible consequences for boards and management are a response to growing awareness of critical risk. As the National Institute of Standards and Technology (NIST) noted, "The national and economic security of the United States depends on the reliable functioning of critical infrastructure. Cybersecurity threats exploit the increased complexity and connectivity of critical infrastructure systems, placing the Nation's security, economy, and public safety and health at risk. Similar to financial and reputational risk, cybersecurity risk affects a company's bottom line. It can drive up costs and impact revenue. It can harm an organization's ability to innovate and to gain and maintain customers."

2014 Regulatory Developments

In February 2014, NIST issued its first Framework for Improving Critical Infrastructure Cybersecurity. The framework provides companies with standards and best practices for managing cyber risks, establishing a common vocabulary for discussions between businesspeople and technical specialists. It offers an incremental approach to cyber risk management and enables companies to flexibly address risk.

Although the NIST framework is voluntary, regulators appear to be tacitly adopting the NIST framework as a guide to evaluating companies. In April 2014, the SEC's Office of Compliance, Inspections and Examinations (OCIE) announced a cybersecurity audit in which it reviewed cyber practices of more than 50 broker-dealers and investment advisors. Despite being only directed to broker-dealers and investment advisors, the seven-page list of cybersecurity questions provides a guide to companies in any industry of the focus of regulators in assessing cybersecurity readiness.

In November, the SEC unanimously adopted Regulation SCI (Systems Compliance and Integrity) to govern the technology infrastructure of the United States' securities exchanges and certain other trading platforms and market participants. The new rules are designed to minimize disruptions to markets and enhance the capability of exchanges and trading platforms to respond to, and remedy, breakdowns in their systems. The rules are the first updates in more than two decades to the technological standards governing exchange-based automated trading systems. The SEC has signaled that it may expand the scope of Regulation SCI to include other key market participants in the future.

Industries also continued to self-regulate. The retail and oil and gas industries established the Information Sharing and Analysis Centers (ISAC) to aggregate, analyze and distribute information regarding threats to their respective industries. The Federal Financial Institutions Examination Council established a site to outline cybersecurity guidance and indicated that member agencies (including the Federal Reserve, the FDIC and the OCC) will begin incorporating cybersecurity assessments into the examination process by the end of the year. The Department of Justice and the Federal Trade Commission issued a joint statement that officially encouraged companies, including direct competitors, to share cyber threat information with one another, emphasizing that "properly designed sharing of cyber threat information should not raise antitrust concerns."

Key Risk Management Considerations

Boards should place cybersecurity near the top of any enterprise risk management program. The following are questions that boards should be asking:

- ***Governance***. Has the board established a cybersecurity review committee and determined clear lines of reporting and responsibility for cyber issues?

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SEC Commissioner
Luis A. Aguilar
June 10, 2014

84 percent of enterprises see big data changing their industries in the next year.

GE and Accenture Industrial Internet Insights Report for 2015

- ***Critical Asset Review***. Has the company identified what its highest cyber risk assets are (e.g., IP, personal information, trade secrets, mechanical controls on equipment, etc.)? Are sufficient resources allocated to protect these assets?
- ***Threat assessment***. What is the daily/weekly/monthly threat report for the company? What are the current gaps and how are they being resolved?
- ***Incident Response Preparedness***. Does the company have an incident response plan and has it been tested in the past six months? Has the company established contracts via outside counsel with forensic investigators in the event of a breach to facilitate quick response and privilege protection?
- ***Employee Training***. What training is provided to employees to help them identify common risk areas for cyber threat?
- ***Third-Party Management***. What are the company's practices with respect to third parties? What are the procedures for issuing credentials? Are access rights limited and backdoors to key data entry points restricted? Has the company conducted cyber due diligence for any acquired companies? Do the third-party contracts contain proper data breach notification, audit rights, indemnification and other provisions?
- ***Insurance***. Does the company have specific cyber insurance and does it have sufficient limits and coverage?
- ***Risk Disclosure***. Has the company updated its cyber risk disclosures in SEC filings or other investor disclosures to reflect key incidents and specific risks?

Cybersecurity is no longer solely an IT issue. The board must do more than simply review the IT budget annually and trust the IT department to self-regulate. The SEC and other government agencies have made clear that it is their expectation that boards actively manage cyber risk at an enterprise level. Given the complexity of the cybersecurity inquiry, boards should seriously consider conducting an annual third-party risk assessment to review current practices and risks.

3. Assess the Impact of Advances in Technology and Big Data

Directors are becoming much more attuned to the important role that information technology will play in their company's future. According to PricewaterhouseCooper's (PwC) 2014 Annual Corporate Directors Survey, 82 percent of directors believe that their company's IT strategy contributes to and is aligned either "very much" or "moderately" with setting their company's overall strategy.[8] As the pace of technological change continues to accelerate, it becomes ever more difficult to stay abreast of changes, much less grasp their implications. This poses significant challenges for management and the boards of directors overseeing management's plans.

Perhaps nowhere are the advances in technology more prevalent than in the information domain. The explosion of mobile technologies and social media is changing the way companies compete. Directors need to understand how these technologies are shaping the competitive landscape and fundamentally changing the rules of engagement with customers. In a digital world where one tweet or one Facebook "like" regarding a company's products or services can go viral in a matter of seconds, the power has shifted to the customer, who is increasingly socially-connected and well-informed regarding products and pricing. Directors need to assess how these changes in customer behavior, as well as the rise in e-commerce and advances in IT, will affect the company's business model, particularly for companies in the retail sector. Cyber Monday 2014 set a record for the biggest online shopping day ever.[9] And by 2017, e-commerce sales are expected to account for over 10 percent of retail sales in the United States, and 60 percent of all U.S. retail sales are expected to involve the Internet in some way, either as a transaction or as a part of a shopper's research.[10] This dramatic change in the retail experience requires directors to consider difficult questions, such as how much brick-and-mortar the company needs, whether the company needs to revise its pricing, advertising and marketing strategies, how the company should deal with lead generators, and whether the company is efficiently utilizing its employees, office space and supply chain and distribution channels.

Directors also need to understand and weigh the risks created by the use of mobile technologies and social media by company personnel and ensure that appropriate policies are in place. Nearly 80 percent of companies now have a social media policy,[11] and 46 percent of directors say they are at least "moderately" engaged in overseeing employee use of mobile technologies, which is nearly double from what it was two years ago.[12] A company's social media policy should align with company values and highlight transparency with honesty, respect and common sense. Restrictions on employees using social media to share confidential, classified, material non-public information about the company and its customers, as well as private or personal information concerning individuals is also a critical component.

Thanks to the ubiquitous interconnectivity of today's world, companies now have available to them a mind-boggling quantity of data that continues to grow at an alarming pace. "Big data" represents a vast wealth of information, and how companies use this data is becoming increasingly important. Both large and small companies are using big data to track customer buying habits, manage capital spending, target their marketing efforts, customize products, forecast sales and increase cash flow. According to a recent study, 84 percent of enterprises see big data changing their industries in the next year.[13] And 66 percent of executives believe that there is an urgent need to adopt big data technologies to avoid losing market position.[14] Despite the impact big data is expected to have on companies, when asked if their company takes sufficient advantage of big data, only 12 percent of directors responded "very much" and 41 percent responded "moderately."[15]

4. Shareholder Activism

No doubt that activism will continue in 2015.

Shareholder activism is on the rise, and activists are becoming more creative in building alliances. With the success that activists are experiencing, and the billions of dollars that they are raising, there is no doubt that activism will continue in 2015.

As of October 15, 249 activist campaigns had been launched so far this year, up from 202 for the same period last year.[16] Whether they are demanding board seats or the removal of officers and directors, launching a hostile bid or advocating specific business strategies, activists are becoming even more of a force to be reckoned with. And activists are emerging with ambitious and creative tactics, most notably the bidder-activist collaboration model used by Valeant Pharmaceuticals and Pershing Square Capital Management L.P. in their hostile bid for Allergan. Although ultimately losing the bid to another buyer, Pershing Square, as a 9.7 percent shareholder, stands to collect $2.6 billion, which profit will likely spur others to try some version of this approach.

In light of the success that activists have experienced in 2014, activist funds are enjoying an influx of capital. Activist investors raised billions of dollars in 2014, growing their funds under management by $9.4 billion in the first half of

2014 to $111 billion.[17] Considering that returns are averaging 5.9 percent, compared to a 3.9 percent gain for hedge funds in general, the money will likely keep coming.[18] As the activists grow, so does the size of their targets. In 2013, the U.S.-listed companies targeted by activists had an average market capitalization of $10 billion, up from less than $2 billion at the end of the last decade.[19]

With the threat of activism in the air, boards need to be prepared. Directors need to understand how activists think and what tactics and tools activists employ. They need to know company vulnerabilities that could attract an activist's attention and understand what defenses the company has in place to protect itself. Directors also need to understand who their company's shareholders are and what they care about. Some specific steps companies need to be taking include:

- ***Understanding the company's vulnerabilities***. Boards need to carefully review their business and strategy to identify any weak spots that might create concern among investors. Underperformance, particularly as it relates to industry peers, is the easiest way to draw activists' attention. Other lightning rods are large cash balances that could be returned to shareholders through dividends or stock buybacks, unrelated or underperforming divisions or business units that could be spun off, and other assets, such as real estate, that do not generate a sufficient return and could be sold. Once vulnerabilities are identified, boards need to determine how to address them while focusing on what is in the best interests of shareholders.

- ***Understanding the company's defenses***. It is also critical that boards assess what defenses the company has in place or readily deployable, as many companies have dismantled their takeover defenses in response to proxy advisory firms over the years. While the Allergen situation has taught us that overly-aggressive defenses can backfire, boards need to be able to defend their companies from opportunistic attacks.

- ***Preparing for an activist attack***. Companies need to be prepared to react if an activist comes calling. Companies should assemble an activist response team, which may include a small team of corporate officers, legal, financial and proxy advisors and investor relations personnel, to develop a plan for dealing with activists. Having a game plan in place that addresses various scenarios will lead to a more thoughtful, effective and timely response.

- ***Knowing and engaging your shareholders***. Companies need to understand the breakdown of their shareholder base and monitor trading of the company's shares. Companies also need to reach out to significant shareholders. This is not only a good way to find out what they want and get their perspectives on the company, but also helps build credibility and stronger relationships. In addition to cultivating relationships with major investors, companies need to continually and effectively communicate their business strategies and plans for value creation to the marketplace, as well as to smaller, but potentially more vocal, investors. Companies should also be taking advantage of the power of the Internet by making sure their Web sites are up-to-date and fully communicating the company's message. And companies should be actively monitoring shareholder concerns and opinions that are expressed through blogs and other shareholder forums and proactively responding to shareholder issues before they escalate.

- ***Determining director involvement***. As part of shareholder engagement, companies need to determine whether, and to what extent, directors should be communicating directly with shareholders on the company's behalf. At least 1,000 U.S. public companies received a letter earlier this year from the Shareholder-Director Exchange (SDX) asking boards to consider formally adopting a policy for shareholder-director engagement.[20] The SDX also adopted the SDX Protocol, which provides guidance for public company boards and shareholders when developing an engagement practice or policy. Whether or not your company received this letter, director engagement is important to investors. According to a recent survey, 66 percent of directors communicated with institutional investors this past year and 29 percent reported that their board interacted with activists this past year.[21]

5. The Return of M&A

M&A activity has been picking up steam during 2014, and is on track to be the biggest year since 2007. Over $2.5 trillion in deals were announced in the first nine months of 2014, with U.S. deal volume leading the way, up 65 percent this year.[22] Europe and the Asia-Pacific region are also experiencing increased deal volume, up 27 percent and 24 percent, respectively, from last year.[23] An improving economy, large cash balances and cheap debt are the primary drivers fueling this uptick in M&A activity.

Mega deals contributed to the increase in overall deal volume, signaling growing confidence by boards to undertake large, strategic and transformative deals, with the majority coming from the pharmaceuticals, life sciences, telecom and technology industries.[24] The inversion trend, where a U.S. company merges with a foreign company in a country with a lower corporate tax rate, also added to M&A activity, accounting for four of the top 10 largest deals in 2014.[25] This trend will likely cool in 2015, however, due to new rules announced by the U.S. Treasury Department and the Internal Revenue Service that make inversion transactions more difficult and less rewarding for companies.

Strategic buyers have also returned to the market, seeking growth and expansion opportunities before competitors beat them to the punch. The stock market has generally rewarded such acquisitions by boosting a buyer's stock after the announcement. In the first half of 2014, nearly 70 percent of announcements of U.S. acquisitions worth $1 billion or more were followed by gains in the stock prices, compared with a seven-year average of 55 percent.[26]

The flip side of increasing M&A activity is that many companies will find themselves at risk of becoming targets of unwanted suitors. Hostile takeovers have made a comeback in 2014, amounting to around 19 percent of the value of all M&A activity in 2014, the most in any year since 2000.[27] Pfizer's attempt to acquire AstraZeneca, Valeant Pharmaceuticals' and Pershing Square's attempt to acquire Allergan, and Charter Communications' attempt to acquire Time Warner Cable are just a few of the unsolicited offers making headlines this past year. Directors need to carefully assess the adequacy of their company's takeover defenses, particularly since many companies have acceded to shareholder demands to destagger boards, eliminate existing poison pills and give shareholders the right to call special meetings and vote by written consent. These efforts to become more shareholder friendly have left companies increasingly vulnerable.

Although the use of poison pills as a takeover defense has been falling out of favor for several years, boards would be wise to have a poison pill "on the shelf," which is ready for adoption on short notice in response to a potential threat. Taking this "on the shelf" approach gives the board more time for a thoughtful and effective evaluation of the poison pill in the absence of a pending threat and enables the board to act quickly in response to an actual threat. Further, there are no public disclosure requirements for merely having a poison pill "on the shelf," so the board is not pressured to include shareholder-friendly provisions recommended by ISS, but instead can ensure the poison pill is sufficiently potent to adequately protect the company.

6. Risk Management

Risk management goes hand in hand with strategic planning—it is impossible to make informed decisions about the company's strategic direction without a full understanding of the risks involved. An increasingly interconnected world economy continues to spawn newer and more-complex risks that challenge even the best-managed companies. According to recent surveys, reputational risk and cybersecurity/IT risk are leading concerns among board members. How boards respond to these risks is critical, particularly with the increased scrutiny being placed on boards by regulators, shareholders and the media.

Proper oversight of risk management encompasses the full panoply of risks that a company may face, including operational, financial, strategic, compliance and reputational risks. Enterprise risk management not only focuses on reducing risk, but also assesses both upside and downside risks, and thus, helps inform the strategic planning process. Boards of directors of all companies should be evaluating the adequacy of their risk management oversight procedures. Among other things, directors should address:

- ***Director education***. All directors need to have a good understanding of their company's business and the major risks it faces. Without a good grasp of both the upside and downside risks, directors cannot properly oversee the company's strategic direction. Indeed, as part of its oversight function, a board needs to be satisfied that the company's risk appetite, that is, the amount of risk the company is willing to accept in pursuit of stakeholder value, is appropriate for the company.[28] As discussed more fully in the topic on board composition, boards should ensure they have directors with sufficient experience and expertise to effectively oversee the risks the company faces, particularly with respect to data security and information technology.

- ***Oversight structure***. The board should evaluate the manner in which it oversees risk management. Depending on how large it is and how well it functions, a board may decide to retain overall authority for risk management oversight at the board level. Other boards may use board committees to carry out certain of their risk oversight duties.

  At many companies, primary oversight responsibility for risk management is delegated to the audit committee. Of course, audit committees are already burdened with a host of other responsibilities that have increased substantially over the years. Consequently, although not widespread, the boards of some companies (primarily in the financial services and insurance industries) have set up separate risk management committees. And several hundred U.S. companies now employ a chief audit executive who reports directly to the full board, allowing the board to receive information that has not been filtered.[29]

  Even if primary oversight for monitoring risk management is delegated to a committee, the entire board needs to remain engaged in the risk management process and be informed of material risks that can affect the company's strategic plans. Given the wide spectrum of risks that most companies face and the myriad board decisions that are permeated by risk considerations, many directors believe that risk management oversight should rest with the entire board. Also, if primary oversight responsibility for particular risks is assigned to different committees, collaboration among the committees is essential to ensure a complete and consistent approach to risk management oversight.

- ***Reporting processes***. Directors need to ensure that they are getting the information they need to understand the company's risks, as well as management's assessment of those risks. They also may want to meet privately with the company's principal risk officer and the internal and outside auditors to discuss risk management issues. If risk management is delegated among several committees, their activities and the sharing of information needs to be coordinated. Also, the board should re-examine how often risk management matters are discussed at board meetings.

- ***Risk management review***. The board (or other responsible committee) should review with management the adequacy of the company's risk management practices. In particular, the board needs to probe whether the company's risk management processes appropriately identify, assess and manage the company's risks to ensure that the risk exposures are consistent with the company's appetite for risk.

- ***Cyber risk***. As part of a board's risk management oversight function, directors should carefully assess the adequacy of their company's data security measures. Cyber risk is not going away, so it is imperative that boards and management do what they can to manage and minimize cyber risk, as discussed more fully in the topic on cybersecurity. This includes identifying those areas where the company is most vulnerable and understanding how they may be at risk. Boards also need to have a response plan in place if and when a cyber attack occurs and ensure they have adequate insurance coverage for data breaches. Failure to adequately oversee this risk can cause dire consequences for the company and create additional issues for directors, including lawsuits and negative voting recommendations.

7. Ensure Appropriate Board Composition

Finding the right mix of people to serve on a company's board of directors is undoubtedly a difficult task. With increasing globalization, changing marketplace dynamics and shareholder expectations, it is essential that boards have the right mix of experience and expertise to oversee the opportunities and challenges that their companies face. Finding directors with the right skills, however, is not the only thing boards should be considering. As discussed below, to achieve optimal board composition consideration should also be given to the diversity of the board, director tenure and board size, all of which have been making headlines as of late.

- ***Board Expertise***. Based on PwC's annual survey, directors continue to view financial, industry and operational expertise as the most important director attributes.[30] Expertise in risk management and technology/digital media followed closely behind as important attributes to have on a company's board.[31] Depending on a company's business and the particular risks that it faces, companies may need to beef up their boards by adding members with expertise in particular areas of concern.

  While many boards have made significant improvements in their oversight of risk management, others would still benefit from the addition of a director with in-depth experience in enterprise risk management. As high-profile cyber attacks continue to make headlines, having a director with IT experience may be critical to effectively oversee the risk in this area and to help ensure that the company is adequately protected against, as well as prepared for, a cyber attack. Plus, with the expanding role that technology has in business, including the Internet, social media and cloud computing, boards of almost all companies would gain from the addition of a tech-savvy director. To fill this void, boards may have to step out of the box of traditional director traits and tap candidates who are younger and have less conventional backgrounds. Lastly, with increasing globalization, multinational companies may find that they would benefit from a more internationally diverse board.

- ***Board Diversity***. While finding the optimal mix of skills for the board is important, there is also a growing focus on the need for a diversified board, particularly with respect to gender. According to a recent ISS survey, 60 percent of investor respondents and 75 percent of issuer respondents indicated that they consider overall diversity when evaluating boards.[32] In a recent speech, SEC Chairman Mary Jo White urged companies

30 percent of new board nominees for S&P 500 companies in 2014 were women.

ISS, Gender Diversity on Boards: A Review of Global Trends (Sept. 25, 2014)

and shareholders to do more to increase the participation of women in boardrooms, suggesting that shareholders make known what actions they want taken.[33] Since 2008, shareholders have submitted approximately 100 proposals on board diversity, more than half of which were submitted in 2013 and 2014, asking U.S. companies to include women and minorities in their pool of director candidates and to adopt formal policies addressing board diversity.[34]

Board diversity is not merely a women's issue—it can also have economic implications for companies and make for a stronger board. Several studies show a positive correlation between women in the boardroom and company financial performance. Particularly, studies have shown that companies with boards of directors that have three or more women have better financial performance, higher returns on equity and greater returns to shareholders.[35] According to U.S. Secretary of Commerce Penny Pritzker, increasing the number of women in corporate leadership positions is necessary to boost economic competitiveness, noting that 73 percent of buying decisions in the United States are made by women, and women control $12 trillion of $18.4 trillion in consumer spending globally.[36] This may explain why S&P 500 companies selling household or personal products consistently have the most female board members, averaging 33 percent female members during 2008 through 2014.[37]

This push for female directors may finally be catching on. Based on a report by ISS, in 2014 nearly 30 percent of new board nominees for S&P 500 companies were women, which is a significant jump from 15 percent in 2008.[38] But there is still a long way to go. Despite studies showing the benefits of having female board members and mounting pressure by shareholders, women currently make up only 18.7 percent of the boards at S&P 500 companies.[39]

- ***Director Tenure***. Director tenure is another board consideration that has made its way into the spotlight. While many U.S. companies have some form of mandatory retirement age policy for directors, only three percent of S&P 500 companies have term limits for directors, none of which is less than 10 years.[40] Term limit policies may facilitate board refreshment, but they do so at the risk of losing directors with highly valued firm knowledge, expertise or perspectives. Long-tenured directors are often among the savviest and most skilled directors, highly valued for their deep understanding of the company and the industry and their ability to provide historical perspective on strategic decisions and company specific issues. In the past few years, however, shareholder groups have argued that long-tenured directors are more likely to align with management, thereby compromising the directors' independence, and make it difficult for companies to refresh their boards with new skill sets and address diversity among their board members. A new shareholder proposal is brewing for the 2015 proxy season that would require at least 67 percent of a company's board to have less than 15 years of tenure. This resolution has been submitted at Costco Wholesale and other submissions are expected at companies where more than two-thirds of the directors have served for 10 years or more, and the board shows other signs of stagnation or entrenchment.[41]

Also, ISS updated its Governance Quickscore scoring system by adding several new governance factors, one of which is director tenure. ISS will now consider, when determining a company's Governance Quickscore, the percentage of non-management directors who have served on the board for more than nine years. ISS has indicated that a tenure of more than nine years can potentially compromise a director's independence. Some investors also view long tenure as problematic. The Council of Institutional Investors revised its best-practices corporate governance policies last year to include tenure as a factor boards should consider when determining whether a director is independent.[42] And State Street Global Advisors adopted a policy to vote against long-tenured directors and nominating committee members in companies it identifies as needing "board refreshment."[43]

- ***Board Size***. The size of corporate boards has become a topic of conversation due to a study finding that of companies with a market capitalization of at least $10 billion, those with smaller boards tended to substantially outperform peer companies with larger boards.[44] Citing examples such as Apple with eight directors and Netflix with a mere seven, the study suggested that smaller boards allow for deeper debates and more nimble decision-making.[45] Researchers suggest that individual directors are more likely to assume responsibility and ownership and have more detailed discussions when there are fewer directors and are more cohesive with fellow board members. On the other hand, directors on a smaller board have to carry a greater workload and smaller boards may find it more difficult to achieve diversity of experiences and perspectives.

As companies focus on board composition, it would be wise for boards to also keep an eye on developments in proxy access. The SEC amended its rules in 2011 to require companies to include in their proxy materials proxy access shareholder proposals, which typically seek to allow shareholders that meet certain criteria to nominate directors and have those directors included in the company's proxy materials. The number of proxy access proposals submitted over the years has been relatively low, but this is changing for 2015. As part of the Boardroom Accountability Project, New York City Pension Funds have submitted 75 proxy access shareholder proposals for the 2015 proxy season, targeting companies with perceived climate change issues, excessive CEO pay or lack of board diversity.[46] While monitoring how the 2015 proxy season unfolds, companies should have a plan to address how to respond to a proxy access proposal if one comes their way.

8. Explore New Trends in Reducing Corporate Health Care Costs

The increasing cost of healthcare is a significant concern for companies that provide health care benefits to their employees. With certain key provisions of the Patient Protection and Affordable Care Act, more commonly known as Obamacare, still looming, and with health care costs expected to grow 6.8 percent in 2015,[47] boards of directors need to understand how health care costs will impact their company's cost structure and strategy going forward. Set forth below are several actions that boards should be considering:

- ***Review and redesign, if necessary, current health care programs***. Many companies are using health care reform as a catalyst to review and redesign their health care programs to slow the rising costs. A growing number of companies are already using private online exchanges to deliver their health care benefits, including Walgreens, Sears Holding Corp., Petco, Kinder Morgan and Darden Restaurants, and more companies are considering jumping on the private exchange bandwagon in the future. Generally speaking, under a private exchange program, employers give their employees a fixed sum of money and require the employee to shop for insurance coverage on a private online exchange. An estimated three million employees are currently getting insurance from their employers through a private online exchange, which number has tripled from a year ago and is projected to grow to 40 million by 2018.[48] In addition, according to a report by Aon Hewitt, companies that use the private exchange concept benefit from lower health care costs than most other employers, with coverage rates increasing an average of 5.3 percent in 2015 for companies on a private exchange versus a six to eight percent increase for large self-insured employers.[49]

Companies are also taking other steps to manage health care costs. Following in the footsteps of Target, Home Depot and Trader Joe's, who already moved away from providing health insurance to part-time workers, Wal-Mart recently announced plans to eliminate health insurance coverage for employees who work less than 30 hours a week and to raise premiums for its other employees.[50] And last year, UPS eliminated health care coverage for employee spouses who have other available coverage.

An increasing number of employers are pushing employees into high-deductible plans that require the employee to pay more out of pocket before coverage kicks in. According to a report by PwC, enrollment in high-deductible plans has tripled since 2009 and 44 percent of employers who haven't made the switch say they are considering it.[51] Other actions that companies are taking include increasing the share employees and their dependents pay in premium contributions, implementing higher medical and pharmacy deductibles, eliminating retiree health benefits, providing wellness programs and reviewing the company's relationship with its providers.

Managing costs will become even more significant for companies as 2018 approaches and the excise tax under Obamacare kicks in for high-cost "Cadillac" plans. Beginning in 2018, certain high-cost group health plans, both insured and self-insured, will be subject to an excise tax of 40 percent on the amount by which the health plan's annual cost for coverage, including both employer and employee contributions, exceeds $10,200 for single-only coverage and $27,500 for family coverage. Based on a recent survey by Towers Watson, three out of four companies responding said that they are either "somewhat" or "very" concerned that they will be subject to the excise tax in 2018 if they don't make adjustments to their current benefit strategy.[52] Forty-three percent of companies surveyed said that avoiding this tax is the top priority for their health care strategy in 2015.[53] As such, companies need to review their health care plans in the coming years to control their costs and avoid the excise tax.

- ***Encourage a healthy workforce***. Having a healthy workforce can give a company a competitive advantage. Employee wellness programs have become a popular choice for companies attempting to reduce health care costs and improve the health of their workforce. These programs are designed to encourage workers to be more healthy, often by using financial incentives to motivate employees to participate, or by using penalties, such as an increase in premiums and deductibles, for certain unhealthy behaviors, such as smoking, or having high cholesterol or a high body mass index. More than half of all organizations with more than 50 employees have a wellness program in place.[54] And according to a recent survey, 36 percent of companies with more than 200 employees use financial incentives tied to health objectives, and 51 percent offer incentives for employees to complete health risk assessments aimed at identifying health issues.[55]

  How much money a wellness program will actually save a company is debatable, but a wellness program does allow a company to shift higher costs to those employees who have unhealthy behaviors, or who don't participate in the program or fail to meet certain benchmarks. Some view this as a form of discrimination. But this approach is acceptable under the Affordable Care Act, which allows employers to vary total premium costs by as much as 30 percent in connection with a wellness program, and to charge tobacco users up to 50 percent more in premiums.[56]

- ***Assess strategy and costs relating to play or pay***. Under the Affordable Care Act, employers with 100 or more full-time employees will have to pay a penalty if they do not offer health insurance to at least 70 percent of their workforce beginning on January 1, 2015, and to at least 95 percent of their workforce beginning in 2016. This employer mandate, often referred to as the "play or pay" rule, kicks in on January 1, 2016 for employers with 50 to 99 full-time employees. Health benefits are often viewed as an important part of an employee's compensation package, so most companies that currently offer health benefits to employees will likely continue to do so for the foreseeable future. But it will be important for the board of directors to know the company's options and responsibilities under the statute to best determine whether the company should take the "play" or "pay" approach in 2015 and beyond. In making this determination, the board should consider, among other things, (i) the costs of the company's health care programs and what steps the company can take to manage these costs, (ii) the amount of any penalties the company would have to pay under the statute if it eliminated health care coverage for its employees and (iii) the actions taken with respect to health care by other companies in the industry. If the company does elect to "pay" instead of "play," it will need to carefully consider how to explain its decision to employees and inform them of their options.

9. Executive Compensation

Executive compensation remains a hot topic for yet another year, particularly with pay disparity and pay for performance regulations still looming. We highlight below some of the matters directors should be considering as they craft executive compensation for 2015:

- ***Say-on-Pay Vote***. The vast majority of companies receive what seems to be routine approval of C-suite compensation with approximately 98 percent of companies receiving majority shareholder support for their executive pay packages in 2014.[57] But boards should not let down their guard. Just because a company had a successful say-on-pay vote one year, does not mean there will not be issues down the road, particularly if there is a misalignment between executive pay and company performance, if pay is extremely high for executives, or if the company has other problematic pay practices.

- ***Proxy Advisory Firm Recommendations***. Proxy advisory firms can be a key driver of the outcome of a vote on say-on-pay or an equity plan proposal. Companies need to analyze their shareholder base to determine the level of influence proxy advisors have on their investors. If a proxy advisory firm gives a negative recommendation on a proposal, companies need to consider whether they want to refute the recommendation through supplemental proxy filings or direct engagement with major shareholders.

  In a move that should increase the accuracy of ISS' analysis of equity compensation plan proposals, companies now have an opportunity to review and verify key data points that ISS uses to evaluate a company's equity plan proposal and to formulate its voting recommendation on such plan. ISS' new Equity Plan Data Verification portal gives companies approximately two business days after the data has been posted to review the data and request modifications.[58]

  Companies also need to stay abreast of changes in the voting recommendation policies of proxy advisory firms. For 2015, when evaluating equity compensation plans, ISS will use a new "balanced scorecard" model, incorporating a range of positive and negative factors relating to the cost of the plan, plan features and the company's historical grant practices, which factors will be weighted based on company size and status. Currently, ISS applies a series of standalone pass/fail tests focused on cost and certain egregious practices to determine an "against" recommendation.[59]

- ***Shareholder Outreach***. Shareholder outreach is an effective way for companies to learn about and address shareholder concerns and lessen proxy advisory firm influence on investors. Whether this engagement should involve a company's management or its directors is debatable. According to a recent survey, 73 percent of directors believe it is at least "somewhat appropriate" for the board to engage in executive compensation discussions with shareholders, while the remaining 27 percent believe it is "not appropriate."[60]

- ***Pending Dodd-Frank Regulations***. Much to the delight of companies, the SEC continues to lag in its rulemaking on several provisions required by the Dodd-Frank Act. While there were rumors that the SEC was pushing to deliver certain final and proposed rules by the end of October 2014, that deadline has come and gone and the SEC is now targeting a deadline of October 2015. In any event, companies should be planning how they will implement and comply with the new rules once adopted.

  - *Pay disparity disclosures*. In September 2013, the SEC proposed rules that would require public companies to disclose the ratio of a CEO's annual total compensation and the median total annual compensation of all other employees of the company (including part-time, seasonal, temporary and foreign employees).[61] The proposed rule provides companies with flexibility in determining the median compensation for employees by permitting the use of statistical sampling in order to ease the compliance burden. With CEOs making on average over 331 times the average worker's salary, it is not surprising that this proposal has sparked quite a bit of controversy.[62] The SEC has received more than 128,000 public comment letters on this proposal.[63] Detractors question the rule's utility and bemoan anticipated compliance burdens while proponents tout the rule as providing meaningful information to shareholders. Whenever final rules are adopted, the SEC will allow companies some transition time to figure out how they will comply. Some companies, however, are being proactive. According to a recent survey, 33 percent of director respondents reported that their boards have already taken steps to comply with the looming disclosures.[64]

- *Pay for performance*. Another contentious provision in the Dodd-Frank Act calls for companies to disclose in their annual proxy statements the relationship between executive compensation and the company's financial performance. Although the SEC has yet to propose rules on this topic, most companies are paying closer attention to pay for performance alignment. According to a recent survey, 60 percent of companies have conducted a pay-for-performance analysis comparing the company's performance and executive pay with those of its peers in the marketplace.[65] Only one third of such companies, however, disclosed the findings of their analysis, as most other companies said they were waiting for SEC rules to be issued.[66]

- *Clawbacks*. The Dodd-Frank Act also calls for the SEC and stock exchanges to implement rules requiring companies to develop and disclose clawback policies for the recovery of incentive-based compensation granted to any current or former executive officer during the three-year period preceding an accounting restatement that is based on erroneous data corrected in the restatement. The language in the statute is broader than the clawback provisions in the Sarbanes-Oxley Act, which apply only to the CEO and CFO, have only a one-year look-back and require misconduct. While some companies are sitting on the fence waiting to see what the new rules look like before adopting a policy, more and more companies are going ahead and adopting some form of clawback policy to appease investors and proxy advisory firms, which favor clawback policies.

10. Maintain Robust Compliance Programs

Directors should make sure that their companies maintain robust compliance programs and disclosure controls and procedures, as the SEC has stepped up its enforcement efforts with a goal of pursuing all types of violations of the federal securities laws. SEC Chair Mary Jo White has vowed to pursue even the smallest infractions, basing the SEC's "broken windows" enforcement policy on the theory that "minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines."[67] And just over a year into her tenure, she has done just that, with the SEC filing a record 755 enforcement actions in 2014.[68]

These enforcement actions span the securities industry and include several first-ever cases. Among other things, the SEC continued its aggressive cross-border anti-corruption enforcement in 2014, filing significant actions against several companies under the Foreign Corrupt Practices Act (FCPA), and obtaining the highest-ever FCPA penalties against individuals. Signaling that "even the smallest infraction" will be pursued, the SEC recently brought enforcement actions against 34 individuals and companies for failure to promptly report their securities holdings and transactions as required under Section 13(d) or (g) and Section 16 of the Securities Exchange Act of 1934, and against 10 micro-cap companies for failing to file required Form 8-Ks disclosing certain financing agreements and unregistered stock sales.

In addition to utilizing new investigative approaches and innovative data and analytical tools to ferret out many of these violations, the SEC received more than 3,500 tips from whistleblowers in fiscal year 2014, the largest number since the whistleblower rules went into effect in 2011.[69] Since 2011, the SEC has given 14 whistleblower awards, nine of which were awarded in 2014. And the SEC recently announced its largest ever award of $30 million, which is more than double the previous record of $14 million. The size of these awards provides strong incentive for individuals to report suspected conduct to the SEC.

The increase in whistleblower activity shows no signs of abating. To the contrary, Sean McKessy, Chief of the SEC's Office of the Whistleblower, has said that he intends to broaden the scope of the SEC's activity in this area, making employers who retaliate against whistleblowers a priority. The SEC brought its first whistleblower retaliation case in June, resulting in $2.2 million in sanctions against the offending company. McKessy has suggested that this case may be the first of many, noting that the SEC is actively looking to bring cases against employers who make it more difficult for whistleblowers to come forward and provide information to the SEC. Employee confidentiality agreements, including in the context of employment and severance agreements, that "impede" whistleblower activity are now falling under heightened scrutiny. Of particular concern are clauses that prohibit employees from reporting misconduct to a government agency without first getting approval from a supervisor, or that prohibit all discussion of such misconduct without including an express exclusion for protected whistleblower activity, particularly if such clauses threaten an employee with termination or legal action based on a disclosure.

In light of these developments, it is critical for companies to have comprehensive and effective compliance programs in place, including a transparent process for internal investigations. Companies should also review and update as necessary their anti-retaliation policies and procedures and make sure employees and executives at every level are sufficiently trained in this area.

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