2017–2018 NACD Public Company Governance Survey

Executive Summary

About Our Survey

Today's rapidly changing business environment presents a formidable challenge to corporate directors seeking to advise management and fulfill their own governance oversight responsibilities. Directors seek a point of reference as they assess the efficacy of their governance practices and determine whether they are fit for purpose. It is therefore no surprise that annually more than a thousand directors and executives participate in NACD's Board Governance Surveys. They find value in benchmarking their board's practices in key oversight areas such as strategy, risk, and organizational culture and in gauging the effectiveness of their board's approach to recruitment, education, and evaluation year over year. They use the results to identify opportunities for improvement and confirm board priorities for the coming year. This year's public company governance survey report offers detailed insights on directors' outlook for 2018 on

- key business trends and critical board priorities;
- the board's role in overseeing the organization's culture;
- the state of board risk oversight, specifically cyber risk; and
- the growing challenge of activist investors.

In addition, this year we have supplemented NACD survey data with board structure and composition data compiled by Main Data Group, a provider of executive compensation benchmarking and corporate governance data and analytics.

Highlights of the *2017–2018 Public Company Governance Survey*

1. Boards Are Concerned About Growing Industry Disruption, but Environmental and Social Issues Seem to Matter Less.

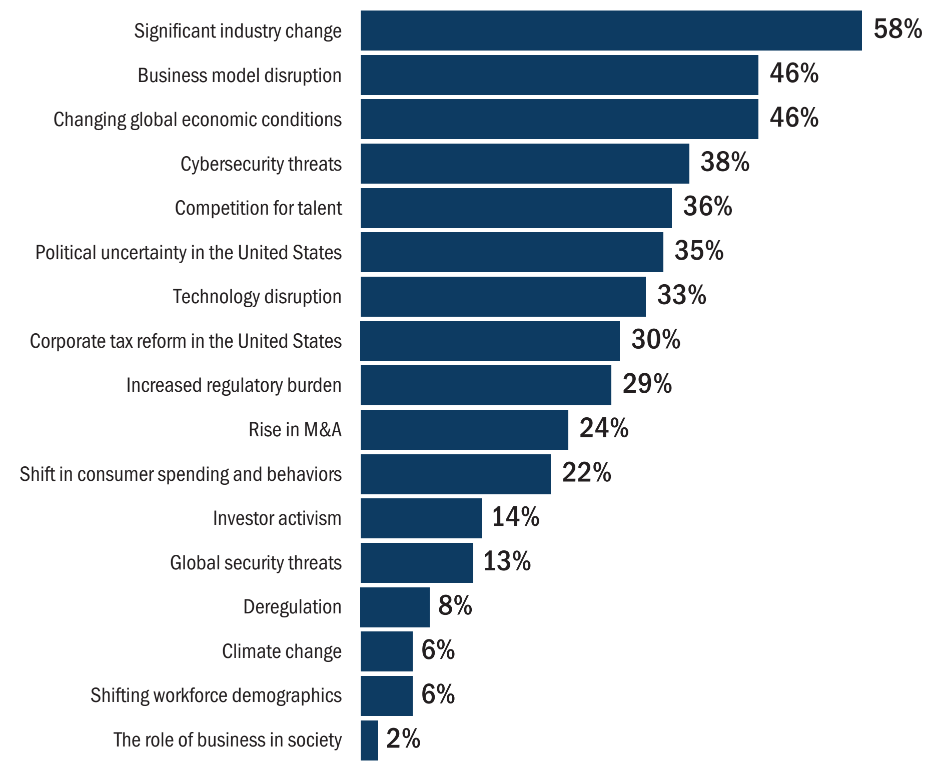
Significant industry change was selected by **58%** of respondents as one of the five trends likely to have the greatest impact on their companies in 2018. When asked to break down the key drivers of change in their industries, respondents most frequently mentioned technology disruption, industry consolidation, and shifting regulations. In light of major industry change, it is notable that industry experience is the most desirable attribute that boards look for in new director candidates. They will need to carefully assess if the past industry experience of candidates is still relevant for the company's future needs.

Business model disruption and competition for increasingly scarce talent—which contribute to major industry upheaval—are also ranked among the top five 2018 trends, suggesting boards are concerned about a dramatic transformation in how enterprise value is created and their companies' ability to effectively adapt.

Perhaps not unexpectedly in light of the Trump administration's focus on repealing or softening federal regulations, respondents' concerns about the impact of the regulatory burden dropped significantly, from **58%** in 2016 to just **29%**. However, a lower regulatory burden in the United States may be offset by proliferating compliance requirements and heightened regulatory enforcement in other markets—specifically, in the European Union and China.

Similar to the results in last year's survey, very few boards consider social and environmental issues as top trends that will impact business performance over the next 12 months. Just **6%** of respondents selected climate change as a top-five trend for 2018, while only **2%** believe the changing role of business in society is a key trend impacting their company. This suggests that most boards continue to see these challenges as peripheral to near-term business success, despite increased expectations about corporate sustainability from investors and declining trust in business among the broader public. In fact, only **24%** of respondents consider it important or very important that their board improve oversight of ESG matters in 2018.

What five trends do you foresee having the greatest effect on your company over the next 12 months? (Respondents could select five of the 17 issues below.)



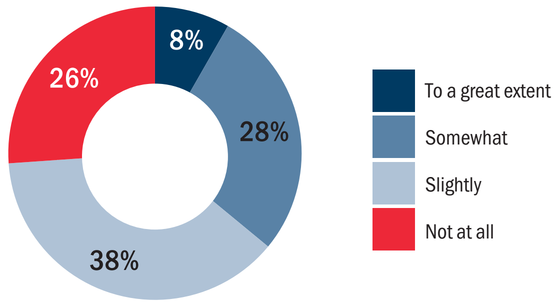
2. Shareholder Activism Exacerbates the Short-Term Performance Pressure Felt by Boards.

The impact of short-term performance pressure continues to be acutely felt by boards and management teams. **Seventy-four percent** of respondents report that management's focus on long-term strategic goals has been compromised by pressure to deliver short-term results, either slightly, somewhat, or to a great extent. This is consistent with last year's findings, when **75%** of respondents felt that the impact of short-term pressure undermined a long-term focus, demonstrating that short-termism continues to be a significant driver in today's business environment.

This year's survey reveals that companies which feel the heat of activist investors are more likely to report that short-term pressure compromised their long-term strategic goals compared to organizations that did not receive activist attention. **Eighty-five percent** of respondents who were approached by an activist over the last 12 months indicate that short-term pressure from external sources compromised management's focus on long-term strategic goals, versus **73%** of respondents who did not report an activist approach.

Boards are trying to reduce the threat of excessive management risk-taking to meet or exceed short-term performance targets. **Eighty-four percent** of respondents report that their compensation committees now balance short- and long-term performance metrics in executive-compensation design, and **83%** say they review overall compensation approaches to ensure they drive the right risk-taking behaviors.

At your organization, to what extent has short-term pressure from external sources compromised management's focus on long-term strategic goals?



3. External Volatility and Uncertainty Drive a Desire for Deeper Board Involvement With Strategy.

Economic and political uncertainty, top trends in last year's public governance survey, continue to pose a challenge for corporate directors and their companies. **Forty-six percent** of respondents selected changing global economic conditions as a top-five 2018 trend that will impact their business, while **35%** ranked the uncertain political environment in the United States as a top-five 2018 trend.

Boards are not entirely sure that their executive teams are prepared to lead their companies through significant turbulence in the operating environment. Just over half of board respondents (**54%**) are confident or very confident that management can appropriately address growing geopolitical risks to their business, while **61%** of directors have confidence that management can navigate rapidly shifting global economic conditions.

Directors themselves admit that they need to do a better job in contributing to strategy. **Seventy-one percent** of directors indicate that their boards must better understand the risks and opportunities that affect performance and drive strategic choices over the next 12 months. **Sixty-seven percent** of them report that their boards must improve their contribution to the development of the strategy, while the same number of respondents feel that it is important for their boards to strengthen the monitoring of strategy execution.

In last year's survey, improving the board's contribution to strategy was also a top-ranked priority, suggesting that many boards still struggle to move from a traditional review-and-concur approach to deep and continual engagement with strategy. One obstacle to more robust board engagement with strategy may simply be insufficient time allocation. **Fifty-one percent** of respondents this year indicate that the lack of adequate time during board meetings for in-depth strategy discussions is an important barrier to effective strategy engagement, up from **44%** last year.

For your board, how important are improvements in the following areas over the next 12 months? (Top five most important board improvement areas based on % ranking improvement over the next year as "Important" or "Very important")

4. The Board's Understanding of Corporate Culture Doesn't Extend Beyond the Tone at the Top, Creating a Risky Disconnect.

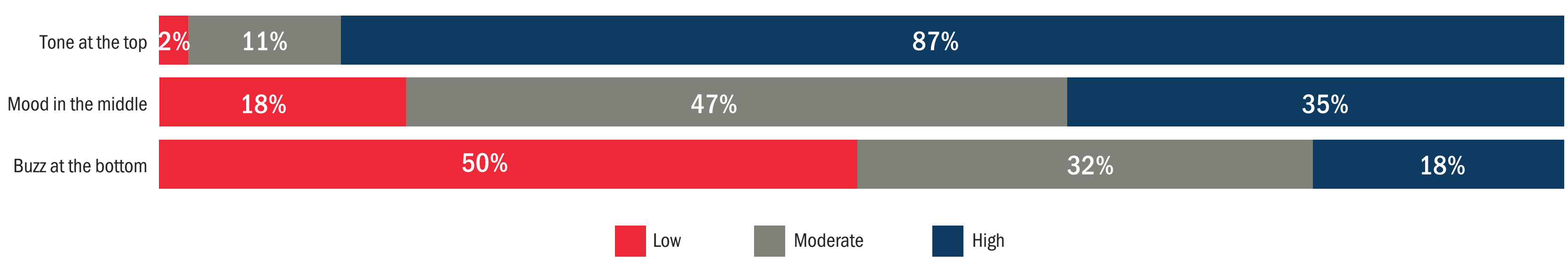
A strong majority (**79%**) of directors report that they are confident or very confident in management's ability to sustain a healthy corporate culture in a period of significant performance challenges, yet **92%** of respondents rely on reporting from the CEO about the health of organizational culture. Fewer boards also hear directly from specialist functions, such as internal audit (**39%**), compliance and ethics (**30%**), and enterprise risk management (**20%**), which possess a much deeper and perhaps more independent perspective on the strength of the corporate culture than the CEO does. And only a minority of boards proactively seek out information about the health of the corporate culture. **Forty-one percent** of board respondents held confidential conversations about possible culture issues with leaders below the C-suite, while **48%** visited different company locations to develop a firsthand view of culture.

Not surprisingly, **87%** of directors report that they have a good understanding of their companies' tone at the top, but this number drops significantly when looking at the mood at the middle and on the front lines—those levels in the organization where culture can have enormous impact in driving the wrong or right employee behaviors. Only **35%** of directors say they have a good understanding of the mood in the middle, and just **18%** of them indicate they have a good grasp of the health of the culture at lower levels of the organization.

It is encouraging to see that a large majority of boards (**76%**) are now discussing whether existing compensation practices are driving the right behaviors, while **56%** of boards formally review the CEO's effectiveness in leading the company culture. However, far fewer boards report that they have integrated culture-related metrics into executive-compensation plans, perhaps the board's most powerful tool to reinforce CEO accountability. Only **11%** of boards consider employee-turnover metrics and **11%** assess workplace diversity measures, while **37%** use employee-engagement levels and **33%** use customer satisfaction as nonfinancial metrics when determining CEO pay.

This year, our annual *Blue Ribbon Commission Report* issues a call to action for directors of all organizations to elevate their dialogue on culture—including culture inside the boardroom—in order to improve the quality of the board's work and enhance its impact.

How would you rate your board's understanding of the health of the organizational culture at each of the following levels?



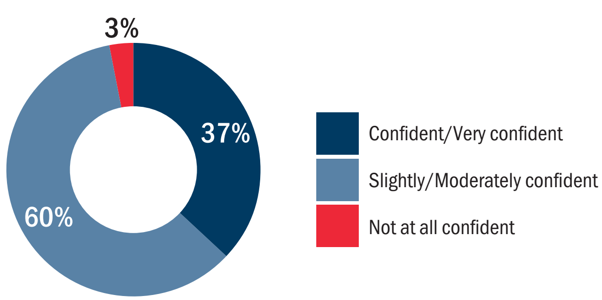
5. Boards Are Less Confident About Cyber-Risk Preparedness.

Thirty-seven percent of board respondents feel confident or very confident that their company is properly secured against a cyberattack, compared to **42%** last year. A slightly higher percent (**49%**) is confident or very confident in the ability of management to address cyber risk. This lack of board confidence in their ability to control cyber risk may be driven by the fact that existing defense systems quickly become obsolete when cyber threats mutate and companies adopt new technologies.

This year's survey findings suggest that boards are gradually increasing their understanding of cybersecurity, which may also explain their increased skepticism of management's efforts. Boards are now more informed and more prepared to challenge the effectiveness of their companies' cybersecurity programs. In 2015, **22%** of directors reported that their boards had no or very little knowledge of cyber risk. That figure dropped to **15%** this year.

More than one-fifth of directors (**22%**) expressed dissatisfaction with the quality of cyber-risk information provided to the board by management. Of those "dissatisfied" or "very dissatisfied" with this information, most indicate that the information they receive doesn't provide enough transparency into problems (**44%**) or doesn't allow for effective internal and external benchmarking (**41%**).

How confident are you that your company is properly secured against a cyberattack?



6. Boards Want to Improve CEO-Succession-Planning Practices in 2018.

Fifty-eight percent of directors indicate that improving CEO-succession planning is a critical improvement priority for 2018, up from last year when **47%** of respondents reported this as a key priority. There was also a large increase in discussing CEO and executive-team succession with investors, from **8%** of respondents in 2016 to **19%** this year. One of the drivers behind this growth may be increased investor scrutiny of CEO performance, and unexpected, forced departures of high-profile CEOs in 2017.

For your board, how important are improvements in CEO succession planning over the next 12 months? (Based on % ranking improvement over the next year as "Important" or "Very important")

7. Boards Are Slow in Adapting to Increased Expectations About Continuous Improvement of Their Skills, Practices, and Processes.

Directors today are facing unprecedented challenges, demands, and expectations that amount to a new mandate for boards. They can more significantly contribute to long-term value creation by continuously keeping their skills and processes in tune with the organization's shifting needs, as NACD recommended in its *2016 Report of the NACD Blue Ribbon Commission on Building the Strategic-Asset Board*. Based on this year's survey findings, we see mixed results against this heightened expectation of continuous improvement:

- **Director Recruitment:** For the second year in a row, search firms continue to be the most utilized resource (**39%**) for identifying new directors. Respondents cited a desire for more diverse candidates (**52%**) and difficulty finding unique skill sets/ backgrounds (**39%**) as the top two reasons for engaging a third party (i.e., a search firm).

- **Board Culture: Fifty-eight percent** of respondents report that their boards should improve the candor of boardroom conversations over the next 12 months. Moreover, lack of candid feedback is seen as a major obstacle to making board evaluations more effective. Only **54%** of public company boards today actively discuss their boardroom culture and underlying problems in executive session.

- **Board Operations:** A majority of respondents (**more than 50%**) believe that their boards allocate enough time to key governance issues, including executive compensation, cyber risk, and regulatory compliance. However, directors acknowledge the need for improvements in board operations. **Fifty-six percent** report that it is important to improve the rigor of board decision making in 2018, while **58%** say that their boards must get better in following through on recommendations that come out of board meetings.

- **Director Education: Forty-five percent** of board respondents said that not enough time was allocated to director education in board meetings over the last 12 months. The amount of time directors currently dedicate to formal education is **21 hours** annually, a slight increase from last year, when it was **18.5 hours**.

- **Board Evaluations: Sixty percent** of respondents now evaluate individual director performance in the evaluation process, up from **41%** last year. Most individual director evaluations are conducted annually (growing from **79%** last year to **89%** this year); it is less common to conduct them every two years (**9%**) or three years (**5%**).

- **Board Tenure Limiting Mechanisms: Fifty-two percent** of respondents report using age limits. Despite the reliance on this mechanism, only **37%** of respondents that use age limits find them to be effective or very effective in ensuring the right board composition.

- **Board-Shareholder Engagement:** For the first time since 2014, half of all respondents (**50%**) had a board representative meet with institutional investors in the prior year. The percentage of respondents reporting that they have been approached by an activist has dropped to the lowest point in two years. **Sixteen percent** of all respondents indicated they had been approached in the prior 12 months, versus **22%** in 2016 and **19%** in 2015.

About the National Association of Corporate Directors

The National Association of Corporate Directors (NACD) empowers more than **17,000** directors to lead with confidence in the boardroom. As the recognized authority on leading boardroom practices, NACD helps boards strengthen investor trust and public confidence by ensuring that today's directors are well prepared for tomorrow's challenges.

World-class boards join NACD to elevate performance, gain foresight, and instill confidence. Fostering collaboration among directors, investors, and corporate governance stakeholders, NACD has been setting the standard for responsible board leadership for 40 years. To learn more about NACD, visit www.NACDonline.org.

About Pearl Meyer and Main Data Group

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage.

Main Data Group provides compensation professionals with executive compensation benchmarking and corporate-governance data and analytics through an affordable, easy-to-use, online service.

For more information, please visit pearlmeyer.com and maindatagroup.com or e-mail info@pearlmeyer.com and info@maindatagroup.com.