Director Accountability in the Spotlight

Introduction

In the coming months, legislative and regulatory initiatives will be considered that may dramatically change the way corporate directors are nominated and elected. Among other things, these initiatives call for the majority election of directors and permit large shareholders to nominate director candidates using a company's proxy materials. If one or both of these initiatives are enacted, the dynamics of selecting and evaluating directors will change in the following ways:

- Companies will need to run proactive "campaigns" to ensure that their director nominees receive a majority of the votes cast at the their annual meeting of shareholders; this process will be more challenging if, as proposed, brokers are prohibited from voting uninstructed shares for management's nominees.
- Large shareholders will be able to nominate their own candidates for one or more board seats, and companies will be required to include these nominees, along with information about them, in the companies' proxy materials
- Investors will have a greater say in the development of corporate policy, as well as the ability to hold directors accountable for their actions and decisions

This is likely to have its most immediate impact in the ongoing controversy about executive compensation practices and levels. Shareholders will not be reluctant to use the powerful new weapons at their disposal to unseat directors if they object to specific executive compensation decisions or are dissatisfied with a company's overall performance. Consequently, directors – particularly those serving on Compensation Committees – should recognize that their continued service may come down to their responsiveness to shareholder attitudes and positions on executive compensation matters.

In addition, these initiatives could further enhance the influence of the major proxy advisory firms, such as RiskMetrics Group, Inc. and Glass Lewis & Company, whose executive compensation policy guidelines may become the de facto standard for what are "acceptable" compensation practices. Thus, companies that deviate from these standards or which engage in what are considered to be "poor pay practices" may find themselves vulnerable to board turnover and the resulting loss of director oversight and continuity.

This article summarizes these pending initiatives and explains how they could affect corporate governance – and executive compensation – practices in the near future.

Recent Developments

The corporate governance and executive compensation landscapes are evolving rapidly. Earlier this week, the Administration announced a series of new compensation standards, or "best practices," for financial institutions and other companies intended to ensure that compensation programs are better aligned with investor interests. In addition, the Administration announced that it intends to pursue legislation that would give shareholders at all public companies a non-binding advisory vote on executive compensation and strengthen the independence of board compensation committees.

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Majority Election of Directors

Growing investor complaints that the existing system for the election of directors does not provide meaningful accountability has led activist shareholders to press for a majority voting standard for director elections. This movement gained significant momentum following the corporate scandals earlier this decade and the enactment of the Sarbanes-Oxley Act of 2002 and has resulted in nearly three-quarters of the companies in the S&P 500 adopting some form of majority voting requirement. Nonetheless, the vast majority of U.S. companies still maintain a plurality voting standard for director elections (that is, the director who receives the most votes is elected).

This could change later this year as Congress, seeking to stabilize the American economy, considers numerous corporate governance reforms. In fact, the Shareholder Bill of Rights Act of 2009, which was introduced in the U.S. Senate by Senator Charles Schumer (D-NY) in May, and which proposes several significant reforms (including a non-binding advisory vote on executive compensation ("Say on Pay"), declassified boards, and independent board chairs) would require that every reporting company adopt a majority voting standard.

At a minimum, such a requirement would compel companies to devote significant attention to the selection of their director nominees to ensure that they were acceptable to their major shareholders. At the same time, investors critical of a company's performance or policies (such as its executive compensation program) would have the ability to unseat management's slate of directors through a "Just Vote No" campaign or other concerted action. As a result, many director elections would likely take on a "contested" flavor, even in the absence of an opposition slate, forcing companies to spend considerable time and expense to ensure the election of their board each year. This problem would be further aggravated if the pending rule change described in the following section is adopted in the coming months.

Elimination of Broker Voting

While a change to the voting requirements for corporate directors will impact the selection of director nominees, when coupled with a second pending change – the elimination of broker discretionary voting in uncontested director elections – the election process itself will be radically altered, potentially making it more difficult for management to get its slate of directors elected.

Under the New York Stock Exchange's Rule 452, brokers have the right to vote shares held in investor accounts on "routine matters" if they do not receive voting instructions from the beneficial owner prior to the annual meeting of shareholders. Traditionally, the election of directors has been considered a "routine matter" for purposes of this rule. As a result, in a majority voting setting, it is not uncommon for management's slate of nominees to start out with a 20% - 40% block of broker discretionary votes; particularly in a company with a large retail shareholder base.

In 2006, the NYSE Proxy Working Group recommended that Rule 452 be amended to reclassify uncontested director elections as a "non-routine matter"; effectively eliminating brokers' ability to vote uninstructed shares. Until this year, the proposed change languished at the SEC, which must approve all rule changes by national securities exchanges. However, in February, the SEC announced that it was seeking comment on the proposed amendment, signaling that it may be ready to proceed with changing Rule 452. This action has

prompted many observers to conclude that the SEC is preparing to approve the rule change in time for the 2010 proxy season.

If the amendment is approved, the dynamics of many director elections could change dramatically. Without the "cushion" provided by broker discretionary voting, companies subject to a majority voting standard will have to work harder to ensure that their nominees are elected. The objections of one or more large shareholders to an individual director could put that nominee's election into jeopardy. Further, a company with a large retail shareholder base may need to conduct a "get out the vote" campaign each year, even in the absence of organized opposition to its director slate.

Shareholder Access to Proxy Materials

On May 20, 2009, the SEC proposed a new proxy rule that would permit large shareholders at public reporting companies to nominate one or more director candidates in company proxy materials. Culminating a six-year struggle between the corporate and shareholder communities over "proxy access," the proposal remains highly controversial (as evidenced by the Commission's 3-2 vote to publish the proposal for comment) and is expected to trigger a fierce and bitter debate over the next several months. While it is expected that some form of shareholder access rule will be eventually be adopted and be in place in time for the 2010 proxy season, given the proposal's checkered history, the outcome is anything but certain. If a rule is adopted, however, shareholders will add a significant weapon to their arsenal with which to apply pressure on uncooperative Boards of Directors or, if all else fails, to run their own director candidates.

Here are the key features of the SEC proposal.

Shareholders Eligible to Nominate Directors

As proposed, a shareholder (or group of shareholders) that beneficially own the required minimum number of a company's voting securities for at least one year prior to the date the proposed nomination (or nominations) are submitted to the company would be entitled to include the nominee (or nominees) in the company's proxy materials for consideration by its shareholders. This minimum securities ownership requirement would vary depending on the size of the company:

- For companies with a market float of at least $700 million ("large accelerated filers" for SEC reporting purposes), the minimum ownership requirement would be 1%;
- For companies with a market float of at least $75 million ("accelerated filers" for SEC reporting purposes), the minimum ownership requirement would be 3%; and
- For companies with a market float of less than $75 million ("non-accelerated filers" for SEC reporting purposes), the minimum ownership requirement would be 5%.

This rule would be subject to an overriding requirement that the applicable state law and the company's charter documents permit shareholders to nominate directors.

Number of Nominees

Eligible shareholders would be permitted to nominate the greater of (a) one individual or (b) 25% of the number of board seats that were up for election. In a situation where multiple eligible shareholders (or groups of shareholders) sought to submit nominees to the company that exceeded the number of permissible nominees, the company would be required to include only the nominees of the shareholder who first provided timely notice to the company of its intent to submit nominees.

Nominee Qualifications

Any individual nominated by an eligible shareholder (or group of shareholders) to serve on the company's board of directors would have to satisfy the "independence" standards of the national securities exchange on which the company's securities were listed. In addition, the nominating shareholder (or group of shareholders) could not have in place any agreement with

the company regarding the nomination, would have to certify that it was not seeking to gain control of the company or gain more than minority representation on the board of directors, and would have to agree to continue to hold their equity position in the company through the subject election. Finally, the nomination would not be permitted if it violated applicable law.

What's Likely to Happen?

Although Boards of Directors and Compensation Committees have made progress in identifying and addressing shareholder concerns in recent years, particularly involving executive compensation, the ongoing crisis in the financial sector, coupled with the long-standing frustration of many investors as to the absence of meaningful accountability for directors, has created an environment in which landmark corporate governance reforms are becoming more probable with each passing week. While shareholder access has garnered most of the attention from the media, as a practical matter, the adoption of a majority voting standard will likely have a greater – and more far-reaching – impact on most companies.

If a majority voting standard is adopted, directors may become targets for dissatisfied or opportunistic shareholders if they make controversial – and even unconventional – compensation decisions. As a result, Compensation Committees may become reluctant to implement innovative pay practices or to make "hard" decisions for fear of setting off a response that could change the direction of the compensation program or, even worse, destabilize the Board of Directors. At worst, companies may resort to more conservative and standardized approaches to executive pay to avoid any potential fall-out that could lead to a "contested" election.

Further, just as companies have had to adopt strategies for engaging their major shareholder to ensure approval of their equity compensation plans, similar actions will be necessary to ensure the election of the Board of Director each year. In addition, companies will need to undertake significant communication initiatives for engaging their major shareholders to identify issues of concern and monitor shareholder satisfaction; activities that only a few large companies currently conduct.

If, as anticipated, versions of majority voting and/or shareholder access become the norm, the corporate governance landscape, as well as many executive compensation and other practices, could look very different next year.

Need Additional Assistance?

Compensia has had significant experience in helping technology and life sciences companies understand the implications of their corporate governance obligations and the impact of ongoing regulatory developments on their executive compensation programs. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like to arrange a briefing for your Board of Directors or Compensation Committee, please feel free to contact us. ■

Director Accountability in the Spotlight (continued)

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