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**Timely Commentary on Critical Events
and Regulatory Developments**

New SEC Initiative Underscores Need for Independent and Effective Governance/Nominating Committees

No rest for the weary! Public company directors who retained or gained seats this year have hardly been sitting still. They have been responding to new requirements and expectations flowing from passage of Sarbanes-Oxley, and keeping up with new rules, proposed and final, from the major stock markets.¹

Now a new issue confronts boards: the director election process itself. In recent days, the **Securities and Exchange Commission (SEC)** has been looking into possible proxy voting process reforms—including one that would give shareholders the ability to nominate board members directly, bypassing the governance/nominating committee.

This issue of *DMX* summarizes recent SEC and NACD actions with regard to director elections, and suggests ways boards can strengthen their governance/nominating committees to improve shareholder relations. The goal for all: action in the long-term interests of shareholders and other corporate constituencies.

on the heels of SEC announcements in April and May on this topic—and culminated 60 years of SEC staff activities in this domain.

The staff report summarized nearly 700 comments on this topic, including one from the NACD board of directors (www.sec.gov/rules/other/s71003.shtml). More than 400 responses were from individuals, including many leading shareholder activists. The remaining comment letters came from institutional investors and funds, as well as from law firms, associations, corporations, and various advisory services. (For highlights, see Box 1 on p. 3.)

Comment letters were responding to the SEC's May 1, 2003, solicitation of views on proxy rules regarding director elections (Release No. 34-47778, www.sec.gov/news/press/2003-59.htm). In this solicitation, the SEC said it was considering ways to increase "shareholder participation" in the proxy voting process regarding the nomination and election of directors.

The SEC is considering several possible reforms, including the following (quoted directly from the SEC's July 15 press release announcing the staff report):

- Require more robust disclosure of the nominating committee processes of public companies, including the consideration of candidates recommended by shareholders.

Director Summary >>

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SEC Actions

On July 15, 2003, the SEC Division of Corporate Finance issued a staff report, "Review of the Proxy Process Regarding the Nomination and Election of Corporate Directors" (www.sec.gov/news/studies/proxyreport.pdf). This report came

1 For descriptions of Securities and Exchange Commission rulemaking implementing the Public Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley) see past issues of *DMX*. To keep up with SEC developments between issues of *DMX*, visit sec.gov, and see "proposed rules," "final rules," and "SROs." For June 2003 events not yet covered in *DMXs*, see "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" (June 5, 2003) Release Nos.: 34-47986, IC-26068; File Nos.: S7-40-02, S7-06-03 (www.sec.gov/rules/final/33-8238.htm); and "Self-Regulatory Organizations: Rule Changes...Relating to Equity Compensation Plans" (June 30, 2003) Release No. 34-48108; File Nos. SR-NYSE-2002-46 and SR-NASD-2002-140 (www.sec.gov/rules/sro/34-48108.htm).

- Require specific disclosure of the processes by which shareholders may communicate with the directors of the companies in which they invest.
- Require that major, long-term shareholders (or groups of long-term shareholders) be provided access to company proxy materials to nominate directors, where there are objective criteria that indicate that shareholders may not have had adequate access to an effective proxy process. Examples of events that would trigger this access could include situations where the results of the proxy process are not acted on by companies or where there is substantial shareholder dissatisfaction with the operation of the proxy process.

The July 15 staff report acknowledges the challenges inherent in such a change, recapping a list of 23 possible impediments to (or side effects of) reform, including possible conflicts with state law, need to qualify shareholders, potential misuse of the proxy mechanism in contests of corporate control, and need to limit number of candidates. Any reform must resolve such issues, admits the report. Finally, the report notes that in order to provide direct access to shareholders, the SEC would have to change a number of rules—including those governing proxy voting, disclosure of beneficial ownership, and insider transactions.

Despite these challenges, the SEC staff report concludes by recommending that the SEC “propose and solicit public comment on new proxy rules that would allow a shareholder group or group of shareholders to place their nominees in a company’s proxy materials.”

This is a significant development worthy of careful attention. It may not be Armageddon, but it is no time for apathy.

NACD Actions

Even before the SEC’s recent initiative, the NACD was taking action to strengthen governance/nominating committees and their responsiveness to shareholder nominations.

Task Force

In April, the NACD joined with the **Council of Institutional Investors** to form a joint Task Force on Improving Director-Shareholder Communication, co-chaired by **Warren L. Batts** of Chicago, a long-time CEO and corporate director, and **Peter M. Gilbert**, chief investment officer of the **Pennsylvania State Employees’ Retirement System**, a Council member. The Council is an association of about 120 public, labor, and corporate pension funds that has been working for better corporate governance since the 1980s.

The task force aims to investigate the current barriers to director-shareholder communication and to see how some companies and directors have overcome them. The joint CII-NACD task force is expected to recommend strength-

ening of board governance/nominating committees, among other reforms.

Survey

NACD surveyed its members to find out their views on shareholder voting. Responses formed a “bell curve” of views—ranging from a small group that expressed opposition to any shareholder involvement in director nomination, to another small group that favored direct access to proxy voting for all shareholders. The majority in the middle said they favor the status quo or moderate reforms, including nominations from shareholders who hold 5 percent or more (www.nacdonline.org/surveythanks.asp).²

Comment Letter

As an outgrowth of its work with the task force, the NACD leadership has expressed its views on director elections to the SEC. In a June 13 letter (www.sec.gov/rules/other/s71003.shtml), the NACD board asserted, “the process for director nominations should be entrusted to a committee of independent directors.” (See Box 1.)

What Boards Can Do

In light of these recent actions by the SEC and NACD, what can boards do? Our suggestion: form independent governance/nominating committees³ that take shareholder nominations seriously, as suggested in the NACD’s June 13 comment letter. The task force report this October will describe actual board “best practices” along these lines.

Sadly, independent nominating committees are still the exception rather than the rule on today’s boards. The most recent data from **Institutional Shareholder Services**, a proxy advisory firm in Rockville, Maryland, show that most public companies still lack independent nominating committees. Based on 2002 proxy statements of the 5,000 largest public companies, only 47 percent have a nominating committee with more than 50 percent independent directors (defined as directors having no relationship other than their director fees).

The **New York Stock Exchange** and **Nasdaq** have proposed listing rules that would require independent governance/nominating committees, as well as a mandatory disclosures of how concerned parties can communicate directly with the board, through either a designated “presiding” independent director, or with independent directors as a group. These changes have not yet received SEC approval, however, so it is up to directors to *act now*.

A “Make or Break” Proposition

Boards need independent and effective governance/nominating committees now more than ever. How boards respond to this issue could “make or break” governance as we know it. ■

2 Apparently at least 20 percent of respondents so far would favor direct access by qualified shareholders, but this is not certain, as the wording of the questions is general.

3 For a guide to governance/nominating committees, see *The Governance Committee*, a recent publication in the NACD Director’s Handbook Series (Washington, D.C.: NACD, 2003) (<http://www.nacdonline.org/publications>).

Box 1. Director Elections: Comment Highlights

On May 1, 2003, the **SEC** asked for comments on the subject of director elections and proxy voting, setting a deadline of June 13. Here is a summary of some notable comments. All rules referenced are rules under the Securities and Exchange Act of 1934, unless otherwise identified.

National Association of Corporate Directors (June 13). Chairman **B. Kenneth West** and President-CEO **Roger W. Raber** favor board solutions. "The process for director nominations should be entrusted to a committee of independent directors of the board that has at least the nominating functions described in the proposed New York Stock Exchange listing rules pertaining to the governance/nominating committee; that the committee should develop and disclose to shareholders its criteria for recommending nominees to the board; its process for receiving and reviewing director candidates from shareholders for placement on the proxy voting cards and other proxy materials; and the deadline date by which nominations must be received in order to be considered at an annual meeting." The letter notes that shareholders "may, if so disposed, amend the bylaws of the company to provide for a process different from the one described...above." Also recommended are improvements in the format of proxy voting cards, and an increase in the amount of information re director candidates (at least the most recent business or professional position held by the candidate).

American Corporate Council Association (June 13). **Broc Romanek**, a lawyer, editor, and website publisher, writing as Chairman of ACCA's Corporate and Securities Law Committee, takes a moderate stance. "Rather than altering this fundamental component of a company's governance framework, we believe it is wiser to address the issues that investors believe are most critical at this time with increased disclosures." For example, the SEC might require companies to "disclose in a timely manner what actions the company implemented in response to shareholder proposals that pass." Also, the SEC might require that the governance/nominating committee "publish a report in the annual meeting proxy statement to address the processes employed to identify and evaluate qualified director candidates and evaluate shareholder nominations," similar to the reports already required of the audit and compensation committees.

American Bar Association (May 20). The ABA's Taskforce on Shareholder Proposals, including **R. Todd Lang** of **Weil, Gotshal & Manges**, met with **Lillian Cummins**, Special Counsel, Office of Mergers and Acquisitions, Division of Corporation Finance, **SEC**, to discuss director elections. Cummins noted that the meeting was held, but did not disclose the contents of the deliberations. In a meeting with NACD nominees to the joint CII-NACD task force, Lang set

forth five mechanisms the ABA had outlined for SEC consideration. The ABA task force presented the mechanisms neutrally, without favoring one over another.

American Society of Corporate Secretaries (May 12). Representatives of the ASCS met with **Lillian Cummins**, Special Counsel, Office of Mergers and Acquisitions, Division of Corporation Finance, **SEC**, to discuss director elections. Cummins noted that the meeting was held, but did not disclose the contents of the deliberations.

The Business Roundtable (June 13). **Henry A. McKinnell**, Ph.D., Chairman and CEO, **Pfizer**, met with the SEC on May 9. Recapping the meeting, he writes that "direct shareholder access to company proxy statements to nominate directors is inconsistent with the proposed NYSE corporate governance listing standards (as well as similar Nasdaq proposed standards) and detracts from the role and independence of nominating committees." His letter points out conflicts with existing state and federal law.

CALPERS and other institutional investors from California, New York, Pennsylvania, and Wisconsin (June 13). This letter favors shareholder access to director nominations via the proxy, with several safeguards, including a threshold requirement, long-term ownership ("period of years"), limits on number of shareholder nominees (to prevent takeovers), reasonable length for all candidate descriptions (e.g., 500 words), exemption from Rule 13d-1 (unless seeking control, in which case access is denied), and reimbursement of expenses.

Council of Institutional Investors (May 10, 2003). **Sarah Teslik**, CEO, begins her letter by stating, "the Council believes that the single most important reform is to give shareholders more of a voice regarding who represents them on corporate boards. The Council believes that reasonable access to company proxy cards for long-term investors to nominate candidates for directors would substantially contribute to the health of the U.S. corporate governance model."

Intel Corporation (June 10). **Cary Klafter**, Vice President, Legal and Government Affairs, warns against changing the basic fabric of shareholder voting. Instead, Klafter cites an example of how the Intel board works well within the current system. "We proactively engage directly with our institutional and retail investors through, e.g., our Investor Relations and Corporate Social Responsibility groups. We believe it is important and proper to tell our story directly to our investors, and to that end we have long-term involvement with many of our institutional investors and with social investment and other special-interest groups." The letter describes Intel's procedures in detail.

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, private, and closely held firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD chapter members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

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