

Preparing For Proxy Season 2011

by Robert G. Berick and Rachel L. Posner

One year can make a huge difference in corporate governance. Proxy season 2011 will look very different from that of 2010, with the end of broker voting, much more disclosure on votes, risk, pay, social issues, succession planning and, of course, shareholder “say on pay.” What will you need to assure your board and management are ready for this tidal wave of proxy change?

Over the past 12 months, the world of corporate governance for U.S.-listed companies has changed rapidly. The various regulatory bodies looked to create better investor safeguards in the wake of the unprecedented collapse of the global financial markets in 2009. As a result, directors will now operate in a dramatically different—and much more difficult—working environment, particularly during the annual proxy season.

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In the past year, corporate boards have had to contend with such governance challenges as:

□ *“Just Vote No” campaigns.* These campaigns involve applying pressure on an issuer by encouraging fellow shareholders to vote against a corporate proposal or withhold votes from an incumbent director. Similar campaigns have been waged to defeat the quorum for meetings when it appears likely that shareholders would not have had an opportunity to express their views.

□ *Elimination of broker voting in uncontested elections.* This change has likely received the most discussion in boardrooms. Companies are trying to understand the ramifications of brokers no longer voting on behalf of their clients (and, in most cases,

casting their votes in favor of management). The elimination of broker voting has ended the implied “automatic support” for management proposals, which is proving troublesome at companies with majority voting rules.

□ *Real-time reporting of vote results.* The Securities and Exchange Commission (SEC) approved amendments to Form 8-K that require companies to disclose the results of a shareholder vote within four business days after the end of the meeting at which a vote is held. Issues directly impacting shareholder interest, such as the election of directors, changes in shareholder rights, investments or divestments, must be reported in a timely manner. This supersedes the requirement to disclose voting results in Forms 10-K and 10-Q, which often are filed months after the relevant meeting.

□ *Enhanced discussion of risk surrounding oversight, compensation practices and climate change.* New disclosure rules require companies to clearly explain the relationship of pay policies and practices to risk management. The risk exposures of potential climate change impacts must be disclosed also. In particular, the discussion of compensation should help investors determine whether a company has incentivized excessive or inappropriate risk-taking by employees.

The new rules also require companies to expand their disclosure to include a discussion on the board’s overall role in the oversight of risk, such as how it administers this oversight, and the effect it has on the board’s leadership structure.

□ *Discussion of board diversity.* Another new disclosure requirement calls for companies to outline whether (and if so how) a nominating committee considers and defines diversity in identifying

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nominees for director positions. If the nominating committee or board has a policy on considering diversity in identifying director nominees, the rules require disclosure of how this policy is implemented, and how the nominating committee (or full board) assesses its effectiveness.

□ *Discussion of management succession planning.* Much greater emphasis is now being placed on the outlook for companies' future leadership teams. While investors are not necessarily looking for names of specific candidates, they increasingly seek more visibility into the process the board uses in preparing for an eventual leadership transition.

□ *Enhanced disclosure of board members' past affiliations and involvement in litigation.* As shareholders continue to increase their scrutiny of directors, reviewing past relationships and legal battles is now a more significant part of the standard due diligence process. Companies must disclose any directorships at public companies and registered investment companies that directors or nominees held at any time during the previous five years.

Further, companies must disclose legal proceedings (such as SEC securities fraud enforcement actions) against the director or nominee, going back 10 years instead of the current five years. The list of legal proceedings included in this disclosure has also been expanded.

□ *Greater transparency about board members' experience, qualifications, attributes and skills.* This new disclosure enhances the standard biographical information typically included in a company's proxy statement. The goal is to help investors understand why the company's slate of directors was selected to serve on the board, as well as how their individual experiences and qualifications will assist management in executing the company's long-range strategic plan and governance. Over the past year, this expanded content has proven to be a critical piece of a company's proxy materials, particularly when the company is promoting a management slate of nominees over shareholder-nominated candidates.

□ *Enhanced disclosure of a board's rationale for a particular leadership structure.* This disclosure is intended to provide further transparency on how the

board functions, and the relationship between the board and senior management. As such, it requires a company to explain why it has chosen to combine or separate the CEO and board chairman position, a major flashpoint for governance rating agencies and activist investors.

Companies now must provide greater transparency and strategic rationale for their chosen board leadership structure, including a detailed explanation of the role of the lead director (if the company has one).

The changes of 2010 were just the beginning. In 2011, public companies will be required to submit a "say-on-pay" proposal to their shareholders. Thus, the "rules of engagement" for public companies and their boards will be further altered by this regulatory change. It is coupled with the looming proxy access change which may encourage more shareholder proposals in 2011, and the SEC's proposed "Whistleblower Bounty Program" offering a 10 to 30 percent bounty on any financial penalty imposed upon a public company as a result of SEC notification of perceived corporate malfeasance.

Ensure that your board and management understand the pressures the new proxy changes will bring, and that your investor relations policy is up-to-date and well understood.

Boards can take several steps now to prepare for the 2011 proxy season, says Holly J. Gregory, a partner with Weil, Gotshal & Manges. According to Gregory, these steps include:

□ Ensure that *senior management and directors are up to speed on the new requirements*, and understand the heightened pressures. Adjust board and committee calendars to ensure sufficient time to tackle these new demands. (It is also important to provide regular updates, and allow time for discussion, on new requirements.)

□ Ensure that the company's *investor communications policy is up-to-date and well-understood* by directors, senior management and investor relations personnel. This policy should coordinate the corporate messaging used with internal and external

audiences, protect boardroom confidentiality and comply with Regulation FD.

□ Ensure that information systems and communications programs are in place. These should enable management and the board to *monitor changes in the nature or activism of the company's shareholder base*, and identify and respond readily to shareholder concerns in a responsible and timely fashion.

□ The influence of proxy advisers is likely to grow with the advent of say-on-pay and proxy access. These advisers have been very receptive to “short slates” of directors nominated by activists, so *be well-versed on the hot button issues among your company's institutional investors*, as well as the proxy adviser positions for these issues. Likewise, it is critically important that the board, the management team and its advisers be well-prepared to articulate and defend the company's particular rationale wherever its approach departs from these positions.

□ Before the corporate secretary begins drafting this year's proxy, the company should *conduct a thorough review of last year's proxy materials*. Also review analyses conducted by any proxy advisers to see if this year's materials can be more effective in communicating positive steps the company and board have taken.

Consider whether added board qualifications are appropriate for your bylaws, since “access” nominees could be seated without vetting by the nominating committee.

□ *Consider amending the “advance notice” provisions of the company's bylaws* to provide that any timing or other provisions that would be preempted by the pending proxy access rule would not apply to access nominations. Director qualification requirements should also be considered. There may be objective, minimum requirements for board membership that have not been stated in the bylaws as director qualifications. The board may now wish to formalize these in the bylaws.

Consider whether any additional qualifications are appropriate in light of the fact that “access” nominees

could be seated without vetting by the nominating and governance committee of the board. Finally, review majority voting provisions to ensure that the customary exception for election contexts is broad enough to encompass access nominations.

□ *Evaluate the company's executive compensation program and disclosures* from a shareholder perspective, recognizing that these will be put to the test in say-on-pay votes. Focus on whether there are any pay elements that may lead to inappropriate risk-taking or misalignment between “pay” and “performance” and how the program matches up to proxy adviser guidelines.

To that end, take a fresh look at this year's Compensation Discussion & Analysis (CD&A) to ensure it explains the company's compensation philosophy in a clear and convincing way, how its compensation processes are conducted, and *why* specific pay decisions have been made. Demonstrating the independence of the company's compensation processes also will be important to reflect in the CD&A content.

□ *Review compensation committee membership and advisers* to determine whether any changes are likely to be needed to pass future independence tests. For example, assess your compensation committee under the audit committee independence tests. In fact, a general conflict-of-interest disclosure criteria should be applied to all consultants to the board as a safeguard.

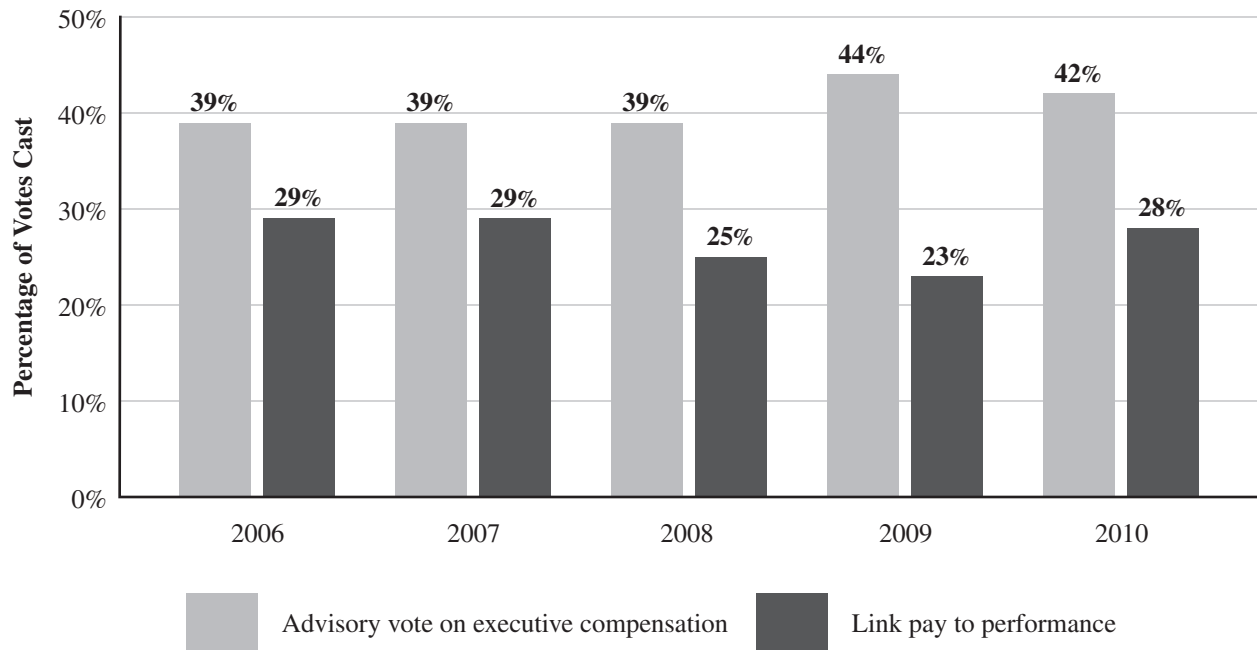
□ *Consider whether to recommend to shareholders a say-on-pay vote* every one, two or three years, and your rationale for the recommendation (for example, a multi-year timeframe for measuring the attainment of incentives).

Directors should encourage their management teams to view the proxy season as a campaign rather than a contest. In today's environment, companies should engage in an on-going discussion with investors throughout the year on strategic and governance matters, rather than pleading their case only with the mailing of proxy materials.

Waiting too long to engage investors in an insightful discussion can have dire consequences for the company. Activist investors will use this void of information to harvest their near-term (and typically

“Saying On Pay” Already

Strong Proxy Votes On Pay And Performance



Source: Georgeson

self-serving) agenda. Address such critical issues as the company’s progress toward its desired future state of financial and operational performance; the company’s unique growth catalysts; its value-creating track record and potential over the long term; or the benefits of its particular governance practices.

If your company lacks a relationship with proxy decision makers at an institution, it is vital to build those relationships quickly.

We offer several key recommendations to consider in preparing for the 2011 proxy season:

Know your shareholder base. Determine whether a majority of your shares are held by institutional investors or retail shareholders. Learn whether your larger institutional holders develop their own proxy voting guidelines, or follow the recommendations of a proxy advisory firm. Finally, determine how often they engage with companies and on what types of

voting issues. Without a working knowledge of the voting trends and policies of your shareholder base, it is impossible to predict whether a proposal will garner majority support.

Engage shareholders early. One of the common misconceptions among companies is that their day-to-day institutional contacts (including analysts and portfolio managers) have significant input in voting proxies. While that may be the case in some instances, particularly in mergers and acquisitions and proxy contests, many institutions have established proxy voting or governance departments.

If a company lacks an existing relationship with a proxy decision maker at an institution, it is vital to develop those relationships. Furthermore, if you are aware of a problematic issue on the ballot, it is best to engage with institutions to gauge their stance on the matter. Early engagement can save a company time and energy required to fix the problem during the course of a solicitation.

Finally, if a meaningful percentage of company

common stock is held by retail investors, make an effort to reach these investors long before you need their support. Consider dedicated content for retail investors on the IR portion of your website, a quarterly update that is mailed with dividend checks (if applicable), social media tools, or the distribution of key trade media or business media coverage.

□ *Build relationships with proxy advisory firms.* Establishing productive, ongoing relationships with the key proxy advisory firms, such as Proxy Governance, Glass Lewis and RiskMetrics, will serve the company well over the long term. Also consider meeting with the RiskMetrics analyst who will be making the recommendation on the action items at the annual meeting.

Bear in mind, however, that these meetings are granted at the analyst's discretion, and there is no obligation (implied or otherwise) to meet with management to discuss the various items on its proxy ballot. Furthermore, during the busy proxy season, these meetings usually occur only by phone to allow the analyst as many meetings as possible.

Although there is no guarantee that a discussion will result in a favorable recommendation, it will at least provide the company with the ability to refine and sharpen any governance message. RiskMetrics typically releases its voting recommendation about two weeks before a company's annual meeting.

□ *Engage a proxy solicitor.* Solicitation firms can greatly assist your efforts in the proxy solicitation process. A proxy solicitor will use its market intelligence and research to help companies predict possible vote outcomes, as well as help to develop a proactive shareholder outreach strategy designed to invest time wisely by focusing on those shareholders still on the fence regarding particular proxy items.

A proxy solicitor will help identify a decision maker within an institution if the company does not already have a relationship with that person. They will analyze whether a retail shareholder campaign is needed in the event of a close vote and, if so, help to shape the components of that campaign. Plus, they assist companies and their outside advisers in understanding the voting policies of the various

proxy advisory firms.

□ *Keep the entire team updated.* It is imperative for management and the board to stay apprised of key developments and findings. Both groups must have a clear understanding of where the company's institutional holders stand on current and looming issues.

Likewise, they should be alerted to any major changes in the shareholder base and underlying factors driving those shifts, as well as any inquiries received or expressions of interest from known activist funds (such as attending conference calls or requesting one-on-one meetings with management at industry conferences).

Similarly, management and the board should be briefed regularly (as part of the investor relations update) on important regulatory changes and the impact of these changes on the company, especially those that may put the company at risk.

□ *Expect more shareholder activism.* Valuations are still well below expectations for most publicly traded companies. This, coupled with the recovering financial condition of many hedge funds and activist investors, will increase the likelihood of your company finding itself in the crosshairs of an activist campaign.

The enhanced disclosure requirements around board structure, board member background and qualifications, and executive pay will face close scrutiny by activist shareholders looking for vulnerabilities to exploit and leverage. Likewise, a company's sustainability practices and impact on the environment could also come under greater examination as investment funds with particular social agendas become more active and vocal.

□ *Be prepared.* Long before a proxy fight arises, boards should have a well-thought-out, documented rationale for their strategic decisions and governance practices. These include board composition, board structure, executive compensation packages, and risk management oversight protocols. By doing this work in advance of any potential conflict, a company (and its external advisers) can more quickly and accurately respond should a challenge arise. ■