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Institutional Investor Priorities

In her regular column on corporate governance issues, Holly Gregory explores institutional investor priorities for regulatory and voluntary governance reform, including key insights from representatives of pension funds, the Council of Institutional Investors and Institutional Shareholder Services Inc.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

Investor expectations around corporate governance practices have changed dramatically in the past 15 years, and will likely continue to influence governance reforms imposed through SEC regulations, stock exchange listing rules and voluntary corporate action or "private ordering." The SEC has adopted a number of regulations designed to enhance shareholder rights and investor protections since the Dodd-Frank Act was enacted. However, institutional investors would like to see further SEC activity focused on governance issues.

Institutional investors would also like companies to widely embrace certain governance practices, and often use shareholder proposals to press for engagement and movement on these issues. "It would be great if companies could join us and take voluntary action rather than wait for regulation or shareholder proposals. Proxy access and diversity on boards spring to mind," says Bess Joffe, Managing Director of Corporate Governance at TIAA-CREF.

Anne Simpson, Senior Portfolio Manager and Director of Global Governance at CalPERS, emphasizes that attention to communication and the shared goals of companies and shareholders should guide consideration of governance issues. "Communication is all. The megaphone diplomacy of recent years is giving way to real conversations. We are seeing governance discussions anchored to long-term strategy, and that is where companies and pension funds really have common interest," explains Simpson.

As companies begin to prepare for the 2015 proxy season, they should be mindful of the priority items on the governance reform wish lists of key institutional investors. Efforts to improve the link between executive compensation and performance, eliminate staggered boards and poison pills, and expand shareholders' ability to call meetings and act by written consent are likely to continue. However, priorities for regulatory and voluntary governance reform appear to be shifting to:

- Shareholder rights in director elections.
- The quality of the board.

MEANINGFUL OPPORTUNITY TO ELECT DIRECTORS

The most important governance reforms relate to the fundamental ability of shareholders to have a meaningful impact on board composition, according to Ann Yerger, Executive Director of the Council of Institutional Investors (CII), an association of public and union pension funds and other institutional investors with more than $3 trillion under management. "We want shareholders to be able to fully exercise their basic right to elect and remove directors," says Yerger.

Not surprisingly, other institutional investors and advisors share concerns about the need for both regulatory and private ordering reform in this area.

UNIVERSAL PROXY BALLOTS

Both CII and the SEC's Investor Advisory Committee have urged the SEC to amend the proxy rules to enable use in a contested board election of universal proxy ballots that would list all board candidates, regardless of the nomination source. A universal proxy ballot would allow shareholders to pick and choose among the directors from various nominees more easily.

Currently, outside of actual in-person attendance at the shareholders' meeting, it is difficult for shareholders to vote for a combination of dissident and management nominees in contests for control of the board. This is because the bona fide nominee rule provided in Rule 14a-4(d)(1) under the Securities Exchange Act of 1934 (Exchange Act) requires that nominees consent to be listed, unless the contest falls within the short slate exception.

Patrick McGurn, Executive Director and Special Counsel of Institutional Shareholder Services Inc. (ISS), agrees that the SEC should consider relaxing the bona fide nominee rule. "The 2014 proxy season has laid bare the antiquated and inflexible nature of the SEC's existing multi-card rules. The SEC's 20-year-old short slate workaround has never taken hold due to its complexity and the perception, real or imagined, that it will confuse voters," says McGurn.

McGurn posits that the existing rules appear to have actually tipped the playing field in the direction of dissidents. "During the current season many incumbent boards have settled contests and typically picked up dissidents' running solicitation and legal tabs as a way of cutting their potential seat losses. In a number of recent fights, incumbent boards have slashed their slates, but not the number of seats up for election, to 'leave room' for the election of dissident nominees. Opting to vote for such partial slates on management cards limits proxy voters' say as to which dissident nominees will fill the boardroom vacancies and could advantage candidates with the strongest ties to the dissidents. As such, use of a universal ballot could help to level the playing field."

CII Governance Reform Priorities

CII's website, *cii.org*, lists the following three governance reform priorities:

- **Universal proxy.** In contested director elections, management and dissidents should provide shareholders with proxy cards that list all director nominees.
- **Dual-class stock.** CII's corporate governance policies endorse the principle of "one share, one vote." Each share of a public company's common stock should have one vote.
- **Executive compensation.** Executive compensation should be transparent and tied tightly to corporate performance, create value for the long-term and advance a company's strategic goals.

MAJORITY VOTING

While the vast majority of S&P 500 companies have adopted some form of majority voting for uncontested director elections, among the Russell 3000, plurality voting continues to be the dominant practice. CalPERS, with $265 billion in assets, identifies action on this issue as a regulatory priority (see *Box, CalPERS Governance Priorities for SEC Attention*). CalPERS and CII would like the NYSE and NASDAQ to amend listing rules to include a requirement that directors resign if they do not win a majority of the votes cast in uncontested elections.

According to Yerger, "All companies should adopt meaningful majority voting for directors." CII encourages companies to voluntarily adopt majority voting. Under Section 2.2 of CII's Corporate Governance Policies, directors in uncontested elections should be elected by a majority of the votes cast, while plurality voting should apply in contested elections (where there are more candidates than board positions available). Directors who fail to receive a majority of the votes cast in an uncontested election should not be allowed to serve under state law holdover rules. Instead, they should step down as soon as practicable and not be reappointed.

CalPERS Governance Priorities for SEC Attention

CalPERS has identified several governance-related reform priorities for the SEC, which are described below.

INVESTOR RIGHTS

- Fill the SEC's position of Investor Advocate.
- Renew rulemaking for proxy access to allow shareholder nomination of director candidates by addressing the issues raised in the DC Circuit Court decision, *Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011)*.
- Amend the SEC staff position to allow shareholder proposals relating to the acceptance and retention of auditors, thereby promoting private ordering in this area.
- Review the proxy voting rules to address technological advancements and other developments, and consider rules that would improve transparency, efficiency and accountability in proxy voting.

BOARD QUALITY AND DIVERSITY

- Monitor the adequacy of the SEC's enhanced disclosure requirements on diversity, and director and director nominee qualifications.
- Support the amendment of the NYSE and NASDAQ listing rules to include a requirement that directors resign if they do not win a majority of the votes cast in uncontested elections.

INCENTIVES

- In addressing long-awaited SEC rules mandated by the Dodd-Frank Act regarding the relation of executive compensation to performance, emphasize long-term performance targets, with risk hurdles, and strategic goals, factoring in relevant sustainability factors such as environmental, regulatory and health and safety provisions.

CORPORATE REPORTING

- Expand the SEC's 2010 interpretive guidance beyond climate risk to underscore the importance of material sustainability risk disclosure.
- Complete the plans for bringing US and international standards for international financial reporting and audit into alignment.
- Continue discussions with the Sustainability Accounting Standards Board regarding the development of industry-specific sustainability accounting standards for publicly listed companies.
- Consider disclosure regulations regarding company policies for decision-making on charitable and political expenditures.

Search By-laws or Certificate of Incorporation: Majority Voting Provision for the by-laws or certificate of incorporation of a Delaware or New York public corporation requiring majority voting of stockholders for the election of the board of directors.

Search Director Resignation Policy for a sample form requiring the directors of a Delaware corporation to offer to resign in the event of certain triggering events.

PROXY ACCESS

CalPERS and CII would like shareholders to have the ability to nominate directors in the company's proxy statement. CalPERS continues to favor a regulatory mandate. It has indicated in its governance priority list of regulatory reform issues that the SEC should revisit its attempt to impose proxy access on all companies through SEC regulation, addressing as necessary the concerns raised by the DC Circuit when it invalidated Rule 14a-11 under the Exchange Act in 2011 (see *Business Roundtable, 647 F.3d 1144*).

In the absence of a regulatory mandate, CII calls on companies to voluntarily provide proxy access. Section 3.2 of CII's Corporate Governance Policies states that companies should provide access to management proxy materials for an investor or group of investors that have held in aggregate at least 3% of voting stock for at least two years to nominate less than a majority of directors up for election.

ONE SHARE, ONE VOTE

Whether the right to vote is proportional to the size of an investor's holdings is an issue that relates to director elections, but it also extends to all matters on which shareholders vote. Dual-class or multi-class share structures with unequal voting rights have been used in a number of high-profile IPOs in the past several years. These structures have reignited the debate about whether control rights disproportionate to ownership interests should be allowed.

CII includes this issue on its list of priorities for reform, and has requested that both the NYSE and NASDAQ propose a rule for SEC approval that would prohibit:

- Initial listing by a company with two or more classes of common stock with unequal voting rights.
- Future issuance of multi-class common stock.

Absent a listing rule prohibition, CII advocates that companies voluntarily avoid issuing stock with unequal voting rights. According to Section 3.3 of CII's Corporate Governance Policies, each share of common stock should have one vote and companies should avoid classes of common stock with disparate voting rights.

BOARD QUALITY

McGurn predicts that board succession issues will be high on investors' agenda in 2015. However, he does not suggest that this is an area for regulatory action. "'Board refreshment' appears primed to morph from buzzword to buzz saw," says McGurn. He points to growing shareholder concerns over low turnover rates, slow improvement of board diversity and industry sector knowledge deficits as indicating a need for boards to improve their periodic evaluations.

While calls for regulatory activity in this area do not appear to be a shareholder priority, outside the US there is a greater focus on regulation regarding issues such as board tenure and diversity, as well as enhanced disclosure on board evaluation efforts.

BOARD TURNOVER

Shareholder concern over a perceived lack of appropriate turnover on US boards and its impact on director independence and diversity is leading to increased focus on long-tenured directors. Very few US companies impose term limits on directors (just 3% according to the 2013 Spencer Stuart US Board Index). Retirement ages, which tend to be flexible, have been rising. However, the average tenure of directors in S&P 500 companies is less than nine years, according to Spencer Stuart.

CII amended its Corporate Governance Policies in 2013 to provide that when evaluating director independence, consideration should be given to a director's years of service on the board. According to Section 7.1, "Extended periods of service may adversely impact a director's ability to bring an objective perspective to the boardroom." A similar philosophy underlies the UK rule that after nine years of service a director no longer qualifies as independent. ISS considers tenure of more than nine years to be excessive for purposes of its Governance QuickScore rating, but it does not set a recommended term limit or retirement age in its proxy voting guidance.

DIVERSITY AND QUALIFICATIONS

The composition of the board in relation to the specific needs of the company is becoming an area of increasing focus for institutional investors. While majority director independence has been an important reform, there is some concern that it has at times come at the expense of the deep industry expertise that companies require at the board level. Shareholders can be expected to refocus on how the education and experience of directors relate to the ability to provide sophisticated oversight of the business and business risks.

CalPERS has emphasized in its governance priority list that the SEC should monitor the adequacy of its enhanced disclosure requirements on both diversity, and director and director nominee qualifications. Both diversity, and director qualifications are areas that shareholders are increasingly focused on.

DOCUMENTS

The following related Standard Documents can be found on practicallaw.com

>> Simply search the resource title

Board Self-evaluation
Audit Committee Self-evaluation
Compensation Committee Self-evaluation
Nominating and Corporate Governance Committee Self-evaluation

BOARD EVALUATIONS

"While many boards profess to conduct in-depth boardroom and individual director evaluations, most directors admit that such programs lack teeth. Going forward, directors must be able to demonstrate that such evaluations are robust and drive continuous refreshment efforts," according to McGurn.

CII issued a report in September 2014 emphasizing that investors want more information about the board evaluation process. The report, *Best Disclosure: Board Evaluation* (available at *cii.org*), provides examples from 2013 and 2014 proxy statements of what CII considers "best in class" disclosure relating to board evaluations. These examples fall into two categories:

- Explanation of the mechanics of the evaluation process.
- Discussion of the key takeaways from the most recent evaluation.

The CII report recognizes that the latter type of disclosure is uncommon among US companies, but is more prevalent in the UK, Europe and Australia.

Search Issues to Consider Before Conducting a Board Evaluation: Checklist for key considerations in formulating a board's evaluation process.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.