

CGQR

CORPORATE GOVERNANCE QUARTERLY REVIEW



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QUARTERLY SUMMARY

The fourth quarter of 2010 concluded one of the most progressive years for corporate governance and investors. During the quarter, the Securities Exchange Commission (SEC) began substantive rule-making as required by the Dodd/Frank Wall Street Reform

and Consumer Protection (Dodd/Frank) Act. The first topic below discusses the status of the SEC rule that provides shareholders the right to nominate directors to a corporate board. The second topic explains a rule that was proposed to require advisory votes on executive compensation for the 2011

proxy season to address concerns over perceived excessive executive remuneration. The third topic reviews the 2010 proxy season, which marks a potential turning point in communication between corporations and their shareholders.

PROXY ACCESS

Activist investors were emboldened by the SEC's final rule release on Facilitating Shareholder Director Nominations, also known as "proxy access." Proxy access is the tool shareholders have been seeking for decades to hold corporate boards accountable for their actions. It is not just about the power to nominate directors, but the *potential* to nominate directors.

However, even if a number of investors pooled their shares to attempt to meet the minimum holdings requirements of 3 percent of shares outstanding for three years, there are a substantial number of companies where meeting that hurdle is not realistic. Furthermore, if a group of shareholders managed to get a director nominated, the likelihood of the nominee director getting elected with majority support is potentially small. The time, money, and effort required to campaign for a shareholder nominee would be prohibitive for a majority of investors. Nevertheless, investors are

hoping the threat of proxy access will encourage directors to hold management accountable, develop long-term executive remuneration packages tied to company performance, and adopt good corporate governance behaviors.

On October 4, 2010, the Business Roundtable and the Chamber of Commerce of the United States petitioned the United States Court of Appeals for the District of Columbia Circuit (Court) seeking review of the proxy access rule. This was not a surprise to investors. What was not anticipated though was the SEC's decision and action to stay the rules until a full judicial review was completed.¹ The SEC commented in its notice to stay the rules that "Among other things, a stay avoids potentially unnecessary costs, regulatory uncertainty, and disruption that could occur if the rules were to become effective during the pendency of a challenge to their validity."²

In its petition, the Business Roundtable argues:

- ⇒ The SEC did not appropriately calculate the costs that would be incurred due to proxy access.
- ⇒ The SEC miscalculated the frequency of proxy access utilization.
- ⇒ The rules conflict with state laws.
- ⇒ Investment companies should not have been covered by the rules.
- ⇒ The SEC does not cite empirical evidence as a basis for the rules or for their impact on director elections and board accountability.

The expectation is the Court will begin proceedings on the petition in the first quarter of 2011. As a result, it is anticipated proxy access will not be available to investors until the 2012 proxy season, at the earliest.

Corporate Governance Committee

Simon S. Russin, Chair
Herman Santos
Michael Schneider
Mark Saladino, Alternate

¹ <http://www.sec.gov/rules/final/finalarchive/finalarchive2010.shtml>, Release #33-9136

² <http://www.sec.gov/rules/other/2010/33-9149.pdf>

ADVISORY VOTE ON EXECUTIVE COMPENSATION

On October 18, 2010, the SEC released proposed rules on shareholder approval of executive compensation and golden parachute compensation.¹ The proposed rules satisfy a requirement in the Dodd-Frank Act to mandate 1) non-binding shareholder votes on executive compensation, 2) the frequency of such votes, and 3) approval of remuneration packages for separated executives due to a change in control. The first two requirements go into effect for companies whose annual meetings are on or after January 21, 2011, regardless of when the final rule is released. The third item is effective January 21, 2011 or when the final rule is released, whichever is later.

First, all public companies will be required to include a proxy ballot agenda item for a non-binding advisory vote on executive compensation, also known as “say-on-pay” (SOP). The vote covers the compensation structure of the Named Executive Officers as disclosed in the Compensation Disclosure and Analysis section of the proxy statement. The rule requires additional disclosure; however, no specific format is required for types of pay or amounts and metrics used in calculating the total executive compensation package. The SOP initiative was

included in Dodd/Frank to address perceived unreasonably high executive compensation levels and a potential serious disconnect between executive pay and the creation of shareholder value.

Second, all public companies must submit a proxy ballot agenda item for a non-binding vote to address whether an SOP vote should be held every one, two, or three years. This initiative is known as “say-when-on-pay” (SWOP) or “say-on-frequency.” Furthermore, companies will be required to conduct a SWOP vote once every six years. Expectations are that companies will recommend a triennial vote, whereas investors will likely vote for annual SOP. Again, the SWOP vote is non-binding and companies may actually decide to implement a frequency that is different from the frequency that receives majority support. Third, companies that issue a proxy for a special meeting of shareholders to approve a change-in-control situation, must also include an agenda item requesting approval of the executive compensation to become payable upon the completion of the change-in-control. This item is known as “say-on-golden-parachute” (SOGP). However, if the golden parachute was already approved in a prior SOP vote, a SOGP vote is not required at the special meeting.

Although SOP votes are now mandatory for all public companies, the exercise is not new. Financial firms that received funds from U.S. Treasury’s Troubled Asset Relief Program during the 2008 and 2009 financial crisis were required to submit their executive compensation to an advisory vote in 2010. In addition, some companies adopted a management say-on-pay (MSOP) agenda item either voluntarily or via acceptance of a majority-support shareholder proposal. Nevertheless, for the 2011 proxy season, investors are strategizing and developing gameplans to manage the anticipated volume of SOP votes, as well as determining what period is appropriate for the SWOP proposal.

While it’s difficult to speculate what the outcomes might be, most commentators expect similar results to 2010 for SOP votes. In 2010, the average support level for SOP was 89.6 percent and three companies (Motorola, Occidental Petroleum, and KeyCorp) received less than majority support for their advisory votes on executive compensation. Therefore, it’s expected the average support level in 2011 will be around 90 percent and there will be a handful of companies that do not receive majority support.

¹ <http://www.sec.gov/rules/proposed/2010/33-9153.pdf>

2010 PROXY SEASON REVIEW

The 2010 proxy season was less active in corporate governance initiatives compared to 2009. Generally speaking, the economy and corporate profits had improved from the depths of the Great Recession in 2008. As a result, investors may have felt a bit more optimistic and less

confrontational in challenging corporate board behaviors. It might also have been that investors were busy working on and awaiting the completion of the Dodd-Frank Act for any resulting mandated corporate governance reforms. However, the most likely explanation is investors were much more involved in corporate

governance discussions with corporate boards before issues landed on the proxy ballot. Nevertheless, of the proposals that went to a vote, support for governance-related reform moderated from the high levels of 2009.

Table 1
Shareholder Proposal Sampling

Proposal	Number of Proposals in 2010	Average support level in 2010	Number of Proposals in 2009	Average support level in 2009
Repeal classified boards	60	58.7% ¹	69	62.4%
Majority vote in election of directors	30	57.6%	50	51.3%
End or reduce supermajority voting requirement	32	71.1%	13	70.5%

According to Institutional Shareholder Services (ISS), the largest proxy research provider, as of September 1, 2010, 120 of the 392 shareholder proposals (30.6%) that were voted received majority support.² That was down from 160 of the 435 shareholder proposals (36.8%) that received majority support in 2009. **Table 1** above displays a sampling of the most common shareholder proposals, the number of proposals voted, and their average support level in 2010 and 2009.

The drop in the number of and support for shareholder proposals was mirrored in the results of uncontested director elections. Surprisingly, the number of directors to receive less than majority support fell to 88 in 2010

from 93 in 2009. Furthermore, the average vote against directors dropped to 6.1 percent from 7.4 percent over the same time periods. At the beginning of the proxy season, investors anticipated a higher level of dissent for directors due to the elimination of broker discretionary voting and perceived director entrenchment.

It appears more corporate boards are taking action before shareholders have the opportunity to withhold votes from directors. This proactive behavior can be measured, or at least gauged, by the number of shareholder proposals that are withdrawn. A shareholder proposal is typically withdrawn and not placed on the proxy ballot when the corporation and

investor come to an agreement, to the proposing shareholders' satisfaction, on a corporate governance issue.

As of June 30, 2010, 145 of the 370 shareholder proposals filed were withdrawn.³ That number equals the amount of proposals withdrawn in all of 2009, a record-breaking year for withdrawn proposals. Most investors would consider a withdrawn proposal more of a success than a high level of support for the proposal.

If the trend of increasing numbers of withdrawn shareholder proposals continues in 2011, it could indicate investors are finally having an impact in challenging corporate mismanagement and weak governance practices in the

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¹ <http://www.issgovernance.com/docs/2010USPostSeasonReport>,

² The 58.7% average support level was on 48 of the 60 proposals that had been voted upon as of September 1, 2010.

³ Latest data available.



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companies they own. Directors may be realizing the benefit of engaging with long-term investors to address issues before they become confrontational. Such an approach

may be more important going forward as corporations will be faced with advisory votes on executive compensation in 2011 and perhaps proxy access in 2012. Time will tell

how they respond to shareholders and if shareholders continue to moderate their aggressive approach of 2008 and 2009.

LACERA
300 N. Lake Avenue Pasadena, CA 91101
1-800-786-6464 lacera.com