his issue of the Corporate Governance Quarterly Review discusses the Securities and Exchange Commission’s (SEC’s) proposed rulings on proxy access, provides an update on the NYSE’s proposal to eliminate uninstructed broker voting, and reviews the compliance results of the new executive compensation disclosure rules.

During the third quarter, the SEC sparked considerable debate over shareholder access to the election process by proposing two opposing rules for public comment. In addition, the SEC stalled the efforts of the NYSE to amend Rule 452 that would eliminate discretionary broker voting. Finally, the SEC took direct aim at corporations for their lack of clarity in the 2007 proxy statements which required compliance with the new executive compensation disclosure rules.

On July 27, 2007, the SEC proposed two different proxy access rules for public comment. The first rule (Rule 1), SEC File No. S7-16-07, allows shareholders that have held a minimum five percent stake in a company for at least one year to propose changes to bylaws governing the director election process, as long as the shareowner(s) submitting the proposal makes the specified public disclosures. The second rule (Rule 2), SEC File No. S7-17-07, allows companies to reject all shareholder proposed director election bylaw changes.

Naturally, as the two proposed rules are in direct opposition, the rulings have fostered considerable debate. The majority of shareholders are not happy with either ruling, stating that, in the case of Rule 1, the five percent ownership threshold is too high and the public disclosure requirements are far too onerous. Corporations are typically opposed to any shareowner access to the director election process on the grounds that it potentially allows special-interest groups to win seats which may lead to fractious board meetings. As expected, corporations support Rule 2 which codifies the position to reject such proposals.

In an August 24th memorandum to the SEC, the Council of Institutional Investors (CII) responded to Rule 1. In the memo, they set aside the disclosure requirements and focused on the five percent threshold. They indicated to the SEC that they had consulted with member funds that have an active governance program that includes regular submission of shareowner resolutions and found that “the five percent threshold appears to be unworkable.” Further, they stated that “preliminary research indicates that even if the ten largest public pension funds were to aggregate their holdings of a single public company’s securities, those funds combined would likely be unable to clear the five percent hurdle.”

In response to the SEC proposed rulings, LACERA submitted two comments. Please see continued on pg.4

1 The SEC requires a 13G filing, whereby any shareowner(s) seeking proxy access must disclose such items as: their identity, any material relationships with the company, any stock holdings in a company’s competitor, any discussions with a proxy advisor, and any meetings or contacts with company management.
2 Kara Scannell, “Can SEC’s Cox Win Playing the Middle?” Wall Street Journal October 1, 2007, C17

From LACERA’s Corporate Governance Committee
The current NYSE Rule 452 allows brokers to vote on “routine” items, including the election of directors, if beneficial owners have not provided voting instructions 10 days prior to the scheduled annual meeting. With almost 80 percent of all shares in U.S. public companies held in brokerage accounts, many investors have criticized the NYSE broker rule because these votes are routinely cast with management, calling into question the integrity of the proxy voting process.

In May 2007, the NYSE’s Proxy Working Group submitted an amended plan to the SEC for approval that would eliminate uninstructed broker votes from director elections beginning on/or after January 1, 2008. Two months later, SEC Chairman, Christopher Cox, told Capital Hill legislators that the issue of uninstructed broker votes would be considered in the overall proxy rulemaking that the commission intended to propose at the end of July 2007. However, when the proxy access proposals were released by the SEC, the uninstructed broker vote proposal was not addressed.

Confirming this action, the NYSE sent a letter to its listed companies on September 24, 2007 informing them that the exchange’s plans to eliminate uninstructed broker votes from director elections have been stymied at the SEC. The NYSE letter stated, “It was our intention to have the rule change in place effective by January 1, 2008. Based on recent conversations with SEC staff members, however, we learned that our proposed rule filing is being considered by the commission as part of a broad range of issues relating to shareholder communications and proxy access. As a result, our rule finding will not be approved for the 2008 proxy season. We will continue to work with the SEC staff to move our proposed filing forward.”

SEC EXECUTIVE COMPENSATION DISCLOSURE RULES

The SEC’s revised executive compensation disclosure rules went into effect on November 7, 2006. These rules significantly changed the disclosures a public company must provide about how it compensates its most highly paid executive officers, including its CEO, CFO and its three other highest paid executives.

On December 22, 2006, in a controversial, last-minute move, the Commission further amended the disclosure requirements for executive and director compensation by requiring disclosure of total compensation for senior executive officers, the fair value of stock option grants, and potential post-employment and/or retirement payments and benefits. The amended rules also enacted a new -company report –

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7 “CVS/Caremark Director Retires after Shareowners Apply Pressure” Counsel of Institutional Investors Alert Volume #12, Issue #25, July 13, 2007, 2.
the Compensation Discussion and Analysis (CD&A) – a narrative explanation of the objectives and implementation of a company’s executive pay program. The amended rules were in effect for the 2007 proxy season.

Now that the 2007 results have been reported, the impact of the new rules, in many respects, followed initial expectations. Virtually every company’s executive compensation disclosure was longer and more detailed than in previous years. For most companies, pay information comprised more than half their proxy statement. And, as expected, disclosures were generally more confusing than in the past, as the new rules exposed the enormous complexity of most executive compensation programs. Mercer Consulting states, “coupled with the usual ambiguities and interpretive issues that accompany any new regulatory scheme, companies often struggled to fit their compensation plans and arrangements into the new disclosure framework.”

Regarding the ambiguity issues of the new disclosure requirements, CII asserts “it is critical that the new Compensation Discussion & Analysis section of the proxy statement fulfill the expectations of shareowners and those of the SEC and other interested parties.” Furthermore, “Widely publicized reports note that the SEC has identified significant deficiencies in CD&As and has sent the first wave of comment letters – said to number 300 – seeking improved disclosure and additional information.” The Council urged the SEC to focus on the following issues:

- Overall clarity and use of plain English
- Disclosure of specific performance targets
- Peer group comparisons and benchmarks
- Disclosure of termination and change-in-control arrangements
- Compensation consultant’s role in setting pay
- Disclosure of material differences in packages awarded to named executive officers (NEOs)

In early October, the SEC published its report discussing the principal themes that emerged from its first-year review of the executive compensation disclosures of 350 public companies. Overall, the Commission said proxy statements’ manner of presentation, format and clarity were lacking. Specifically, the SEC found fault with explanations of how companies used performance targets to set pay, their compensation discussion and analysis disclosures, descriptions of their compensation philosophies and decision-making mechanics, explanations of the differences in compensation policies and decisions for various named executive officers, descriptions of how they used benchmarks in making their compensation decisions and discussions of the change-in-control and termination arrangements.

Now that the SEC agrees that corporate executive compensation disclosures are deficient, much discussion is underway about how companies can improve their disclosures for the 2008 proxy season. It will take time for companies to fit their compensation plans into the SEC’s disclosure rules and the SEC will likely need to revise some requirements to better match existing compensation plans. LACERA supports the efforts of the SEC to improve corporate executive compensation disclosure and the companies that are working to comply. LACERA will follow the progress as both sides work to find middle ground and will continue report on this issue in future Corporate Governance Quarterly Reviews.

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separate comment letters to the SEC. Addressing Rule 1 (Attachment A), LACERA informed the SEC that their latest proposal, “with it’s difficult to attain five percent threshold for eligibility, discourages and ultimately disqualifies shareowners from nominating a director. Therefore, LACERA cannot endorse the latest SEC proxy access rule.”

Addressing Rule 2 (Attachment B), LACERA advised the SEC that “LACERA’s Corporate Governance Principles emphasize that ‘good governance must maintain an appropriate balance between the rights of shareholders and the needs of the Board and management to direct and manage the corporation’s affairs.’ Given that the proposed SEC rule would severely strain this delicate balance by eliminating shareholder access resolutions from the proxy voting process, the Board of Investments vigorously opposes the proposed amendment to Rule 14a-8.”

The SEC’s two commissioners that are key supporters of allowing shareholder proxy access are scheduled to leave the SEC by the end of this year. As a result, support is likely to shift to Rule 2, the proposal favored by the two remaining Republican commissioners. Because of this membership change, many investors are asking Chairman Cox to extend his self-imposed year-end deadline to vote on the proposals. However, if the SEC issues a year-end ruling in favor of Rule 2, it at least puts a rule in place for the 2008 proxy season, while it also creates another opportunity to address the proxy access rule the following year. 4

4 Scannell, C17.