



DIRECTOR ELECTION ISSUES - BULL'S EYE ON THE BOARD

Director elections no longer are “routine” in any sense of the word. Activist and other investors, who in years past often focused on peripheral issues such as confidential voting and achievement of a range of societal objectives (perhaps worthy, but frequently lacking sufficient tie-in with shareholder value creation), have finally discovered the ultimate corporate pressure point – the board.

THE PROBLEM – MOST INVESTORS DO NOT UNDERSTAND OR APPRECIATE THE BOARD’S ROLE AND CONTRIBUTIONS

Instead of trying to directly micro-manage corporate behavior, investors are now focused on the *oversight* of these behaviors. This focus includes who serves on the board, the process by which they are nominated and elected, their perceived independence, and their accessibility and accountability to investors. This scrutiny typically is limited to review and comment on the observable – such as board structure (annually-elected or classified, separate or combined CEO/Board Chair); number of board and committee meetings; and the election mechanisms (plurality or majority election standard, whether shareholders have the right to call special meetings or to act by consent). This focus on the observable, in turn, too often leads to “one-size-fits-all” box checking when it comes to “grading governance”, proxy voting and activism.

Unfortunately, the greatest value provided by boards typically is unobservable to the majority of shareholders and other commentators. And this is for good reason. To be effective, directors must operate and interact with each other in an atmosphere of confidentiality, trust and mutual respect (i.e. collegiality). Shareholders and others outside the boardroom have little means to measure and appreciate the true independence and unique contribution of each individual director or of the board collectively. Clearly, these contributions cannot be measured or appreciated through obsessive focus on the above observable metrics and criteria.

This yields a situation in which truly valuable directors may be judged, or misjudged, by the wrong criteria. This can both affect their election and thus their ability to serve, or even discourage some from offering to serve in the first place.

To mitigate this situation, companies and their boards are challenged to find the right balance between increasing the level and quality of director disclosure, transparency and accessibility to investors, while maintaining the necessary degree of collegiality.

While it is true that the SEC, earlier in 2010, expanded the proxy disclosure requirements about directors, this simply raised the floor for these disclosures, so companies meeting these new requirements will not automatically gain credit for exceeding the required level of disclosure.

WHY DIRECTOR ELECTIONS NO LONGER ARE “ROUTINE”

- As you know, the NYSE eliminated broker discretionary voting in uncontested director elections, beginning in 2010.
- Increasingly, companies are transitioning to “majority” election standards, from the traditional US “plurality” standard. These first two items give real teeth to “withhold” (or “against”) votes on directors.

- Concerns and publicity about perceived excessive CEO pay are causing many investors to consider board oversight of compensation as the litmus test of their effective independence. This, in turn, has contributed to more frequent votes withheld from compensation committee members at companies where investors or their proxy advisors have compensation-related concerns.
- While Say on Pay (and Say When on Pay) votes may siphon some discontent away from withholding on compensation committee members (at least for the initial Say on Pay votes most companies will conduct in 2011), companies selecting biennial or triennial frequency may in the future find themselves in receipt of higher levels of director withholds in the years between Say on Pay votes.
- Although “Proxy Access” is temporarily on hold due to a court challenge, we must all be prepared for the likelihood that it will survive in some form and be in place for 2012. More cost-effective means for shareholders to nominate alternative candidates will inevitably lead to an increase in this type of activity which, in turn, will compel targeted companies to wage “true campaigns” in support of their preferred nominees.
- With Proxy Access on hold, the United Brotherhood of Carpenters and Joiners of America (the “Carpenters’ Union”) has started a letter-writing campaign to encourage large issuers to adopt “Board Access” guidelines, which would allow one-percent investors or groups the opportunity to meet directly with board committees, in particular with all members of the nominating committee. While such meetings and related dialogue might initially be less confrontational than submitting alternative Proxy Access nominees, the proposed 1% Board Access ownership requirement is a significantly lower hurdle than the 3% requirement contemplated under Proxy Access.
- Each year, the proxy advisory services expand the list of reasons they will issue “withhold” vote recommendations, and this year is no exception. For 2011, ISS indicated that the presence of any one of the following may by itself trigger withhold votes from compensation committee members:
 1. Excessive perquisites or tax gross-ups
 2. Change in Control agreements exceeding 3 times base salary and average bonus or without involuntary job loss (i.e. single-triggers)
 3. Repricing or replacing underwater options without prior shareholder approval

DIRECTOR WITHHOLD VOTES – TALE OF THE TAPE

During 2010, ISS recommended votes against 17% of all U.S. company directors up for election. Put another way, this translates to over 2,000 director nominees receiving negative voting recommendations. Of this group, almost one half received 20% or higher votes withheld.

Percentage of Nominees Exceeding Various Thresholds of Opposition*

Opposition level	2007	2008	2009	2010	2011
20%+ opposition	4.8%	5.5%	9.8%	8.0%	?
40%+ opposition	0.8%	1.0%	2.1%	2.0%	?
Majority opposition	0.2%	0.2%	0.6%	0.6%	?

Much has been made of the fact that “only” 95 director nominees at 54 Russell 3000 companies failed to receive majority support in 2010 -- almost all of these at smaller, plurality voting companies -- and that to date, directors have stepped down from the board at only four of these 54 companies.**

That analysis fails to account for the downstream consequences. Even though the plurality companies are under no obligation to take action, the Council of Institutional Investors (CII) already has written to these apparently unresponsive companies, urging their boards to remove the directors who did not receive majority support. Other activists may opportunistically target these companies, claiming “where there is smoke (of investor discontent), there must be fire”, in support of their own short-term agenda.

The key takeaway is that, while majority opposition makes headlines, directors with 20% or greater withholds can expect increased scrutiny in future elections, hence the need to identify and address the underlying causes before they escalate.

**Russell 3000 meetings through August 31, Source: Proxy Governance*

***Sources: ISS; Council of Institutional Investors*

THE ACTIVIST 2011 GAME PLAN

In response to this tepid action from plurality companies, activist investors -- who were bitterly disappointed that Dodd-Frank did not mandate majority elections -- are continuing to push this in 2011:

- This summer the Florida State Board of Administration wrote to all Russell 3000 companies that do not have majority elections, urging them to make this change.
- The Carpenters' Union is filing 75 to 85 majority vote proposals at S&P 500 companies (i.e. the vast majority of S&P 500 companies that have not yet adopted majority voting).
- CalPERS has asked the 58 largest companies in its portfolio to embrace majority voting, and is filing proposals at four of these.
- CalSTRS is filing 25 such proposals at smaller companies.

As we indicated earlier, adoption of the majority election standard gives director withhold votes real teeth. This means that companies need to manage the director election process – and take all reasonable steps to anticipate and minimize director withholds – before they find themselves exposed to negative publicity and future “piling-on” activism campaigns.

PHOENIX ADVISORY PARTNERS CAN HELP YOU IN THE FOLLOWING WAYS:

- Provide a road-map for and support you in effective engagement with the proxy voters at your top institutional investors;
- Quantify the likely impact and influence of proxy advisors such as ISS and Glass-Lewis over your unique ownership base;
- Identify vulnerabilities in your governance profile and board composition;
- Project the vote on a range of potential management and shareholder-sponsored proposals;
- Develop and implement strategies to improve retail voting participation.

To discuss these issues and how we can assist you, please contact us at (212) 493-3910 or info@phoenixadvisorypartners.com.