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Corporate Governance Best Practices - 2012 Proxy Season

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As we enter proxy season, the boards of directors of public companies will be considering various corporate governance issues. While each public company is different, and while corporate governance practices that work well for some companies may not work well for others, there are certain issues that boards and, in particular, nominating committees of a board, should consider in their discussions.

The nominating committee is generally tasked with reviewing and recommending companies' corporate governance policies, including evaluating the board and its performance, and recommending to the board directors who can fill the seats on the board and its committees. Because of the critical role that they play today in the corporate governance regime, nominating committees, too, should consider certain governance issues that the U.S. Securities and Exchange Commission ("SEC") and corporate governance activists have been promoting for the forthcoming proxy season. In particular, companies may need to address five corporate governance issues in the 2012 proxy season:

- Rotation of committee members
- Board diversity
- Independent chairmanship
- Lead independent director
- Auditor rotation

Rotation of Committee Members

Most large-cap companies have a policy in place for rotation of committee members. The nominating committee is often tasked with managing the rotation of the chairs and members of committees, and determining if a rotation would improve committee performance or facilitate the business of a committee. It would seem that a majority of companies do not have strict committee rotation policies, although some boards have adopted fairly strict policies. Such policies require committee rotation at five- to seven-year intervals, particularly if it would provide

fresh perspectives and enhance directors' familiarity with different aspects of the company's business. Rotation tends not to be mandated because there are additional board aspects to consider, such as:

- Board diversity
- Member experience
- Desires and skills of the individuals
- Applicable listing requirements
- Subject matter expertise (particularly for the audit committee)
- The need for continuity

A number of U.S. pension funds have issued limited guidance on their views of the assignment and rotation of committee members. California Public Employees' Retirement System ("CalPERS") has maintained that a company's retiring chief executive officer ("CEO") generally should not continue to serve as a director, and often should not sit on any of the board committees. The Council of Institutional Investors ("CII") asserts that the CEO also should not appoint the committee chairs and members. CII believes the appointment process should instead be reserved to the board, and its methods should be disclosed to the shareholders. CII recognizes that it is beneficial to have the members of the compensation committee rotate periodically among the board's independent directors. This enables members to become more informed with regard to compensation and any related matters. Institutional Shareholder Services Inc. ("ISS") is without a committee rotation policy at this time.

Companies considering the rotation of committee members should weigh the value of rotation carefully against the benefit of committee continuity and experience. If it would balance director experience and interest, and aid the board in carrying out its fiduciary duties to the shareholders, a formal rotation policy may be in a company's best interests. The company, however, should remain up-to-date regarding any evolving legal and regulatory considerations, and ensure that a rotation would not cause the company to run afoul of any listing or other requirements.

Board Diversity

The SEC requires that public companies discuss their board diversity practices in their proxy statements. Specifically, a public company must state whether its nominating committee considers diversity when recommending nominees to the board, and if so, how. If a public

company has a diversity policy, it must disclose how it is implemented and how its effectiveness is assessed.

In today's global marketplace, instituting a diversity policy can assist a company in reflecting its various constituencies. There are a number of characteristics to consider when creating a diverse board, including a director's background, experience, age, race, gender, ethnicity, and viewpoints. The nominating committee will play a large role both in considering these characteristics and in creating a diverse board.

Empirical evidence regarding whether board diversity increases shareholder value is mixed. The SEC intentionally does not define "diversity" strictly so that companies can develop and disclose their own standards, and can address matters that pertain to their business model and specific needs. Instead, the SEC seeks disclosure in proxy statements, and strives for complete transparency. As opposed to commenting on each company's policy, the SEC considers whether a company discloses any sort of diversity policy, and whether such disclosure is thorough. Organizations such as ISS and the Teachers Insurance and Annuity Association – College Retirement Equities Fund ("TIAA-CREF") agree with this approach, and believe that each company should take into account factors related to its business model and specific needs, and disclose the rationale for the criteria used. Thus, it is up to each company to determine what, if any, diversity policy would best suit its specific needs and goals. Once such a policy is in place, the company should examine it regularly to ensure that it continues to have a positive impact on the company and that it remains relevant over time.

Independent Chairmanship

An independent chairmanship exists when the offices of chairman of the board ("chairman") and CEO are performed by two separate individuals. Some companies combine these two positions, finding that the company is better served when the CEO is a direct connection between the management and the board. When the roles are combined, it is wise to designate a lead non-executive director to convene or chair sessions of the outside directors. This will ensure a balance of power, and will increase the accountability of the board.

In recent years, there has been a greater demand from shareholder activists and policy groups for separation of the two roles, and this year looks to be no different. The American Federation of State, County and Municipal Employees ("AFSCME") has filed proxy proposals at more than

21 large corporations advocating separation of the two roles. As a result, companies may feel more pressure to separate these positions this year. According to public data, separate individuals serve as CEO and chairman at 27 of the top 100 companies (based on a combination of their market capitalizations and latest annual revenues) in the United States. This number has increased significantly over the past few years and will likely continue to increase in response to governance activism. Only 10 of those companies have adopted an explicit policy of separating the offices, and nine of the top 100 companies specifically state that the offices of CEO and chair of the board should not be separated. Only two of the top 100 companies do not address this topic.

While most companies do address this topic, many do not have a formal policy. Instead, directors are free to decide which approach is in the best interests of the company. Separation provides independent oversight, which may better protect shareholder interests since self-monitoring would not be required. But, in certain circumstances, such as a small-cap company with a limited group of leaders, board separation may not be necessary, in particular under circumstances where there is a lead director in place who is able to run the board effectively.

Lead Independent Director

Companies at which the CEO and chairman roles are combined are increasingly appointing a "lead" independent director to oversee operations. Corporate governance activists uniformly recommend such an approach to ensure that there is accountability for, and organization of, all director and board functions. Generally, a lead independent director's duties include, but are not limited to, the following:

- Advising on board meetings and agendas
- Chairing executive board sessions
- Overseeing the flow of information to the board
- Serving as a liaison between the independent directors and the CEO
- Coordinating and overseeing performance evaluations of both the board and the CEO

The appointment of a lead independent director may strengthen the objectivity of a company's board and ensure it remains independent from management. Governance activists point out that this is particularly true if a company has a single-tier board system. CII does, however, caution companies to remember that the lead independent director should expect to devote a greater

amount of time to board service than the other directors, but that the director's service will enable the independent directors to effectively and responsibly perform their duties.

Auditor Rotation

At this time of year, companies must remain mindful of shareholder proposals for consideration at annual shareholder meetings. Of interest, on January 27, 2012, the SEC issued a response to shareholder proposals on audit firm rotation. Shareholders from American Electric Power Company, Dow Chemical, and Alcoa have submitted shareholder proposals in recent months outlining a plan that would require companies' audit review committees to establish an audit firm rotation policy. Such a policy would require audit firms to rotate off the company's engagement at least every seven years, and stay off for a minimum of three years. These shareholders believe that this would preserve audit firm independence and avoid accounting fraud.

In response, the companies sought no-action assurance from the SEC so that those proposals could be omitted from their proxy materials under Rule 14a-8(i)(7) of the Securities Exchange Act of 1934, which states that a company may exclude a shareholder proposal "if the proposal deals with a matter relating to the company's ordinary business operations." The SEC agreed with the companies, and stated that such proposals may be excluded from proxy materials because they relate to ordinary business operations.

It appears this issue did not gain any traction with the SEC, but it is too early to say. It should be noted that both the Public Company Accounting Oversight Board ("PCAOB") and the European Union are considering auditor rotation policies as a means of restoring investor confidence in the audit process.

Recent Development

On February 16, 2012, the SEC's Division of Corporation Finance advised PepsiCo that it may not omit a shareholder proposal asking that the corporation establish a risk oversight committee from its proxy materials. The stockholder seeks a board level risk oversight committee to manage the risks the corporation faces. In the stockholder's letter, the stockholder cited PepsiCo's audit committee charter, which includes risk assessment and management as part of the committee's duties. The stockholder pointed to a single line in the audit committee's charter that outlines the committee's risk oversight duties. The stockholder believes that, in light of the

broad scope of its other duties, the audit committee would not be able to devote the time and effort necessary to properly assess PepsiCo's risk.

PepsiCo contended that the proposal should be excludable from its proxy materials under Rule 14a-8(i)(7) because the risk oversight committee oversees risks related to the company's ordinary business operations.

The SEC disagreed with PepsiCo, stating that the proposal focuses on a single policy issue – specifically the board's role in the oversight of the company's management of risks – and that including the proposal would not amount to so much micromanaging of the company that it would be necessary to exclude it.

The proposal put forth by the PepsiCo stockholder is indicative of a larger movement by stockholders to move risk oversight out of the audit committee's responsibilities, and to establish a separate committee on the board devoted entirely to risk oversight.

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