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A Look Ahead to the 2012 Proxy Season

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Overview

Against the backdrop of a stagnating economy, Occupy Wall Street protests, and a presidential election, 2012 has all the makings of a highly-charged proxy season. However, corporate pre-season actions, including increased shareholder engagement, governance and compensation reforms, and no-action challenges, are softening the polemic and lightening the load of shareholder proposals.

With a year of votes behind us, this year's say on pay (SOP) should bring fewer surprises or reprises of eleventh-hour tweaks and annotations to compensation programs. Surveys by compensation consultants indicate that most companies are simplifying their CD&As, and many are reevaluating tie-ins between pay and performance and eliminating problematic pay practices. These efforts are borne out by initial 2012 SOP votes, which have improved significantly at companies that received low support levels last year.

The most closely watched issue this season, proxy access, may ultimately make only a minor showing on ballots as a result of settlements and no-action challenges. While institutional proponents are being judicious in their targeting and reaching compromises with issuers, retail activists seeking a homogenized "proxy access for the 99%" may well see their efforts shot down at the SEC. The season's other major new shareholder campaign, on audit firm rotation, was upended early on by the SEC, though a downsized proposal will appear at later-year annual meetings.

The season will still be replete with mainstay shareholder proposals on board declassification, majority voting in director elections and the repeal of supermajority voting, which are generally easy wins because of their broad acceptance within the investor community. Less easy wins will be further reforms aimed at easing shareholders' ability to call special meetings or act by written consent, which saw weakening support levels last year. In either case, issuers will have a harder time implementing these reforms due to changes in New York Stock Exchange (NYSE) rules which now prohibit uninstructed broker voting on corporate governance proposals. Companies may also be forced to retreat from exclusive forum provisions in the face of shareholder lawsuits and the prospect of negative proxy advisor opinions.

Among all proxy season topics, corporate lobbying and campaign finance will generate the greatest dissonance at annual meetings, where a raft of proposals sponsored by union and social activists will be chorused by Occupy the Boardroom protests. Understandably, the stakes are high in this year's elections. A Republican presidential win will usher in a rollback of burgeoning regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act, and stem the progress of activist agendas, which have been embraced by the Obama Administration.

In short, 2012 may not prove to be the most momentous proxy season on record, but it will still present its share of challenges for issuers. Below are some of the top issues and trends to watch.

Proxy Access

With the federal rule vacated last year, private ordering of proxy access is making its debut this season with both institutional and retail proponents testing a variety of proposals. However, proxy access "lite" stands to become even liter.

Of the 19 shareholder proposals announced to date, over half are being challenged for exclusion by the targeted companies. Most are non-binding proposals submitted by retail investors affiliated with the U.S. Proxy Exchange, which would allow holders of 1% of the shares for two years and/or 100 holders who meet

SEC Rule 14a-8(b) eligibility requirements to nominate up to 12% of the board. The grounds cited for omission cover a gambit of deficiencies, including the proposals being impermissibly vague and indefinite, relating to ordinary business, violating state law, and constituting multiple proposals. Even if not rebuffed by the SEC, the U.S. Proxy Exchange proposals hold little appeal for mainstream institutional investors who regard the ownership thresholds as overly lenient.

Two of the targeted companies have preempted the shareholder resolutions by adopting their own, albeit more rigorous versions of proxy access. Hewlett-Packard negotiated the withdrawal of a proposal from Amalgamated Bank's LongView Fund by agreeing to put a proxy access bylaw on its 2013 annual meeting ballot. Although the company's bylaw mirrors the key features of the proponent's resolution (ownership of 3% of the shares for three years), it will only allow shareholders to nominate 20% of the board, rather than the 25% proposed by Amalgamated Bank. KSW adopted a proxy access bylaw in January with the intent of omitting a more permissive bylaw proposal from Daniel Rudewicz's Furlong Fund as being "substantially implemented." KSW's regime allows a holder of 5% of the shares for one year to nominate one director (versus 2% for one year, as proposed by Rudewicz).

Despite the early adopters, the real utility of shareholder proxy access proposals is becoming manifest, namely as leverage to extract other governance reforms from companies. Nabors Industries, which has been stalwart in resisting activist campaigns, is adopting a host of revisions in response to a 3% for three-year proxy access proposal from a group of public pension funds. These include waiving Chairman Eugene Isenberg's $100 million severance package, repealing supermajority voting requirements, and declassifying the board. Last year, the company's SOP vote failed, and a shareholder proposal to destagger the board received majority support for a second consecutive year.

Companies targeted by Norges Bank Investment Management (NBIM) are also reaching accords through governance revisions. NBIM pulled its binding 1%/one-year proxy access proposal at Pioneer Natural Resources after the company agreed to declassify its board and adopt majority voting in director elections. Another target, Western Union, backed off proposing its own proxy access bylaw at its annual meeting in favor of declassifying its board, which won majority support as a shareholder proposal last year. Because NBIM largely compiled its focus list based on governance rather than performance concerns, other targeted firms may resort to similar appeasement measures. While such actions may not always result in a withdrawal of the proxy access proposals, they at least dampen the likelihood of their receiving high support.

Say on Pay

Year two of say on pay (SOP) promises far less drama than in its inaugural year. If early results are an indicator, companies whose SOP votes fared poorly last year have made positive adjustments to their pay programs. Of the seven firms that received less than 70% SOP approval in the first two months of 2011, virtually all have won high marks on SOP this year, including two that registered failures a year ago (Beazer Homes USA and Jacobs Engineering). Only Johnson Controls showed slippage, with support receding from 62.4% in 2011 to 54.2% this year. Overall, the percentage of firms receiving less than 70% support on SOP so far this year is comparable to last year, and most are companies that are conducting SOP votes for the first time.

Activist pressure has also resulted in a clean-up of executive pay programs. As reported by the *Wall Street Journal,* a coalition of union and public pension funds have withdrawn pay-related shareholder resolutions after reaching accords with 10 companies that received low SOP support in 2011. Among the concessions are the elimination of problematic pay practices (such as excise tax gross-ups), longer stock holding periods for executives, and restrictions on the accelerated vesting of equity awards following a change in control.

Issuers that disregard last year's SOP message are in for a more deafening broadcast this year, particularly from proxy advisory firms. Both Institutional Shareholder

Services (ISS) and Glass Lewis are ratcheting up their scrutiny of executive pay plans that received only marginal support last year (less than 70% in the case of ISS and 75% in the case of Glass Lewis). Companies that fail to adequately explain in their proxy statements how they responded to the vote, including their engagement with shareholders, will face the dual prospect of opposition to both SOP and their compensation committee members.

The wildcard in this year's pay votes is ISS's wholesale overhaul of its pay-for-performance (PFP) methodology, which takes effect for February annual meetings onwards (see Alliance Advisors' November 2011 newsletter). While ISS's new model has some positive attributes, such as more emphasis on long-term PFP linkage, gray areas, such as ISS's choice of peer groups, will make it harder for issuers to handicap their odds of receiving a favorable opinion on SOP. ISS doesn't expect the new methodology to produce a greater number of negative recommendations, but they will likely occur at different companies than under the prior model. So far, 13 companies with February and March meetings have experienced a reversal of ISS's opinion from "for" in 2011 to "against" in 2012. In all cases, the companies had received at least 77% support on SOP last year, and over half received over 90% support.

Although ISS's opinions weighed heavily in last year's pay votes—85% of the SOP proposals that received below 70% support were opposed by ISS—the landscape may be changing. This year, compensation research firm Equilar is launching its own PFP analytics suite, which the Council of Institutional Investors (CII) is making available to its member institutions. Unlike ISS's model, Equilar's will utilize realizable pay based on the current market value of equity awards, rather than the pay opportunity based on grant date valuations, and will designate peer groups based on publicly-disclosed relationships, rather than on company size and fixed industry classifications. Glass Lewis is also integrating Equilar's peer groups and realizable pay data into its own PFP model for SOP proposals occurring after July 1, 2012. Depending on how widely it is used by institutional investors, Equilar's PFP product could eventually diminish ISS's influence on SOP vote outcomes.

The 1% and 99%

Populist rancor over the divide between the wealthy and working class is unlikely to impact 2012 pay votes due to scale-backs in top executive compensation, though it is spilling over into annual meetings in other ways. Themes of imperial CEOs, tax dodgers and income inequality are featuring in some of this year's shareholder resolutions, while Occupy the Boardroom protesters plan to liven up shareholder gatherings where resolutions are being presented on corporate lobbying and political spending (see next section).

Goldman Sachs and JPMorgan Chase are headlining this year's proposals calling for an independent chairman by the American Federation of State, County and Municipal Employees (AFSCME), whose president, Gerald McEntee, proclaimed, "On Wall Street, the model of the imperial CEO who also serves as board chair has proven to be a failed experiment." AFSCME's director of capital strategies echoed those sentiments, observing, "The financial crisis shows there hasn't been enough adult supervision of CEOs."

Although between 30 and 40 independent chairman proposals appear on ballots each year, they rarely receive majority support because many companies have a lead director to counterbalance their combined chairman/CEO. Activists, however, received an unexpected imprimatur from a group of current and former corporate board chairs comprising the Chairman's Forum. In a recent model statement, the Forum urged boards to prepare for "next generation leadership" in their succession planning by appointing an independent chairman by default, following the departure of an incumbent chair/CEO. While it is uncertain whether this approach will attract a following among companies, investors and proxy advisors, issuers should remain vigilant of any developments in this area.

Wall Street one-percenters are also showcased in some of this year's shareholder pay proposals. New resolutions by Trillium Asset Management, the Nathan Cummings Foundation, and faith-based institutions ask

Goldman Sachs and JPMorgan Chase to address reputational risks associated with high levels of senior executive pay. The proponents assert that compensation packages of CEOs and senior executives play a significant role in the nation's growing income inequality and, by one study, account for 60% of the top 0.1% of income earners. The two banks, along with Morgan Stanley, were also prodded by the New York City pension funds to strengthen their clawback policies to hold senior executives financially responsible for excessive risk-taking and harmful conduct by their subordinates. Both Goldman Sachs and Morgan Stanley have agreed to comply.

Other shareholder resolutions at major banks address their role in the housing and financial crisis. Although the five largest mortgage servicers recently reached a settlement with 49 state attorneys general over foreclosure abuses, the New York City pension funds and Presbyterian Church are moving forward with proposals at Bank of America, Citigroup, JPMorgan Chase and Wells Fargo to review internal controls and policies on loan modifications, foreclosures and securitization. Similar proposals last year averaged 24.4% support. New resolutions to limit banks' director and officer indemnification (Harrington Investments) or report on potentially risky repurchase transactions (religious orders) are largely being omitted.

Although more nuanced than the Occupy movement's street theatrics outside of General Electric's headquarters, AFSCME and religious orders are once again targeting companies that are dodging their "tax revenue responsibilities." The proposals, which were all excluded last year as ordinary business, request reports on the reputational, financial and commercial risks associated with aggressive tax reduction and avoidance strategies, such as the use of transfer pricing and tax haven subsidiaries. So far, proposals have been omitted at Boeing and General Electric and withdrawn at Goldman Sachs.

Political Contributions

Galvanized by this year's presidential elections and the 2010 *Citizens United* decision, shareholder activists are blanketing the landscape with resolutions seeking greater transparency of corporate political spending. With nearly 100 filed to date, this will be the most numerous type of shareholder proposal for a second year in a row (see Alliance Advisors' January 2012 newsletter).

Most of the resolutions are part of two broad-based shareholder campaigns. Affiliates of the Center for Political Accountability (CPA) have filed 50 of their longstanding requests for disclosure of companies' political spending policies and their soft money contributions, independent expenditures, and payments to trade associations and other tax-exempt organizations that are used for political purposes. Separately, a coalition of 40 pension funds and sustainable investors organized by AFSCME and Walden Asset Management have filed 40 resolutions specifically addressing companies' policies and expenditures on lobbying activities, including direct lobbying, grassroots lobbying communications, and indirect lobbying conducted though trade associations or tax-exempt organizations that write and endorse model legislation. At least ten companies have received both types of proposals and, to add to the melee, the SEC has rendered differing determinations as to whether the proposals are sufficiently duplicative to warrant omission of the later one filed. So far, four companies (CVS Caremark, Occidental Petroleum, Union Pacific and WellPoint) have been allowed to exclude one of the proposals, while AT&T was not.

Other types of political spending resolutions are also being ramped up this season despite receiving only single-digit support in 2011. These include proposals by James Mackie and NorthStar Asset Management seeking a shareholder vote on corporate political contributions, and proposals by Trillium Asset Management and individual investors asking companies to refrain from any political spending.

Average support for political spending disclosure has stayed fairly flat in recent years, notwithstanding the endorsement of the proxy advisory firms. Unless activists can enlist broader investor interest, the fervor around this issue may not last beyond this year's election cycle.

Governance Reforms and Broker Votes

Stock-and-trade shareholder resolutions to repeal classified boards and adopt majority voting will be prevalent again this year as proponents migrate their campaigns to mid- and small-cap companies. In addition to 25 majority voting proposals sponsored by the Carpenters, the California State Teachers' Retirement System (CalSTRS) and California Public Employees' Retirement System (CalPERS) are reportedly filing over 60 majority voting proposals at Russell 1000 and Russell 2000 companies. Other public pension plans are becoming active this year on board declassification in conjunction with the Harvard Law School's Shareholder Rights Project (SRP), spearheaded by Professors Lucian Bebchuk and Scott Hirst. The SRP is providing engagement and proposal advice to the Illinois State Board of Investment (targeting 22 companies), the Ohio Public Employees' Retirement System (targeting five companies), the North Carolina State Treasurer and the Los Angeles County Employees' Retirement System, in addition to ongoing work with the Nathan Cummings Foundation.

As in past years, issuers are actively responding to shareholder proposal submissions and past majority votes by implementing desired governance reforms. Indeed, this could be a record-setting season for management proposals to destagger boards and adopt majority voting. However, starting this year, well-intentioned companies may find it harder to obtain shareholder approval for charter and bylaw amendments due to recent changes to NYSE Rule 452, which will no longer permit uninstructed broker voting for corporate governance proxy proposals, such as declassifying boards, implementing majority voting in director elections, repealing supermajority voting provisions, or expanding shareholders' rights to call special meetings or act by written consent. Companies listed on other exchanges will also be affected since most brokers are NYSE members.

The most pronounced impact will be on companies with a significant retail base or that have supermajority voting requirements. However, failure to pass a management proposal won't necessarily relieve issuers of continued activist pressures. Eli Lilly and Baxter International, for example, received shareholder resolutions this year to destagger their boards, notwithstanding the companies' repeated but unsuccessful attempts in the past to declassify (five times by Eli Lilly and twice by Baxter). Eli Lilly is responding once again with management proposals to not only repeal its classified board, but also its supermajority voting provisions (which similarly failed to win shareholder approval over the past two years).

Special Meetings and Written Consent

Campaigns by retail activists John Chevedden and William and Kenneth Steiner to enhance shareholders' ability to call special meetings or act by written consent are showing signs of battle fatigue. Although filings are still plentiful, most notably at new company targets, shareholder support has been languishing. Leery of the potential for abuse, many investors are reluctant to grant shareholders an unabridged right to act by written consent or to lower the ownership threshold for calling special meetings to the 10% advocated by the proponents. Last year, only five out of 30 special meeting proposals and 12 out of 33 written consent proposals received majority support.

In view of the persistence of the proponents, issuers are devising a host of ways to deflect the proposals. Companies targeted with special meeting resolutions most often counter them with a management proposal to grant the right to holders of 25% or more of the shares. However, several issuers (Amazon.com, Danaher, Newell Rubbermaid, R.R. Donnelley and Western Union) found a new angle for omission based on a shortcoming in this year's version of the shareholder resolution. The proposal requests that the governing documents be amended to permit holders of no less than 10% of the shares, *or the lowest percentage permitted under state law,* to call special meetings. While that boilerplate may be workable for companies in states that impose a minimum ownership threshold for calling special meetings, it qualifies as vague and indefinite regarding what ownership level would apply to a Delaware company: 10% or the lowest threshold that is legally permissible (one share)?

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With the written consent campaign in its third year, a number of companies are responding to previous majority votes or repeat proposal submissions by crafting their own provisions. Some (Altera and CVS Caremark) are following Home Depot's lead from 2011 and including procedural parameters, such as minimum ownership thresholds for initiating a consent (e.g., 20% or 25%), restrictions on timing and agenda items, and a requirement to solicit all shareholders. While the proponents object to any exclusionary language (Home Depot is being retargeted this year), this year's management proposals will test the acceptability of limited written consent with institutional investors and proxy advisors. Last year, ISS criticized Home Depot's restrictions, although it ultimately supported the company's resolution.

Exclusive Forum Provisions

Corporations are in for some severe blowback this year over charter and bylaw provisions that designate Delaware as the exclusive jurisdiction for litigating derivative actions, fiduciary claims and other intra-company disputes. According to the January 2012 updated study by Claudia H. Allen of Neal, Gerber & Eisenberg, 195 companies have adopted forum selection clauses to avoid parallel lawsuits in multiple jurisdictions.

Although most exclusive forum provisions were implemented in conjunction with initial public offerings, many established companies have adopted them through bylaw amendments. Shareholders are now challenging these provisions, both through lawsuits (nine companies) and proxy proposals to rescind them.[1] Amalgamated Bank, for one, is seeking repeal at a handful of companies, including Chevron and Roper Industries.

Questions over the enforceability of non-shareholder-approved bylaws (*Galaviz v. Berg*) prompted six companies last year to submit their exclusive forum clauses to a vote. Although all but one (at Allstate) passed, the prospects for winning shareholder approval this year are shakier. Both CII and the proxy advisory firms have sharpened their stance against restrictions on shareholders' legal recourse. Glass Lewis will oppose all management resolutions to adopt exclusive forum provisions and will recommend against governance committee chairs at companies that adopted such bylaws without shareholder approval. ISS will similarly oppose management proposals, but provides a carve-out for companies that have a shareholder-friendly governance regime (an annually elected board, majority voting in director elections, and no non-shareholder-approved poison pill) and that can demonstrate they have been materially harmed by shareholder litigation outside of their state of incorporation. So far this year, only one management resolution has been put to the test, at Sally Beauty Holdings. Notwithstanding proxy advisor objections, it readily passed because one-third of the company's shares are held by a private equity firm.

Auditor Tenure

Although routed from spring annual meetings by the SEC, one of the year's most sweeping shareholder campaigns on audit firm tenure is expected to make a mini-revival at later year meetings with a reworked proposal.

Originally, the United Brotherhood of Carpenters Pension Fund and Sheet Metal Workers National Pension Fund had targeted 45 large-cap companies with long-tenured auditors to adopt a policy to rotate their audit firms every seven years with a three-year cooling off period. Although 18 were reportedly withdrawn following company engagement, the remaining proposals have been omitted as ordinary business, despite the proponents' assertion that the issue had risen to a significant policy issue. Last fall, the Public Company Accounting Oversight Board (PCAOB) issued a concept release on auditor independence and term limits, while the European Commission proposed new rules requiring audit firm rotation every six years followed by a four-year cooling off period. The PCAOB will be holding a public roundtable on March 21-22 to hear opinions from investors, corporations,

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[1] Companies facing shareholder lawsuits include Autonation, Chevron, Curtiss Wright, Danaher, Franklin Resources, Navistar International, Priceline.com, SPX, and Superior Energy Services.

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audit firms and other interested parties on ways to improve auditor independence, including through mandatory auditor rotation.

Meanwhile, the proponents plan to target at least 15 companies with summer and fall meetings with a revised resolution which proposes enhanced disclosures on auditor tenure rather than a rotation policy. The requested report would include:

- The tenure and aggregate fees paid to the audit firm during its period of engagement.
- The audit committee's policy for assessing the risk of retaining a long-tenured audit firm and considering audit firm rotation.
- The process used for selecting the lead audit partner.
- Any training programs for audit committee members relating to audit firm independence, objectivity and professional skepticism.

While it is uncertain if companies will mount challenges to the new proposals, dialogue with the proponents may prove effective in addressing their underlying concerns with ensuring the integrity of corporate audits.

Regulatory Developments

Beyond proxy season, the 2012 presidential election holds out the prospect of a reversal of burdensome regulations, including Dodd-Frank and portions of the Sarbanes-Oxley Act, if Republicans win the White House. However, notwithstanding the outcome of the election, issuers may still see some relief from recent legislation introduced in Congress.

Bipartisan bills in the House and Senate (H.R. 3606 and S. 1933) would improve small and medium-sized companies' access to capital markets by reducing compliance costs. The Jumpstart American Business Act and companion Reopening American Capital Markets to Emerging Growth Companies Act would exempt new public companies from portions of Sarbanes-Oxley, Dodd-Frank, and certain SEC rules for up to five years, or until they reach $1 billion in annual revenue or $700 million in public float. During the on-ramping period, emerging companies would be excused from holding SOP and say-on-golden parachute votes and from having an outside auditor attest to internal controls and procedures. The exemption period would also apply to any future rules adopted by the PCAOB and SEC mandating audit firm rotation and the reporting of CEO and median employee pay ratios.

Separately, in mid-February a House Financial Services subcommittee passed H.R. 2308 (the SEC Regulatory Accountability Act), which would require the SEC to thoroughly evaluate the economic impact of any new rulemaking, including a pre-adoption cost-benefit analysis and a post-adoption reevaluation of the effectiveness of the rule. If passed, the legislation would slow the pace of outstanding Dodd-Frank rulemaking, including proxy access, which was derailed last year by the D.C. Circuit Court of Appeals because of an inadequate cost-benefit analysis.

While such initiatives may represent a setback for governance activists, they are an attestation that for lawmakers on both sides of the aisle the over-arching priority is invigorating economic growth and job creation. And those are aspirations that benefit both companies and shareholders alike.

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