

DM EXTRA!

March 5, 2004

Director Nominations: Evolution vs. Revolution

Director Summary >

Every year in each public company—typically in the spring—shareholders vote for directors, choosing from among candidates named by the board. In 2004, this annual rite of passage is unfolding against a backdrop of change, both *evolutionary* and “*revolutionary*.”

This *DMX*, a sequel to the alert we published December 3, 2003, summarizes the “evolutionary” changes that have increased the effectiveness of director nominations via independent nominating committees. More important, it reports on a more “revolutionary” change that could occur in the near future—namely, direct nomination of board candidates by major long-term shareholders who under certain conditions could obtain direct access to the nominating process.

Evolutionary Changes

On the evolutionary front, companies have already made progress internally on a *voluntary* basis:

- Some companies have made great strides in communicating with their shareholders and giving them increased access. For example, Apria Healthcare has created its own mechanism to ensure a shareholder voice in director elections.

[http://media.corporate-ir.net/
media_files/irol/11/111451/corpgov/
NominationOfDirectors.pdf](http://media.corporate-ir.net/media_files/irol/11/111451/corpgov/NominationOfDirectors.pdf)

- An increasing number of companies over the past decade have formed *independent nominating committees to nominate directors*. Ten years ago, only one out of four companies had such committees. Now that number has doubled, according to the NACD governance survey report for 2003-2004. Furthermore, three out of every four boards today have a majority of independent outside directors—up from all previous years.

[http://nacdonline.org/publications/
pubDetails.asp?pubID=224](http://nacdonline.org/publications/pubDetails.asp?pubID=224)

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



Two Lafayette Centre
1133 21st St. NW, Suite 700
Washington, D.C. 20036
202-775-0509 • www.nacdonline.org

Research: Alexandra R. Lajoux, NACD
Legal Review: Richard H. Koppes,
Jones Day, Sacramento, California
Design: Mary A. Graham, NACD

- Furthermore, the 2003-2004 survey suggests that most of these committees (nearly half of all boards) are using *executive search firms* to find their directors—yet another indication of independence.
- The latest NACD survey also shows that in recruiting candidates, boards look for a variety of qualifications, including (in order of importance), integrity, intelligence, expertise, and time and commitment.
- As for time, the survey shows an increase in the average number of hours spent on board and committee meetings, which is now at 156 hours per year—up from 150 two years ago, and 100 hours a decade ago. Committee hours were wide-ranging, from a low of 4 to a high of 500 hours, but the average, at 66 hours per year, represents a rise from past years.

Many of these voluntary actions are now *mandatory* for some or all public companies:

- The **New York Stock Exchange (NYSE)** and **NASDAQ Stock Market** have institutionalized this gradual change. In a rule published November 4, 2003, the NYSE requires all listed companies to have such committees and to have charters. NASDAQ also requires a nominating committee, unless independent directors as a group have the authority to nominate. NYSE guidelines even spell out what the charter should mandate: selection of qualified candidates, setting governance guidelines for the board, and overseeing executive and director evaluation.

<http://nyse.com/pdfs/finalcorpgovrules.pdf>

<http://www.nasdaq.com/about/RecentRuleChanges.stm>

- The SEC published “Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors,”* a final rule published November 24, 2003, and effective January 1, 2004. <http://www.sec.gov/rules/final/33-8340.htm>. This rule requires companies to disclose whether or not they have (or plan to form) a nominating committee; the nominating committee’s charter, if any; the nominating committee’s processes for identifying and evaluating candidates; and the minimum qualifications for a nominee recommended by the nominating committee and any qualities and skills that the nominating committee believes are necessary or desirable for board members to possess. The rule also requires that boards disclose how shareholders may communicate with directors.

* 17 CFR Parts 228, 229, 240, 249, 270, and 274; Release Nos. 33-8340; 34-48825; IC-26262; File No. S7-14-03; RIN 3235-A190.

To help boards develop best practices in communications with shareholders, NACD joined with the **Council of Institutional Investors** to form a Joint Task Force on Board-Shareowner Communications, co-chaired by **Peter M. Gilbert**, Chief Investment Officer, Pennsylvania State Employees’ Retirement System, and **Warren L. Batts**, retired CEO and Chairman, **Premark**, and corporate director. On March 1, the Task Force published its report, which included five recommended best practices. <http://nacdonline.org> (See Box 1 for Best Practices.)

Revolutionary Changes

Despite the gains achieved via this evolutionary progress, however, more *revolutionary* changes could occur in the near future. The SEC may soon act on a proposed director nominations rule on “Security Holder Director Nominations” it published for comment last fall (October 14). <http://www.sec.gov/rules/proposed/34-48626.htm>.

As reported in the last *DMX* (December 3) the proposed rules would require companies under some circumstances to include shareholder-nominated board candidates in their proxy materials, where allowable under state law. Specifically, the proposal would permit shareholders access to the company’s proxy statement for the purposes of nominating directors after either of two “triggering” events has occurred:

- A shareholder group owning 1 percent or more of the company’s outstanding voting securities for at least one year obtains a majority of shares voted on a proposal on the company’s proxy statement asking for direct shareholder nomination and that shareholder proposal is approved by a majority of shares voted, or
- More than 35 percent of shares voted at a meeting to elect directors are withheld from any particular nominee. (This occurred on March 3, 2004, at Disney.)

Following the occurrence of either of these triggers, the proposed rules would require companies to include shareholder-nominated board candidates in their proxy materials, where allowable under state law. Specifically, the proposal would permit a shareholder or group of shareholders holding more than 5 percent of the company’s stock for at least two years as of the date of the nomination to place up to three director nominees on the company’s proxy statement and proxy card for two years. Shareholders could form “nominating security holder groups” and solicit support of their nominees without disseminating a proxy statement. The mechanism would apply where “evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process.”

Box 1. Five Best Practices for Board-Shareowner Communications

1. The starting point for board-shareowner communications is an ongoing communications program that includes regular, comprehensive, and publicly available disclosures about important topics, including performance and governance issues.

2. Boards should provide detailed contact information for the corporate secretary and/or other management representative and for at least one independent director.

3. To facilitate the communications process, boards should detail which issues are appropriate for them to address and which are appropriate for management.

4. Boards should develop and disclose communications policies covering all forms of communication, including in-person meetings, telephone calls, e-mail, and other written communications.

5. Boards should take an active role in developing and adhering to communications policies, and ensure that communication efforts and policies are up to date and effective.

Source: Council of Institutional Investors–National Association of Corporate Directors Task Force on Board–Shareowner Communications, 2004.

NACD has been expressing its views to the SEC over the past year, and will continue to do so. (See Box 2 for Timeline).

NACD's Position on Director Nominations

In the view of the NACD, the nomination of directors should come through the independent nominating committee of the board that considers and seeks candidates carefully. Candidates should not merely be independent; their experience and skills should also fit the future strategic direction and risk profile of the company. Directors are in the best position to determine these matters.

This said, directors should ensure that shareholders understand company strategy and risk. Furthermore, nominating/governance committees should consider the nominations from shareholders carefully and with due respect. Indeed, like many who have commented on the proposed rule, we strongly support a “town hall” meeting approach to director nominations. That is, if a significant percentage of long-term shareowners have a specific grievance against the company, the company should hold a broad-based meeting among key members of the company's board and management and shareholders who have held their shares for a specified period of time. This is consistent with the views of the CII-NACD Task Force report released March 1, 2004.

Some Notable Comment Letters

The NACD is not alone in supporting reliance on independent nominating committees. Of the some 600 letters the SEC has received on this subject, roughly half oppose the rule, and many of these opposing letters affirm the value of independent nominating committees and/or governance committees. Boards have improved their nominating/governance committees, and these committees perform several valuable functions, including the selection of director candidates based on the company's needs. For the full text of the letters, go to <http://www.sec.gov/rules/proposed/s71903.shtml>.

Proponents of the rule have made strong arguments in favor of it. Nonetheless, the NACD board has concerns about the rule. Here are some quotes from other concerned thought leaders and affected groups.

“The newly enacted reforms that are now just beginning to be implemented should be given a fair opportunity to work before the Commission enacts additional, far-reaching rules on a matter as fundamental to corporate governance as director selection. Among other things, acting now may undermine the legitimacy and potential effect of the newly enacted reforms. This subject can be revisited in the future after evaluating whether these recently enacted reforms and other changes in company practices have resolved the concerns that the direct access proposals seek to address.”

American Bar Association

Section of Business Law
Task Force on Shareholder Proposals
January 7, 2004

“The proposed election contest rules would initiate sweeping, harmful changes in corporate governance practices while failing to achieve the Commission's expressed regulatory objectives of improving the proxy process at unresponsive companies. By overlooking the voting practices of institutional investors and the incentives and leverage the rules would give special interest groups, the proposal seriously underestimates the frequency with which election contests would be triggered at even healthy, well managed companies. The proposal likewise does not recognize the expense corporations will feel compelled to incur to ensure that each of their directors' loyalty is to the company and to *all* shareholders rather than to a coalition of union pension funds or other special interest groups.”

Henry A. McKinnell, Jr.

Chairman, Pfizer Corporation
Chairman, Business Roundtable
December 22, 2003

Box 2. Timeline

- **May 1, 2003.** The SEC issued a staff memo asking for comments on the subject of the proxy process, including direct shareholder access to proxy voting, setting a deadline of June 13, 2003, for comments.
- **June 13, 2003.** The NACD board (via Chairman B. Kenneth West and Roger W. Raber) submitted a comment letter stating that if shareholders want to nominate directors, they can amend company bylaws to allow this. The letter urged the SEC to require fuller disclosure of nominating committee processes.
- **July 15, 2003.** The SEC issued a staff memo asking for comments on five proposed reforms to the proxy process, including director nominations by security holders.
- **July 25, 2003.** The NACD issued a press release urging the SEC to “tread carefully” in this area, and citing the June 13, 2003, NACD letter.
- **October 14, 2003.** The SEC issued its proposed rules on “Security Holder Director Nominations.”
- **November 4, 2003.** The New York Stock Exchange (NYSE) and NASDAQ approve final rules for listed companies, including requirements for independent nominating committees and related disclosures. The rules include all 10 of the proposals the NACD submitted for consideration during the comment period.
- **November 24, 2003.** The SEC issued final rules on disclosure of nominating committee processes, as NACD had recommended in its June 13, 2003, letter.
- **December 3, 2003.** NACD publishes a *DMX* newsletter detailing all the previous developments. (To see the newsletter, go to members only, type in your member number, click on *DMX*).
- **December 22, 2003.** The NACD (West and Raber) submitted an official comment letter on shareholder access to nominations, noting that the NYSE and NASDAQ now require listed companies to have independent nominating committees with expanded disclosure requirements.
- **March 1, 2004.** The NACD and Council of Institutional Investors released the report of their Task Force on Board–Shareowner Communications.
- **March 5, 2004.** The NACD publishes *DMX* on director nominations.
- **March 8, 2004.** The NACD submits another comment letter to the SEC on director nominations citing continued governance progress.
- **March 10, 2004.** The SEC holds a by-invitation-only Roundtable on director nominations. NACD director **Warren Batts** and NACD governance counsel **Ira Millstein** will participate.

“Rather than promulgate a new set of regulations governing the inclusion of nominees of significant shareholders in company proxy materials, the focus of reforms should be on reducing inappropriate barriers for beneficial involvement of significant shareholders in the corporate governance of publicly traded firms.”

Randall S. Kroszner

University of Chicago

Non-Resident Scholar, American Enterprise Institute -

Brookings Joint Center for Regulatory Studies

December 22, 2003

“The proposed rules could turn director elections into proxy contests, substantially disrupting corporate affairs, causing significant costs to the company and all of its shareholders, and dissuading from board service well-qualified individuals who do not want to routinely stand for election in a contested situation.”

Linda Koch Lorimer

Chairperson, Nominating and Governance Committee

Sprint Corporation

December 22, 2003

Conclusion

NACD has been an important part of the positive evolution of corporate governance in recent years. We have seen improvement in the nomination of directors, and we believe that it will continue. New stock market listing rules and SEC regulations ensure that this evolution will continue. A revolutionary approach to director nominations could be counterproductive. ■

Procedure to Send Comments to the SEC

The NACD is a not-for-profit organization and does not engage in lobbying. However, we encourage our members to express their views concerning corporate governance matters. Here are instructions for providing comments to the SEC.

Send by one method—U.S. mail or electronic mail—only. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: **rule-comments@sec.gov**. This number should be included in the subject line if sent via electronic mail. Electronically submitted comment letters will be posted on the Commission’s website **http://www.sec.gov**.

When commenting on director nominations, refer to File Number S7-19-03. Deadline: March 31, 2004.