

# DM EXTRA!

April 1, 2004

## Director Nominations: The Shape of Things to Come

### Director Summary >

What does the future hold for director nominations? Will boards and their nominating committees continue to make the final determination of the names on proxy ballots, or will shareholders have new rights to make nominations directly? If such rights come, how broad will they be, and how will they affect the work of nominating/governance committees? Predictions abound. One thing is clear, however: the **Securities and Exchange Commission** is likely to take action on this subject soon, increasing the challenges of board nominating/governance committee service.

### Background

As reported in recent *DMXs* and elsewhere, the SEC now studying comments on a proposed rule to grant shareholders direct access to director nominations under certain conditions.

<http://www.sec.gov/rules/proposed/34-48626.htm>

The rule, proposed October 14, 2003, has inspired thousands of comment letters. When the SEC summarized its first flood of comments in March (more than 13,000 letters), it noted a polarity of views between corporations and those who invest in them:

“A significant majority of the commenters, comprising virtually all of the unions; pension funds; social, environmental, and religious funds; a majority of institutional investors and institutional investor associations; a majority of investment advisers and managers; and a majority of individuals, supported the proposed rules. The exceptions were corporations, corporate executives, and corporate directors; law firms and attorneys; and most of the associations (primarily business associations), which were nearly unanimous in their opposition to the proposed rules.”

**Securities and Exchange Commission**

Division of Corporate Finance

<http://www.sec.gov/rules/extra/s71903summary.htm>

### Panels Raise Issues

In an effort to understand and possibly even bridge these differing views, the SEC held a Roundtable on March 10, 2004, inviting NACD to participate. Director **Warren Batts** served as a panelist, along with governance counsel and past director **Ira M. Millstein**. They joined 39 other panelists on a total of six panels.

### 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, private, and closely held 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.



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## Panel 1

*What problems in the proxy process need to be addressed?*

Positions on this panel seemed to be irreconcilable. Opponents of the rule said that any system-wide governance problems were a thing of the past and would be addressed through pending reforms; proponents of the rule said that such problems continue and must be addressed through more stringent measures such as the proposed rule.

## Panel 2

*Is the proposal a reasonable solution?*

On this panel, there was a higher degree of consensus growing from interest in proposals advanced by two of the panelists (**Ira Millstein** of **Weil, Gotshal & Manges LLP**, and **Joseph Grundfest** of **Stanford University**). The Millstein proposal would set forth a stock exchange/stock market listing requirement that would, in effect, give meaning to "withhold" votes, so that, where there are no opposing nominees, each director to be elected would have to receive a majority vote of those voting. Millstein pointed out that this proposal could bring a cure to the problems posed by the "plurality" voting system used for proxy voting. Under this system, which is based in state corporation law, only yes votes count (shareholders either vote yes or abstain), making it more difficult to lose an election.

## Panel 3

*The application of the proposal to companies and investors.*

In his remarks, Batts, who expressed a favorable reaction to a consideration of the Millstein proposal, emphasized the progress that boards have made in communicating with investors, citing a recent NACD initiative with the **Council of Institutional Investors**.

<http://www.nacdonline.org/images/White-CIITaskForce-2004-2-26-04.pdf>

He stated that in his years as a director, institutional investors had not recommended candidates even when asked. He also expressed concerns about the long time frame of the proposed rule, which takes place in two phases. These comments dovetailed with concerns expressed by some panelists that the proposal would be used to leverage other interests, rather than to merely nominate directors.

## Panel 4

*Impact of the proposal on retail and other investors.*

Timing was also mentioned here. One of the shareholders (legendary gadfly **Evelyn Y. Davis**) suggested that the SEC wait three years before acting; others wanted prompt and even more decisive action by the SEC.

## Panel 5

*Legal issues.*

In this panel, a variety of legal luminaries (attorneys, law professors, and the nation's leading judge) wrestled over this question: Does the SEC have authority to promulgate this rule? One attorney (**R. Todd Lang** of **Weil, Gotshal & Manges LLP** and the **American Bar Association**) said that it does not, while the others claimed that it does. (It is possible that the **Business Roundtable** and the **U.S. Chamber of Commerce** may sue the SEC to prevent this rule, on grounds that it does not have sufficiently broad rulemaking authority.

## Panel 6

*Impact of the proposed rule on voting mechanics.*

This panel featured proxy solicitors, proxy advisors, and a proxy voting tabulator that does 80 percent of all proxy voting tabulations for the country (**Richard J. Daly** of **Automatic Data Processing, Inc.**). Daly said that the rule would have to be passed by June 1, 2004, if it were to apply to the 2005 proxy season, since his company has to rewrite millions of lines of code. He said some changes in proxy card format could be accommodated easily, but other mechanical aspects would be challenging.

Throughout the panel, the SEC Commissioners seemed equally divided between those who favored having a shareholder access rule in the near future (**Harvey J. Goldschmid** and **Roel C. Campos**) and those who questioned the need for such quick action (**Cynthia A. Glassman** and **Paul S. Atkins**). Chairman **William H. Donaldson** may well be the "swing vote" here.

## Brokering a Solution

The panel revealed a need for a middle ground, and the NACD board decided to clear some. In a new comment letter, dated March 26, 2004, NACD Chairman **B. Kenneth West** and CEO and President **Roger W. Raber** suggested that the SEC benchmark and promote nominating committee progress as an interim and perhaps final step in strengthening the nominations process. To help the SEC in this regard, their letter outlined best practices for board nominating/governance committees based on current and pending reforms.

So what is the shape of the future on this issue? Trying to divine from the comment letters and the Roundtable is like taking a Rorschach inkblot test. Many interpretations are possible. But as long as boards continue to do their best and document those efforts, the outcome is bound to be beneficial for all concerned. ■

*NACD letter follows.*



*March 26, 2004*

Re: File Number S7-19-03

Mr. Jonathan Katz  
Secretary  
U. S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Dear Mr. Katz:

On behalf of the board of the National Association of Corporate Directors (NACD), we once again commend the Securities and Exchange Commission and its staff for your ongoing efforts to defend the rights of shareholders and to protect the value of their investments.

With this letter, we would like to repeat and expand our earlier comments re the proposed rule on "Security Holder Director Nominations" (34-48626). We believe that the Commission should consider making some changes to the format of both the proxy statement and the proxy card:

- Cards should be clearly marked for Yes, No, and Abstain. Although arcane state laws regarding plurality may impose some impediments to change in this regard, we believe that this is an area where federal law could provoke needed modernization.
- Beyond the current disclosures, proxy statements should also clearly disclose relationships that director candidates have with incumbent directors and with members of management.

Furthermore, as stated in our letters of December 22, 2003, and March 9, 2004, we believe that the investing public should be given additional time to evaluate the impact of new reforms prior to the launch of yet another regulatory initiative that could dramatically alter the composition and leadership of boards.

We understand fully that the SEC may want to take decisive action on the subject of director nominations now, rather than waiting for many months or years. When NACD leadership and staff attended your Roundtable on March 10, 2004 (with our director Warren Batts and our governance counsel Ira Millstein as panelists), we could not fail to notice how strongly the institutional shareholders supported your proposed reforms.

Since one of your primary responsibilities is to administer federal securities laws that seek to provide protection for investors, you obviously cannot ignore this groundswell of interest and support. On the other hand, we witnessed how adamantly representatives of major corporations opposed the rule, some stating that they might take legal action to prevent it. Therefore, for the benefit of the investing public and for the good of capital markets, we would like to propose a middle ground.

We support any initiative that keeps the role of director nominations under the guidance of an independent board nominating committee. The best approach, in our view, would be to benchmark current nominating committee reforms, both required and recommended.

We propose that the SEC consider ways to benchmark the progress being made by board nominating committees. To help the SEC in this regard, we have abstracted 12 Principles for Nominating/Governance Committees into a form. The text of the form is based on the Commission's current disclosure regulations and on the Task Force report we recently did with the Council of Institutional Investors. Companies could use this form voluntarily to show their compliance with the goals of the Commission now, during a time investors want to see proof of progress.

Standard 1 is required of New York Stock Exchange Companies. Standards 1-10 are required on at least a disclose-or-explain basis under the Commission's final rule of November 24, 2003, for Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors (<http://www.sec.gov/rules/final/33-8340.htm>). The Commission requires Standards 9 and 10 absolutely. The Commission does not require Standards 11 and 12 yet; these standards are based on the recent Task Force white paper from the Council of Institutional Investors and the National Association of Corporate Directors.

Note: In places where the word "INSERT" appears, nominating committees would insert their own materials, as indicated. The NACD has published educational materials that could assist companies in formulating their answers (see asterisked items).

## **12 PRINCIPLES FOR EFFECTIVE NOMINATING/GOVERNANCE COMMITTEES**

1. OUR BOARD HAS A STANDING, INDEPENDENT NOMINATING COMMITTEE OR A COMMITTEE PERFORMING A SIMILAR FUNCTION—SUCH AS A GOVERNANCE COMMITTEE (AS REQUIRED OF NEW YORK STOCK EXCHANGE COMPANIES).
2. OUR BOARD NOMINATING COMMITTEE (OR SIMILARLY TASKED COMMITTEE, E.G., GOVERNANCE COMMITTEE) ADHERES TO A CHARTER THAT WE DISCLOSE IN THE PROXY STATEMENT AND ON OUR WEBSITE.
3. OUR COMMITTEE HAS A POLICY AFFIRMING THAT WE WILL CONSIDER DIRECTOR CANDIDATES AS RECOMMENDED BY SHAREHOLDERS.
4. OUR COMMITTEE DISCLOSES THE PROCEDURES IT USES TO CONSIDER CANDIDATES RECOMMENDED BY SECURITY HOLDERS. THESE PROCEDURES ARE AS FOLLOWS: [INSERT NOMINATING COMMITTEE PROCEDURES HERE.]
5. OUR COMMITTEE HAS SET THE FOLLOWING SPECIFIC, MINIMUM QUALIFICATIONS FOR ALL NOMINEES TO A POSITION ON OUR BOARD OF DIRECTORS.\* [INSERT SPECIFIC DIRECTOR QUALIFICATIONS HERE.]
6. OUR COMMITTEE HAS SET THE FOLLOWING SPECIFIC QUALITIES AND SKILLS THAT WE BELIEVE ARE NECESSARY FOR ONE OR MORE OF THE COMPANY'S DIRECTORS TO POSSESS:\*\* [INSERT SPECIFIC QUALITIES AND SKILLS LIST HERE.]
7. OUR COMMITTEE USES THE FOLLOWING PROCESS FOR IDENTIFYING AND EVALUATING NOMINEES FOR DIRECTOR.\*\*\* [INSERT DESCRIPTION OF PROCESS HERE.]
8. OUR COMMITTEE GIVES EQUAL CONSIDERATION TO CANDIDATES RECOMMENDED BY SHAREHOLDERS, AS LONG AS THESE CANDIDATES MEET THE QUALIFICATIONS AND POSSESS THE QUALITIES AND SKILLS LISTED ABOVE IN POINTS 5 AND 6.

9. AS REQUIRED, WE HEREBY DISCLOSE THE CATEGORIES OF PERSONS OR ENTITIES THAT RECOMMENDED THE NOMINATIONS RECEIVED THIS YEAR TO DATE THAT APPEAR ON THE PROXY, INCLUDING BUT NOT LIMITED TO SECURITY HOLDERS, NON-MANAGEMENT DIRECTORS, CHIEF EXECUTIVE OFFICERS, OTHER EXECUTIVE OFFICERS, THIRD-PARTY SEARCH FIRMS, OR OTHER, SPECIFIED SOURCE. IN ADDITION TO THESE CATEGORIES, THE FOLLOWING ARE THE NAMES OF 5 PERCENT SECURITY HOLDERS THAT HAVE SUBMITTED NOMINATIONS AND PERMITTED US TO PUBLISH THEIR NAMES: [DISCLOSE CATEGORIES AND, IF PERMITTED, SPECIFIC SOURCES HERE.]
10. AS REQUIRED, WE HEREBY DISCLOSE WHETHER WE ARE RETAINING PROFESSIONAL SERVICES IN RECRUITMENT AND EVALUATION, AND IF SO WHAT THESE SERVICES ENTAIL: [INSERT SERVICE DETAILS HERE.]
11. THE FOLLOWING IS CONTACT INFORMATION FOR THE INDEPENDENT CHAIR OF THE COMMITTEE: [INSERT CONTACT INFORMATION HERE.]
12. THE CHAIR OF THE NOMINATING COMMITTEE WILL BE AVAILABLE TO TAKE QUESTIONS FROM SHAREOWNERS AT THE ANNUAL SHAREOWNERS' MEETING.

The above asterisks describe relevant guidance published by the NACD. They are for the Commission's reference, not for the sample form: \*Cf. Report of the NACD Blue Ribbon Report on Director Professionalism (NACD, 2001). \*\* Ibid. \*\*\*Cf. Report of the NACD Blue Ribbon Commission on Board Evaluation (NACD, 2001).

We believe that the form we are proposing can help boards and shareholders determine the extent to which nominating/governance committees are conforming to the letter and spirit of current reforms. The Commission may wish to consider this as an adjunct to and/or acceleration of current disclosure requirements. Meanwhile, we would welcome the opportunity to help the SEC refine, promote, and track these standards.

In closing, we hope that the SEC finds this suggested approach an appropriate middle ground in its effort to respond to shareholder concerns about director nominations.

Sincerely,



B. Kenneth West, Chairman



Roger W. Raber, CEO and President