Governance (Click on the title below to read the article.)

U.S. Corporate Governance Challenges: Say-on-Pay, Proxy Access, Dodd-Frank and Potentially More Auditor Independence Rules

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As directors of U.S. public companies survey the corporate landscape, they may see a glass that's half full or half empty. For many companies, profits are up and they have a large stockpile of cash. On the other hand, the Federal Reserve forecasts sluggish growth and continued high unemployment, U.S. markets zigzag based on concerns over Europe's sovereign debt crisis, the U.S. has its own debt challenges and Occupy Wall Street protesters had a presence in cities around the world.

Looking for good news wherever they can find it, directors may be allured by the state of U.S. corporate governance at the start of 2012. The corporate governance space was dominated in 2011 by "say-on-pay" — shareholder advisory votes on executive compensation. And with companies receiving an average of 92 percent of shares voted in favor, one might conclude that shareholders are happy with executive compensation. Where investors did have concerns about executive compensation, they expressed their displeasure in the say-on-pay votes rather than voting against compensation committee members. And the icing on the cake: In July, a federal court vacated the SEC's mandatory proxy access rule. Directors can exhale. Or can they?

In exploring the corporate governance themes that we anticipate will be significant for 2012 — and that are likely to present challenges in ways both familiar and new — many of the 2011 storylines will continue to unfold: Say-on-pay may get more challenging, the battle over proxy access will move to its next phase and Dodd-Frank Act rulemaking will impose new burdens. In addition, an old storyline will be revived — regulators are again looking at the role of auditors and their relationships with audit clients.

Planning for 2012 Say-on-Pay

In many ways, say-on-pay in 2011 can be viewed as a success. The 2011 votes, however, were just the first steps in a longer process. For some companies, the next steps are clear. For many others, the biggest risk may be complacency. Having successfully navigated say-on-pay in 2011, companies and boards of directors need to understand how the landscape is changing so they can continue to be successful in 2012.

2011 Recap. Proponents of say-on-pay expressed the desire to achieve greater levels of engagement with companies concerning executive compensation, and they were successful. Based on surveys, as well as anecdotal evidence, more companies sought engagement with their institutional investors, and many went deeper down the list of investors, in terms of size of shareholdings, with whom they engaged.

Engagement also took the form of improved proxy disclosure, with companies using a variety of techniques to articulate in their proxy statements how their executive compensation was consistent with their pay-for-performance policy. In addition to charts and graphs, many companies added an executive summary to their Compensation Discussion & Analysis (CD&A), and some created a proxy statement summary that crystallized all of the critical information for shareholders in just a few pages. Another interesting development was the trend of companies, typically in response to negative Institutional Shareholder Services (ISS)

recommendations on say-on-pay, publishing additional proxy materials taking issue with ISS' recommendations and emphasizing the companies' views.

Finally, when companies viewed it as appropriate, they made changes to executive compensation plans and policies that increased the likelihood of a successful say-on-pay vote. In some cases, those changes were adopted early enough to be incorporated into the company's initial proxy disclosure and ISS' initial voting recommendations. In other instances, the changes were made closer to the annual meeting date in reaction to ISS' negative voting recommendations and the feedback companies received from engaging with their institutional investors.

In terms of voting results, based on ISS data, investors heavily supported companies' executive compensation, with an average of 92 percent of votes cast in favor. In fact, only about 40 companies failed to achieve majority support for their executive compensation (with approximately another 170 companies receiving only lukewarm support — more on that later).

The other new vote in 2011 was the "say-on-frequency" vote — a shareholder advisory vote on the frequency of future say-on-pay votes. Based on voting results and company announcements, it appears that the vast majority of companies — approximately 95 percent of S&P 500 companies and 80 percent of Russell 3000 companies — will be holding say-on-pay votes on an annual basis.

The 2012 Proxy Season. Every company, regardless of 2011 voting results, will need to evaluate how its executive compensation has changed during the year, how the company has performed, and how it can improve its proxy disclosure and engagement/communication efforts to secure a favorable say-on-pay voting result for 2012.

Another important element in planning for the 2012 say-on-pay vote will be assessing whether and, if so, how the yardstick used by a company's institutional investors and ISS may have changed from last year. Will institutional investors take a harder line in 2012? For ISS and many institutional investors, pay-for-performance concerns were the critical issue in deciding how to vote on say-on-pay. It is noteworthy that ISS has revised its approach to analyzing pay-for-performance in connection with 2012 voting recommendations. ISS does not anticipate a change in the percentage of negative say-on-pay recommendations it issues (which was approximately 11 percent of companies in 2011), but that the set of companies identified as having a pay-for-performance misalignment "may differ somewhat" under its new methodology.

In addition to the need for all public companies to refresh their say-on-pay self-analysis and map out their engagement strategy accordingly, some companies are behind the eight ball and may need to exert greater effort to achieve a successful say-on-pay vote in 2012. These include the roughly 40 companies that failed the 2011 say-on-pay votes. Beyond those easily identified companies, the more difficult question is knowing the point at which the level of say-on-pay dissent was meaningful enough that extra efforts should be employed and an explicit response is considered advisable. While institutional investors and issuers have very different views on this question, ISS has drawn the line at 70 percent of votes cast — meaning that if a company's 2011 say-on-pay vote garnered less support than 70 percent of votes

cast, ISS will take a harder look at the company's response to that perceived low level of shareholder support and the company's subsequent compensation-related actions. This ISS policy change provides notice to another 170 companies or so (and, in particular, to the members of their compensation committees) that simply getting a majority vote may not be sufficient to satisfy investors when the vast majority of companies are receiving shareholder support for executive compensation at or above the 80 percent level.

Whether or not all investors draw the line at the same level, ISS and institutional investors will be asking themselves whether companies below the applicable line, and directors of those companies, have been responsive to investors' concerns. ISS has noted that it will be looking for "concrete actions" in terms of changes to compensation practices, as well as disclosure of the company's engagement efforts with major institutional investors on compensation issues. This ISS policy update dovetails with an SEC disclosure requirement that will apply to most companies for the first time in 2012. As part of the CD&A, companies must disclose whether they considered the most recent say-on-pay voting results and how that consideration affected their executive compensation decisions and policies.

Under ISS' 2012 policy, the response, or the lack of a response, to a high level of dissent on say-on-pay will factor into ISS' voting recommendations — not only for the 2012 say-on-pay vote, but also for how shareholders should vote with respect to compensation committee members. While there was a significant decline in opposition to directors in 2011 — attributed to shareholders' ability to express displeasure over compensation matters in the say-on-pay vote — that decline may turn out to be a one-year phenomenon, as compensation committee members standing for reelection will again be subject to high negative votes if they are viewed as unresponsive to investor concerns over executive compensation.

Proxy Access

A significant negative vote for a director — whether arising from a perceived lack of responsiveness to a negative say-on-pay vote or due to other investor concerns — certainly can be a complication many companies would prefer to avoid. That complication could grow exponentially if it heightens the risk that directors will face a short-slate proxy contest the following year. A system of proxy access would do exactly that. Proxy access would allow some universe of qualified shareholders (including many who, under the current regulatory structure, are not likely to engage in a proxy contest) to include their chosen director candidates in the company's proxy materials, thereby creating an election contest. As a result, even the threat of a proxy access nomination can impact boardroom decision-making.

In August 2010, the SEC adopted a one-size-fits-all proxy access rule that would allow a shareholder or group of shareholders holding at least 3 percent of a company's shares for three years, and nominating candidates for up to one-quarter of the total number of board members, to have its nominees included in the company's proxy materials. That rule was challenged by the Business Roundtable and the U.S. Chamber of Commerce and vacated by the D.C. Circuit Court of Appeals in July 2011.

The SEC also adopted an amendment to Rule 14a-8 (the shareholder proposal rule) to allow proxy access shareholder proposals. Embracing the notion of "private ordering" — letting boards and shareholders decide what level of proxy access (if any) is appropriate on a company-by-company basis — the Business Roundtable and U.S. Chamber of Commerce did not challenge this rule change, and the amendment to Rule 14a-8 became effective in September 2011. Accordingly, the ongoing battle for proxy access shifts from the battlefields of legislation and regulation to the urban warfare model of block-by-block, or in this case company-by-company, skirmishes.

Many tactical questions remain unanswered on both sides of the proxy access issue. Will the proponents of proxy access shareholder proposals be large institutional investors who submit proposals to a carefully selected handful of companies with perceived poor governance profiles? Or will the proponents be activist individuals who submit proxy access proposals to scores of S&P 500 companies seeking to establish a market standard? Will the proposals take the form of binding bylaw amendments, or will they be precatory proposals urging boards to adopt proxy access? Will investors only support proposals that closely follow the SEC's three-year and 3-percent parameters or will investors vote for proxy access proposals containing thresholds as low as one year and 1 percent?

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Notably, at least 16 public companies have received proxy access shareholder proposals. Seven were submitted by shareholder activists Ken Steiner, John Chevedden and James McRitchie. Those proposals follow a form published by United States Proxy Exchange, a group of retail investors, and call for proxy access for shareholders owning 1 percent of a company's stock for two years or, alternatively, a group of 100 or more shareholders each owning $2,000 worth of company stock for one year. In addition, six companies received binding bylaw proposals from Norges Bank Investment Management calling for proxy access for shareholders owning 1 percent of the company's stock for at least one year.

Although it is likely that all or most companies receiving a proxy access shareholder proposal will oppose it (assuming they are unable to exclude it from the proxy statement), a company's response will need to be the result of deliberation after considering the actual facts and circumstances, including the terms of the proposal and the company's shareholder base. Will we see companies propose board-sponsored proxy access proposals with large and lengthy holding requirements?

ISS has indicated that it will consider proxy access proposals, whether from shareholders or management, on a case-by-case basis and that it will provide additional guidance in January 2012 based on actual shareholder proposals submitted to companies.

It is possible that the answers to many of the questions on proxy access may take multiple proxy seasons to develop fully. In any event, it appears that proxy access has the potential to become a standard corporate governance shareholder proposal menu item — joining topics such as board declassification, shareholders' right to call special meetings, shareholders' right to act by written consent and the elimination of poison pills — selected by institutional investors (particularly labor unions and public pension funds) and individual activists to make their presence felt in boardrooms across Corporate America.

Dodd-Frank: The SEC's To-Do List

As the Dodd-Frank Act was enacted 18 months ago and say-on-pay and proxy access were topics addressed in the statute, corporate officers and directors could be excused for believing that all of the rules implementing the corporate governance provisions of the Dodd-Frank Act must be in place by now. Alternatively, for those paying closer attention, it is understandable if they believe rules to implement the Dodd-Frank Act's corporate governance provisions are a perpetual topic of discussion that will never actually happen. The fact that the SEC still has a substantial to-do list with respect to the Dodd-Frank Act's implementation is a function of the significant amount of rulemaking the act required and the complexity of the issues. And even though the SEC is giving due consideration to the many viewpoints expressed on a variety of topics, at the end of the day the SEC's hands may be tied by the language in the statute. Of the various governance-related rules still to come, the three that may have the greatest potential to burden public companies relate to: (1) disclosing the ratio of CEO compensation to median compensation paid to all other employees, (2) clawback policies to recoup executive compensation in the event of a financial restatement (even absent misconduct) and (3) conflict minerals disclosure.

In the case of pay-ratio disclosure and clawback policies, the SEC has revised the schedule again, now indicating that rules will be proposed by June 2012 and adopted by December 2012. Although those rules will not impact the 2012 proxy season, companies should continue to monitor developments and be ready to comment on the proposed rules. The pay-ratio disclosure may result in significant data collection and analysis costs and appears likely to result in disclosure that may appeal to the press and labor activists but be of little use to investors. The clawback policy rules may result in compensation committees and boards of directors losing the discretion they currently possess under most company-adopted clawback policies and require companies to engage in costly and distracting litigation with current or former employees in the event of a restatement where the potential recoupment is far outweighed by the direct and indirect costs of recovering the funds.

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The conflict minerals provision of the Dodd-Frank Act represents an attempt to solve a geopolitical problem on the backs of U.S. corporations. Rules have been proposed, and are now expected to be adopted by June 2012. As a result, companies may soon be required to determine whether columbite-tantalite (coltan), cassiterite, gold or wolframite are necessary to the functionality or production of their products and, if so, to determine whether any of the minerals used by the company may have originated in the Democratic Republic of the Congo or any neighboring countries. Companies may have to engage in costly and burdensome supply chain due diligence in order to make the necessary determinations and then disclose their conclusions on their websites or in their SEC filings, disclosure that may be of little or no benefit to investors.

Regulators Taking Another Look at Auditor-Audit Client Relationships

When the Sarbanes-Oxley Act was adopted in 2002, reforming the auditor-audit client relationship was viewed as a critical step in restoring investor confidence. A new regulator, the Public Company Accounting Oversight Board (PCAOB), was

created and various rules were adopted to strengthen the independence of auditors and audit committees. So far in the U.S., auditors generally have avoided becoming the topic of new legislation and regulation in the aftermath of the financial crisis that gave us the Dodd-Frank Act.

The questions for 2012 are whether that is about to change and, if so, how any changes will impact public companies and investors. In August 2011, the PCAOB issued a concept release on auditor independence and mandatory audit firm rotation. As described by the PCAOB, the idea of audit firm rotation has been considered at various points since the 1970s. The PCAOB concept release follows the issuance in October 2010 of a European Commission "Green Paper," entitled "Audit Policy: Lessons from the Crisis," that also explores the role of auditors and their independence, including the notion of mandatory audit firm rotation. Various reports and studies, however, have indicated that mandatory audit firm rotation would impose costs on companies and may cause audit quality to suffer in the early years of a rotation. With the European Commission's recently proposed legislation on mandatory audit firm rotation, and the recent attempt by the Carpenters Pension Fund to introduce a series of shareholder proposals on the topic, the question of mandatory audit firm rotation is likely to remain front and center on the regulatory agenda.

The PCAOB also issued a concept release in June 2011 exploring potential changes to the auditor's reporting model, such as requiring an "Auditor's Discussion and Analysis," expanding the scope of the auditor's report and otherwise expanding the auditor's reporting of information outside the financial statements. In addition, the PCAOB recently proposed amending accounting standards to require disclosure of the engagement partner's name in each audit report. Separately, the PCAOB publicly released a previously confidential portion of an inspection report critical of a Big Four accounting firm, the first time the PCAOB has done so.

Although it may be too early to know whether all this activity will result in new regulations, some of the proposals, if adopted, could have a profound impact on audit firms as well as on public companies. Accordingly, companies and audit committees should monitor these developments diligently and be prepared to comment on any proposed rules that they believe would negatively impact the companies' ability to produce high-quality financial statements and other disclosures that can be relied upon by investors.

Conclusions

U.S. companies remain resilient. Nevertheless, the cumulative effects of legislative and regulatory reforms, no matter how well-intentioned, create challenges for companies as they navigate the current slow-growth economy. Add to that the tension between stock market volatility due to macro-economic factors and the potential negative impact on investors' returns on one hand, against the imperative to attract, motivate and retain high-quality executive talent on the other. And for good measure, mix in the prospect of more challenging say-on-pay votes and the prospect of proxy access. As we enter 2012, the proxy season appears likely to be a challenging one.