

WACHTELL, LIPTON, ROSEN & KATZ

# NOMINATING AND CORPORATE GOVERNANCE COMMITTEE GUIDE

2016



## About This Guide

This Nominating and Corporate Governance Committee Guide (this “Guide”) provides an overview of the key rules applicable to nominating and corporate governance committees of listed U.S. companies and practices that nominating and corporate governance committees should consider in the current environment. This Guide outlines a nominating and corporate governance committee member’s responsibilities, reviews the composition and procedures of the nominating and corporate governance committee and considers important legal standards and regulations that govern nominating and corporate governance committees and their members. This Guide also discusses some of the important matters that nominating and corporate governance committees may be called upon to decide or recommend an approach. Although generally geared toward directors who are members of a public company nominating and corporate governance committee, this Guide is also relevant to members of a nominating and corporate governance committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

A few necessary caveats are in order. This Guide is not intended as legal advice, cannot take into account particular facts and circumstances and generally does not address individual state corporation laws. That said, we believe that this Guide will offer directors sound guidance on general rules, practices and considerations relevant to the nominating and corporate governance committee.

The annexes to this Guide include sample committee charters and other policies and procedures. They are included because we believe them potentially useful to the nominating and corporate governance committee in performing its functions. However, it would be a mistake to simply copy published models. The creation of charters, policies and procedures requires experience and careful thought. It is not necessary that a company have every guideline and procedure that another company has in order to be “state of the art” in its governance practices. When taken too far, an overly broad committee charter can be counterproductive. For example, if a charter explicitly requires review or other action and the nominating and corporate governance committee has not taken that action, that failure may be considered evidence of lack of due care. Each company should tailor its nominating and corporate governance committee charter and other written policies and procedures to what is necessary and practical for that particular company.

To the extent this guide expresses opinions on corporate governance matters, these do not necessarily reflect the views of Wachtell, Lipton, Rosen & Katz or its partners as to any particular situation. We would welcome any feedback readers may have on this Guide, either as to specific items or regarding its general layout and utility so that we can make future editions even more useful. Please pass any comments you may have on to Trevor Norwitz (at [tsnorwitz@wlrk.com](mailto:tsnorwitz@wlrk.com)) or Sara Lewis (at [sjlewis@wlrk.com](mailto:sjlewis@wlrk.com)) or to any other contacts you may have at the firm.

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## INTRODUCTION

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The nominating and corporate governance committee goes by different names: the Securities and Exchange Commission (the “SEC”) refers to the “nominating committee,” the New York Stock Exchange (the “NYSE”) to the “nominating/corporate governance committee,” and Nasdaq to the “nominations committee.”<sup>1</sup> Although traditionally known simply as the nominating committee, the increasing incidence of “corporate governance” in the title reflects the wider scope of responsibilities this committee has assumed in recent years. Once focused almost exclusively on identifying and selecting candidates for the board of directors, the nominating and corporate governance committee now typically assumes a leading role in a broad array of corporate governance matters, including the development and implementation of corporate governance guidelines, establishment of director criteria and review of candidates, evaluation of the performance of the board itself and its committees, consideration of shareholder proposals and, in some cases, management succession planning. Sometimes determination of non-employee director compensation is handled by the nominating and corporate governance committee as well, although in other cases this falls within the purview of the compensation committee.

The nominating and corporate governance committee is one of three standing committees, along with the audit committee and the compensation committee, required by the NYSE to be composed entirely of independent directors. In the past decade and a half, considerable public attention has been paid to the audit committee in the wake of the financial scandals of the early 2000s, and then to the compensation committee in light of the options backdating and other controversies regarding executive compensation. Because it is less regulated and had received less attention than those committees, the nominating and corporate governance committee had sometimes been thought of as the “third” of the three standing committees. But this has changed. With the heightened focus on corporate governance, and a steady push by shareholder rights activists and proxy advisory services to enhance “shareholder rights” and conform to “best practices,” the role of the nominating and corporate governance committee has become far more prominent in recent years, and we expect it will play a central role in the years to come. Indeed, it is not uncommon for the chair of the nominating and corporate governance committee to be the lead director at companies where the chief executive officer also chairs the board (although this is of course not necessarily the case).

In simplest terms, just as the audit committee has primary responsibility to ensure that the company’s financial policies and practices are appropriate, and the compensation committee has primary responsibility to ensure that the company’s compensation policies and practices are appropriate, so the nominating and corporate governance committee has primary responsibility to ensure that the company’s corporate governance and nominations policies and practices are appropriate for the company.

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<sup>1</sup> See, e.g., Item 407(c) of Regulation S-K; NYSE Listed Company Manual, Rule 303A.04; Nasdaq Listing Rule 5605-6(e)(B).

The standards governing the composition and operations of the nominating and corporate governance committee are in many respects not as specific or as rigorous as those applicable to the audit and the compensation committees. While SEC rules apply to all listed companies, most of the standards relevant to the nominating and corporate governance committee are to be found in the applicable stock exchange listing standards. Listing standards applicable to the nominating and corporate governance committee are different for the NYSE and Nasdaq, subtly or significantly, depending on the issue.

The landscape within which the nominating and corporate governance committee operates is always changing. The panoply of positions taken and policies adopted by the proxy advisory service firms, large institutional investor groups and, to a lesser degree, other shareholder rights activists are constantly evolving and shifting. Members of nominating and corporate governance committees should be familiar with these policies and positions, which, while not binding on companies, undoubtedly have a significant impact on corporate governance practices.

This Guide is organized into three parts. Part I focuses on the “corporate governance” function of the nominating and corporate governance committee; Part II turns to its “nominating” role; and Part III addresses the committee’s basic organization and procedures. The purpose of this Guide is to describe the standards applicable to the nominating and corporate governance committee in order to assist committee members in better understanding their role and responsibilities.

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**PART ONE:**

**THE “CORPORATE GOVERNANCE” FUNCTION OF THE NOMINATING AND  
CORPORATE GOVERNANCE COMMITTEE**

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## I. The Purpose of Corporate Governance

The term “corporate governance” encompasses a broad range of legal and non-legal principles and practices that, in combination, establish the rights, powers and obligations of the various stakeholders of a company. Although corporate governance principles and practices most directly regulate the relationships among a company’s shareholders, board of directors and management, they also affect all of a company’s stakeholders, including employees, customers, suppliers and creditors. Corporate governance can be seen as a means to facilitate the allocation of power and the division of responsibility among the company’s stakeholders: the company’s shareholders provide capital and approve certain major decisions and transactions; the board of directors is elected by shareholders to oversee management and guide the direction of the company; and senior managers are responsible for the day-to-day operations of the company.

At its core, the proper goal of corporate governance is creating sustainable value. The governance structure and policies that will best achieve this goal are as varied as are companies themselves. A board should tailor its corporate governance decisions to its company, bearing in mind factors such as the unique circumstances of the company and the culture and dynamics among the principal stakeholders. We believe that decisions regarding corporate governance are ideally determined by directors who have the best information to evaluate these factors, who best understand the company holistically and who are ultimately responsible for the results of these decisions as the only group of stakeholders subject to fiduciary duties.

In this respect, it is important for the nominating and corporate governance committee to resist pressure to simply equate “shareholder-friendly” corporate governance policies with “good” corporate governance policies or to substitute the judgment of proxy advisory firms or activist investors for its own. Institutional investors, hedge funds and activist investors have made considerable strides in recent years in taking the shareholder-centric model of corporate governance from the fringe to the mainstream, advocating uniform adoption of so-called “best practices.” However, such “best practices” may not be best for all companies or shareholders. Shareholders have very different objectives and time horizons. Some shareholders, including many activist investors and hedge funds, are looking to maximize their returns over a short period, while others, such as institutional investors and index funds, generally have longer-term objectives. Others, such as union pension funds, may have special interests not shared by the general body of shareholders. Institutional investors are themselves intermediaries for the ultimate beneficial owners of shares, and the interests of decision-makers at those institutions are often not entirely aligned with the interests of those ultimate beneficiaries.

Empowering shareholders at the expense of the board will not necessarily lead to better performance and more efficient management of corporations, and the optimal corporate governance structure for one company may not be the optimal corporate governance structure for another company. In discharging its fiduciary duties, the nominating and corporate governance committee must therefore remind itself of the fundamental goal of corporate governance and make its own determination as to the proper corporate governance for the company. Directors not only may—but should—disfavor so-called “best practice” governance provisions unless they believe that such provisions are in the best interests of the company they serve.

Directors must exercise this judgment in a changing corporate governance landscape defined by increasing direct shareholder engagement and frequent implementation by companies of shareholder proposals. Companies and institutional investors now dialogue more regularly on corporate governance and strategic matters than they have ever done before. Many “best practices” long advocated by shareholder groups—including say-on-pay, the dismantling of shareholder defenses, majority voting in director elections and the declassification of boards—have been codified in rules and regulations or voluntarily adopted by a majority of S&P 500 companies. As institutional shareholders and activists advocate new “best practices” and utilize new approaches in engaging companies and in asserting their agendas, directors must strive to continue to act steadfastly in the best interests of the corporation and its shareholders.

In the last few years, there is evidence that a new paradigm may be emerging for corporate governance, in which leading institutional investors will support long-term investment and value creation by more active engagement and reducing the degree to which they outsource corporate governance decisions to ISS and activist hedge funds. A number of these institutional investors are significantly expanding their governance departments so that they have in-house capability to evaluate governance and strategy.

By way of example, Laurence Fink, Chairman and CEO of BlackRock, has said:

“It is critical . . . to understand that corporate leaders’ duty of care and loyalty is not to every investor or trader who owns their companies’ shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company’s long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sustainable long-term growth. Corporate leaders and their companies who follow this model can expect our support.”

Crucial elements of this new paradigm, which the nominating and corporate governance committee should be aware of and help the board to formulate, include: a well-articulated long-term strategic plan, active board participation in the strategic planning process, communication of the company’s strategic plan to investors, including by direct engagement by management and, where appropriate, directors, a thoughtful and well-communicated approach to corporate governance and appropriate attention to issues of corporate social responsibility and sustainability issues about which the company’s investors care.

As the landscape continues to evolve, the nominating and corporate governance committee can play an important role in helping the board and management stay ahead of the curve.

## II. Sources of Corporate Governance Rules and Policies

The main sources of substantive corporate governance rules are state law and stock exchange listing standards. Within these parameters, a company has a fair amount of flexibility in implementing a corporate governance framework and memorializing that framework in its organizational documents. The SEC's rules generally focus on ensuring adequate disclosure rather than compelling any particular governance practice. Of course, requiring disclosure may in itself nudge corporate governance practices in one direction or another. Additionally, corporate governance decisions are increasingly the result not of black-letter legal requirements, but rather of the substantial influence of proxy advisory firms, policies developed by large institutional investor groups and pressure from shareholder activists.

### A. State Law and Governance Documents

The corporate governance framework of each company is principally defined by the laws of its state of incorporation and by its organizational documents. State corporate statutes provide some limits on how companies can structure their affairs, many of which are so ingrained that it is difficult to imagine corporate governance in any other way. For example, under Delaware law, each director of a corporation must be a natural person, regardless of what a corporation's organizational documents might say about the matter.<sup>2</sup> However, a significant portion of state corporate statutes simply provide default rules in the absence of any provision in a corporation's organizational documents to the contrary. Delaware in particular prides itself on its enabling statute, which provides few mandatory elements but allows a high degree of private ordering. A number of provisions in the Delaware General Corporation Law are prefaced by "unless the certificate of incorporation provides otherwise" or similar phraseology.<sup>3</sup> This leaves the tailoring of a particular corporate governance regime to each individual company in its organizational documents.

Some corporate governance features, such as (in Delaware) classification of the board, must be effected through the company's certificate of incorporation (also known as its charter). This means that shareholder approval is required to adopt such a provision—or to eliminate such a provision. Other corporate governance matters are commonly fleshed out in a company's bylaws, and boards are commonly granted the authority to make, amend or repeal bylaws without shareholder approval. Shareholders generally have the right to amend, adopt or repeal bylaws as well. Other corporate governance policies, especially those that state the company's current position with respect to a governance issue but preserve flexibility to deviate from it in appropriate circumstances, are often best reserved for a company's corporate governance guidelines. These guidelines are typically adopted, and can be changed, by the board.

### B. SEC Requirements

The SEC regulates corporate governance principally by imposing disclosure requirements, although it does impose some substantive requirements, such as those defining "inde-

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<sup>2</sup> 8 Del. C. § 141(b).

<sup>3</sup> See, e.g., 8 Del. C. §§ 141(b) (number of directors), 141(k)(1) (grounds for removal of directors) and 211(b) (election of directors by written consent).

pendence” for purposes of audit committee membership in the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”),<sup>4</sup> and SEC Rule 10A-3 (*see* Section XI.B.1 for a further discussion of these audit committee requirements). Regulation 14A and the accompanying Schedule 14A, which govern the solicitation of proxies at shareholder meetings, are the SEC’s primary mechanisms for requiring corporate governance disclosures. Regulation 14A specifies what information must be presented to shareholders regarding director candidates and other matters to be brought before the shareholders and the format in which it must be presented, and requires disclosure of corporate governance matters, such as board and committee composition, director and committee member independence, attendance at and frequency of board and committee meetings and governance and related-party transaction policies, to name just a few. Rule 14a-8 also provides rules governing the inclusion and presentation of shareholder proposals in a company’s proxy materials. For a discussion of Rule 14a-8, *see* Section IV.A.

The SEC also requires certain corporate governance disclosures under Sarbanes-Oxley, which set new or enhanced standards for public company boards and management in the aftermath of corporate and accounting scandals, and the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”),<sup>5</sup> the financial regulation passed after the financial crisis of 2008. Notably, the SEC now requires shareholders to vote on compensation plans at least every three years<sup>6</sup> under its say-on-pay regime and also to vote on “golden parachute” payments, which are payments to an executive upon an executive’s termination in connection with a change in control transaction, such as a merger.<sup>7</sup> Additionally, companies must disclose compensation of its named executive officers (the CEO, CFO and its three other highest paid executive officers) in securities filings.<sup>8</sup>

In February of 2015, pursuant to Section 955 of Dodd-Frank, the SEC proposed rules that would require disclosure in proxy statements involving the election of directors as to whether the company permits employees (including officers), directors or their designees to engage in transactions to hedge or offset any decrease in the market value of the company’s equity securities held by these individuals.<sup>9</sup> Existing proxy rules require companies to disclose stock ownership guidelines and company policies pertaining to hedging activities of named executive officers, if material. The newly proposed rules would apply beyond named executive officers to directors, officers and employees generally, eliminate the materiality requirement and apply broadly to company securities, whether or not granted for compensatory purposes.<sup>10</sup>

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<sup>4</sup> Pub. L. 107-204, 116 Stat. 745.

<sup>5</sup> Pub. L. 111-203, 124 Stat. 1376.

<sup>6</sup> 17 C.F.R. § 240.14a-21.

<sup>7</sup> *Id.*

<sup>8</sup> 17 C.F.R. § 229.402.

<sup>9</sup> The comment period on the proposed rules ended on April 20, 2015 but final rules have not yet been enacted. On February 10, 2016, Associate Director of the Division of Corporate Finance Elizabeth Murphy noted that SEC staff are currently reviewing the definitions of certain terms in the proposed rule based received comments. Che Odom, *SEC Disclosure Review May See Concept Release in 2016*, BLOOMBERG BNA (Feb. 17, 2016); *see also Disclosure of Hedging by Employees, Officers and Directors*, Release Nos. 33-9723 and 34-74232; 80 Fed. Reg. 8485 (proposed Feb. 9, 2015), available at <http://www.sec.gov/rules/proposed/2015/33-9723.pdf>; *see also* Wachtell, Lip-ton, Rosen & Katz, *SEC Proposes Proxy Disclosure Rules for Hedging by Directors, Officers and Employees* (Feb. 9, 2015), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23845.15.pdf>.

<sup>10</sup> *Id.*

Section 16 of the Securities Exchange Act of 1934 (the “Exchange Act”)<sup>11</sup> also requires all directors, certain executives and shareholders who own 10 percent or more of a company’s securities to report transactions in the company’s securities, and filings of Schedules 13D and 13G (by shareholders with more than five percent of a company’s equity securities) are closely monitored by companies in an effort to anticipate and respond to activism.

Finally, it is worth noting that Form 8-K operates to notify shareholders of certain changes in a corporation’s corporate governance, such as material modifications to rights of shareholders, the election and appointment or departure of directors and certain officers, compensatory arrangements with certain officers, changes in control of the company, amendments to the charter or bylaws, amendments to a company’s code of ethics or waiver of a provision of a code of ethics, results of shareholder votes and nominations of directors by shareholders.<sup>12</sup>

With respect to board composition, the SEC requires that all members of the audit committee be independent.<sup>13</sup> Under SEC rules, an audit committee member is considered independent if he or she has not (1) accepted any consulting, advisory or other compensatory fee from the issuer or (2) been an affiliate of the issuer or any of its subsidiaries.<sup>14</sup> The SEC also provides that national stock exchanges, which must ensure that listed companies have independent compensation committee members, must consider the same factors in assessing the independence of compensation committee members as the SEC uses to assess audit committee member independence.<sup>15</sup>

Although many of the SEC rules regarding corporate governance are “disclosure-based,” the substantive rules that the SEC does impose, as well as the potential impact of disclosure-based rules on actual corporate governance practices, appear to be growing. In a March 2014 keynote address, former SEC Commissioner Daniel Gallagher noted the trend towards increased federalization of corporate governance matters traditionally left to the states, citing Rule 14a-8 and the Dodd-Frank requirement for a say-on-pay vote as particular incursions: “Some of these requirements unashamedly interfere in corporate governance matters traditionally and appropriately left to the states. Others masquerade as disclosure, but are in reality attempts to affect substantive behavior through disclosure regulation. . . . This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.”<sup>16</sup>

### **C. Stock Exchange Requirements**

Both the NYSE and Nasdaq have adopted corporate governance standards that, with limited exceptions discussed below, apply to all companies listing common equity securities on the exchanges. These governance standards generally do not apply to companies listing only pre-

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<sup>11</sup> 15 U.S.C. § 78(a).

<sup>12</sup> Items 3.03, 5.02, 5.01, 5.03, 5.05, 5.07 and 5.08 of Form 8-K. 17 C.F.R. 249.308.

<sup>13</sup> 17 C.F.R. § 240.10A-3(b).

<sup>14</sup> 17 C.F.R. § 240.10A-2(b)(ii)(A).

<sup>15</sup> 17 C.F.R. §§ 240.10A-3(a)-(b).

<sup>16</sup> Daniel M. Gallagher, former Comm’r, SEC, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541315952#.VQfYE9J0xMw>.

ferred or debt securities. The discussion in this section provides a brief summary of the corporate governance standards at both exchanges. Please see Annex A for a detailed comparison.

## **1. Independence**

The rules of the exchanges require that a listed company's board comprise a majority of independent directors.<sup>17</sup> The standards of both exchanges for determining director independence are discussed in Section VII.C.1.

## **2. Committees**

The stock exchanges require listed companies to have an audit committee and a compensation committee, each of which must be composed entirely of independent directors.<sup>18</sup> Each of these committees must have a charter vesting the committee with certain responsibilities and providing for an annual evaluation of the committee.<sup>19</sup> Under NYSE rules, members of the audit and compensation committees must satisfy more stringent independence criteria than other directors. Additionally, the NYSE requires that listed companies have a nominating and corporate governance committee, with a charter, composed entirely of independent directors.<sup>20</sup> Nasdaq does not require listed companies to have a nominations and corporate governance committee, but it does require that listed companies have a formal charter or written resolutions addressing the nominations process and that director nominees be selected by independent directors.<sup>21</sup>

## **3. Corporate Governance Guidelines and Codes of Conduct**

Both stock exchanges require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees.<sup>22</sup> The required contents of the codes of conduct for the two exchanges differ somewhat, but they generally must include standards that address honesty and ethical conduct. Companies must promptly disclose any waivers of the code for directors or executive officers. Each code of business conduct must also contain compliance standards or enforcement mechanisms. As discussed in Section XV.B.1, NYSE-listed companies are also required to adopt and disclose corporate governance guidelines that must address director qualification standards, director responsibilities and other director and corporate governance matters. The Nasdaq listing standards do not address corporate governance guidelines.

## **4. Executive Sessions**

The NYSE requires that non-management directors (even if not independent) meet in executive sessions without management directors or other members of management at "regularly scheduled" meetings and that independent directors meet in executive sessions without non-independent directors or members of management at least once a year.<sup>23</sup> Nasdaq requires that

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<sup>17</sup> NYSE Listed Company Manual, Rule 303A.01; Nasdaq Listing Rule 5605(b)(1).

<sup>18</sup> NYSE Listed Company Manual, Rules 303A.05 and 303A.07; Nasdaq Listing Rules 5605(c)(2)(a) and 5605(d)(2)(a).

<sup>19</sup> NYSE Listed Company Manual, Rules 303A.04 and 303A.05; Nasdaq Listing Rules 5605(c) and 5605(d).

<sup>20</sup> NYSE Listed Company Manual, Rule 303A.04.

<sup>21</sup> Nasdaq Listing Rule 5605(e).

<sup>22</sup> NYSE Listed Company Manual, Rule 303A.10; Nasdaq Listing Rule 5610.

<sup>23</sup> NYSE Listed Company Manual, Rule 303A.03.

independent directors meet in executive sessions without non-independent directors or members of management,<sup>24</sup> with commentary to Nasdaq rules instructing that such executive sessions should occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.<sup>25</sup>

## 5. Shareholder Approval of Certain Matters

Both exchanges require shareholder approval in certain instances.

- Issuance in Acquisition: Both the NYSE and Nasdaq require shareholder approval prior to the issuance of securities in connection with any transaction or series of related transactions if the common stock to be issued is or will be equal to or greater than 20 percent of the voting power or number of shares of common stock outstanding before the issuance (subject to certain exceptions).<sup>26</sup>
- Changes in Control: Shareholder approval is also required under the rules of both exchanges prior to an issuance that will result in a change of control of a listed company.<sup>27</sup>
- Insider Transactions: Under certain circumstances, shareholder approval is required by both exchanges prior to the issuance of common stock to a director, officer or substantial security holder, or any of their affiliates.<sup>28</sup>
- Equity Compensation: Under the rules of both exchanges, subject to certain exceptions, shareholders must be given the opportunity to vote on the establishment or material amendment of equity-compensation plans.<sup>29</sup>

## 6. Exemptions

Both exchanges provide exemption for relief from their rules to certain companies under certain circumstances. Nasdaq-listed cooperatives, registered management investment companies, and controlled companies (defined as a company in which more than 50 percent of the voting power for director elections is held by an individual, group or another company) are not required to have a majority independent board, compensation committee, or independent director oversight of nominations.<sup>30</sup> Nasdaq also exempts limited partnerships from its general corporate governance requirements, but imposes certain partnership specific governance requirements on such entities.<sup>31</sup> Similarly, the NYSE exempts registered management investment companies and

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<sup>24</sup> Nasdaq Listing Rule 5605(b)(2).

<sup>25</sup> Nasdaq Listing Rule IM-5605-2.

<sup>26</sup> NYSE Listed Company Manual, Rule 312.03(c); Nasdaq Listing Rule 5635(a)(1).

<sup>27</sup> NYSE Listed Company Manual, Rule 312.03(d); Nasdaq Listing Rule 5635(b).

<sup>28</sup> NYSE Listed Company Manual, Rule 312.03(b); Nasdaq Listing Rule 5635(a)(2).

<sup>29</sup> NYSE Listed Company Manual, Rule 303A.08; Nasdaq Listing Rule 5635(c).

<sup>30</sup> Nasdaq Listing Rules 5615(a)(2), 5615(a)(5), and 5615(c).

<sup>31</sup> Nasdaq Listing Rule 5615(a)(4). Among other things, a Nasdaq-listed limited partnership must maintain a general partner, have at least three independent directors pursuant to Rule 5605(c)(2)'s audit committee composition requirements, review all related party transactions on an ongoing basis and review potential material conflict of in-

certain passive issuers from most of its corporate governance requirements.<sup>32</sup> NYSE-listed limited partnerships, companies in bankruptcy and controlled companies are not required to have majority-independent boards, compensation committees or nominating and corporate governance committees.<sup>33</sup> All of these companies are, however, subject to the remaining corporate governance standards of each exchange.

Generally, foreign private issuers listed on an exchange are permitted to follow home country practice in lieu of the exchange's corporate governance standards, with the exception of the governance standards regarding audit committees, certification of compliance, and, for Nasdaq only, the prohibition on certain alterations to common stock voting rights.<sup>34</sup> Foreign private issuers listed on the NYSE must disclose any significant ways in which their corporate governance practices differ from listing standards, and those listed on the Nasdaq must report each requirement that they do not follow and describe the home country practice they follow in lieu of that requirement.<sup>35</sup> Additionally, a Nasdaq-listed foreign private issuer that follows a home country practice in lieu of having an independent compensation committee must disclose the reasons why it elected not to have such an independent committee.<sup>36</sup>

## **7. Phase-In Exceptions**

Both exchanges provide that companies in various categories may phase into corporate governance requirements. For example, both exchanges allow companies listed in conjunction with an Initial Public Offering (an "IPO"), and those ceasing to qualify as controlled companies, up to a year from the listing date to establish a majority-independent board.<sup>37</sup> Subject to certain distinctions, both exchanges also allow the companies in these two categories and companies listing upon emergence from bankruptcy to phase in the number of independent directors that serve as members of exchange-required committees: Committees must comprise a majority of independent directors within 90 days and all independent directors within one year of listing or status change.<sup>38</sup>

## **8. Noncompliance**

Both exchanges require that a company promptly notify them in writing after the company becomes aware of any noncompliance with the corporate governance standards.<sup>39</sup> The NYSE additionally requires that the CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE corporate governance standards, qualifying the certification to the extent necessary.<sup>40</sup>

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terest situations where appropriate through use of an audit committee or comparable body of the partnership's board of directors.

<sup>32</sup> NYSE Listed Company Manual, Rule 303A.00.

<sup>33</sup> *Id.*

<sup>34</sup> NYSE Listed Company Manual, Rule 303A.00; Nasdaq Listing Rule 5615(a)(3).

<sup>35</sup> *Id.*

<sup>36</sup> NYSE Listed Company Manual, Rule 303A.11; Nasdaq Listing Rule 5615(a)(3)(B).

<sup>37</sup> NYSE Listed Company Manual, Rule 303.A00; Nasdaq Listing Rules 5615(b)(1)-(2) and (c)(3).

<sup>38</sup> *Id.*

<sup>39</sup> NYSE Listed Company Manual, Rule 303A.12(b); Nasdaq Listing Rule 5625.

<sup>40</sup> NYSE Listed Company Manual, Rule 303A.12(a).

## D. Proxy Advisory Services and Institutional Investors

Large institutional investors commonly hold stock in hundreds of companies and thus are called upon to vote at hundreds of shareholder meetings per year. While institutional investors often have corporate governance departments to inform their voting decisions, most institutional investors deal with this volume either by outsourcing voting decisions to proxy advisory services or by using the recommendations of the proxy advisory services to guide their decisions. Proxy advisory services provide voting recommendations on topics including director elections, say-on-pay, shareholder proposals and mergers. In addition to providing company-specific voting recommendations, proxy advisory services publish voting guidelines setting forth their policies on various issues. The two largest proxy advisory firms—Institutional Shareholder Services Inc. (“ISS”) and Glass, Lewis & Co. (“Glass Lewis”)—enjoy an effective duopoly in the field, with a 97 percent share of the industry.<sup>41</sup> ISS was acquired in 2014 by hedge fund Vestar Capital Partners, and Glass Lewis “is an indirect, wholly owned subsidiary of the Ontario Teachers’ Pension Plan Board, a major institutional investor.”<sup>42</sup>

In the last decade, the influence of proxy advisory firms has increased substantially, and their recommendations are now a powerful (and often decisive) force in influencing corporate governance and voting results. This growing influence is partly the result of the SEC’s creation in 2003 of an effective safe harbor from a 1988 Department of Labor determination that institutional investors owed their clients a fiduciary duty when voting their shares. The SEC safe harbor provides that fund managers may insulate themselves from fiduciary duty claims by, in accordance with a pre-determined policy, relying upon the proxy voting recommendations of a third party.<sup>43</sup> The influence of proxy advisory firms was also greatly increased by the move from plurality to majority voting standards beginning in 2004, as that put “teeth” in their policies of recommending “withhold” votes for directors who did not implement shareholder preferences as reflected in precatory resolutions. It is generally understood that an ISS recommendation in favor of a shareholder proposal increases the approval vote substantially. One commentator conservatively estimates such increase to be, on average, 15 percentage points.<sup>44</sup>

However, both legislators and regulators have started to question the influence of proxy advisory firms and have expressed the need to regulate these firms for conflicts of interest and

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<sup>41</sup> See Staff of H. Comm. on Fin. Servs., 113th Cong., *Memorandum: June 5 Subcommittee on Capital Markets hearing on “Examining the Market Power and Impact of Proxy Advisory Firms”* 3 (May 31, 2013), available at [http://financialservices.house.gov/uploadedfiles/060513\\_cm\\_memo.pdf](http://financialservices.house.gov/uploadedfiles/060513_cm_memo.pdf).

<sup>42</sup> *Id.*; Press Release, ISS, *Vestar Capital Partners Completes Acquisition of ISS* (Apr. 30, 2014), available at <http://www.issgovernance.com/vestar-capital-partners-completes-acquisition-of-institutional-shareholder-services/>.

<sup>43</sup> Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-6. See also Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 Bus. Law. 1, 17 (Nov. 2010) (“The problem of short-termism is also illustrated by the policies of proxy advisory firms whose growth was fueled by the Labor Department’s informed voting requirements for regulated investment funds.”), available at <http://www.ecgi.org/tcgd/2011/documents/Strine%20Fundamental%20Corp%20Gov%20Q%202011%20Bus%20L.pdf>.

<sup>44</sup> James R. Copland, *SEC Needs to Rethink Its Rules on Proxy Advisory Firms*, Wash. Examiner, July 24, 2014, <http://www.washingtonexaminer.com/article/2551268#!>.

other issues.<sup>45</sup> In response to this mounting pressure from both legislators<sup>46</sup> and companies, in June 2014, the SEC issued regulatory guidance concerning the proxy voting responsibilities of investment advisors and their use of proxy advisory firms.<sup>47</sup> The guidance reinforces the SEC's position that investment advisors owe fiduciary duties to their clients in proxy voting and that, to comply with SEC rules in exercising its voting authority, an investment advisor must "adopt and implement written policies and procedures that are reasonably designed to ensure that the investment advisor votes proxies in the best interest of its clients."<sup>48</sup> The SEC advises that to demonstrate compliance with these requirements, an investment advisor could periodically sample votes cast by proxy firms to confirm compliance with its policies and procedures and review its policies and procedures at least once a year. Additionally, the SEC advises that when retaining a proxy firm, an investment advisor should ascertain its "capacity and competency to adequately analyze proxy issues,"<sup>49</sup> including by considering the robustness of a proxy firm's policies and procedures regarding its ability to ensure that its voting recommendations are based on current and accurate information and to identify and address conflicts of interest and any other considerations that the investment advisor may want to consider in evaluating the services of the proxy firm.

In the guidance, the SEC also confirmed that investment advisors are not required to vote every proxy and may instead choose a number of the following arrangements with clients: to agree to forego voting on certain types of proposals due to costs; to vote in line with management or a shareholder proponent; to abstain from voting all together; or to focus resources on certain types of proposals. We believe that it would be a responsible policy for institutional investors that do not wish to devote resources to making educated voting decisions to have a default rule to vote in accordance with the recommendation of the board, unless instructed otherwise. However, as we have noted, SEC guidance may result in investment advisors opting not to vote on various issues, which could magnify the voices of activists or lead to distortions in the character and quality of information conveyed by reported "votes cast."<sup>50</sup>

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<sup>45</sup> See Staff of H. Comm. on Fin. Servs., 113th Cong., *Memorandum: June 5 Subcommittee on Capital Markets hearing on "Examining the Market Power and Impact of Proxy Advisory Firms,"* 3 (May 31, 2013), available at [http://financialservices.house.gov/uploadedfiles/060513\\_cm\\_memo.pdf](http://financialservices.house.gov/uploadedfiles/060513_cm_memo.pdf); See also *Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the Subcomm. on Capital Markets and Gov. Sponsored Enters. of the H. Comm. on Fin. Servs.,* 113th Cong. 1 (June 5, 2013), available at <http://financialservices.house.gov/uploadedfiles/113-27.pdf>; Daniel M. Gallagher, Comm'r, SEC, Remarks at Society of Corporate Secretaries and Governance Professionals (July 11, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539700301>.

<sup>46</sup> See Yin Wilczek, *Congress Will Act if SEC Fails to Move on Proxy Advisors*, Bloomberg BNA, June 27, 2014, available at <http://www.bna.com/congress-act-sec-n17179891633/>.

<sup>47</sup> SEC Staff Legal Bulletin No. 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from Proxy Rules for Proxy Advisory Firms* (June 30, 2014), available at <http://www.sec.gov/interp/leg/cfs/b20.htm>; for analysis of the guidance; see also Wachtell, Lipton, Rosen & Katz, *SEC Issues Regulatory Guidance on Proxy Advisory Firms and Proxy Voting Responsibilities* (July 1, 2014), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23439.14.pdf>.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> Wachtell, Lipton, Rosen & Katz, *SEC Issues Regulatory Guidance on Proxy Advisory Firms and Proxy Voting Responsibilities* (July 1, 2014), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23439.14.pdf>.

Under the SEC guidance, with respect to conflicts of interest, proxy firms must disclose to their clients the significant relationships and material interests in the matter that is subject of a voting recommendation with a level of sufficiency that will enable the client to assess the reliability or objectivity of the recommendation. Although this disclosure can be made to clients directly or publicly, as we noted elsewhere, we expect that proxy firms would choose to disclose publicly so that their highly influential proxy reports are not misleading.<sup>51</sup> The SEC also advised that it expects any changes to the current systems and processes of investment advisors or proxy firms required as a result of the guidance to be made “promptly, but in any event in advance of next year’s proxy season.” While we have noted that it seems likely that the SEC’s guidance is a step in the right direction, further SEC Staff, Commission-level or legislative action will be needed to increase the overall accountability of proxy advisory firms, resolve conflicts of interest and address the lack of transparency in their methodologies and analyses.<sup>52</sup>

Additionally, in recent years money managers themselves have been questioning the wisdom of reliance on proxy advisory firm recommendations and have asserted an active and independent approach to decision-making on corporate governance issues at portfolio companies.<sup>53</sup> In a January 2012 letter sent by Larry Fink, the Chairman and CEO of BlackRock, to 600 companies in BlackRock’s portfolio, BlackRock stated: “We reach our voting decisions independently of proxy advisory firms on the basis of guidelines that reflect our perspective as a fiduciary investor with responsibilities to protect the economic interests of our clients.”<sup>54</sup> In March 2014, BlackRock again took a stand, sending a letter to companies encouraging them to focus on “achieving sustainable returns over the longer term” rather than succumbing to demands for short-term results and return of capital.<sup>55</sup> Similarly, the chairman and chief executive officer of Vanguard clarified that the fund is interested in actively engaging on corporate governance issues: “[i]n the past, some have mistakenly assumed that our predominantly passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth.”<sup>56</sup> In addition, a number of leading institutional investors are building up their own capacities to assess the strategies and governance of the companies in their portfolios, and thus reducing their need to outsource corporate governance activism to ISS and activist hedge funds. Although the increasing assertiveness of large investment advisors may possibly provide some limitations on the outsized influence of proxy advisory firms, in general their positions on corporate governance matters tend to be quite similar, especially in the sense of empowering shareholders—rather than the board—to make major decisions regarding the destiny of the company. In any case, in the current corporate governance environment companies must remain cognizant of the positions of both major institutional shareholders and the proxy advisory firms and their likely reactions to corporate governance initiatives.

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<sup>51</sup> *Id.*

<sup>52</sup> See Wachtell, Lipton, Rosen & Katz, *Some Thoughts for Boards of Directors in 2015* (Dec. 1, 2014), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23672.14.pdf>.

<sup>53</sup> See Kristen Grind & Joann S. Lublin, *Vanguard and BlackRock Plan to Get More Assertive with Their Investments*, Wall St. J. (Mar. 4, 2015), <http://www.wsj.com/articles/vanguard-and-blackrock-plan-to-get-more-assertive-with-their-investments1425445200>.

<sup>54</sup> Letter from Larry Fink, BlackRock Chairman and CEO (Jan. 17, 2012), available at <http://www.blackrock.com/corporate/en-hk/literature/whitepaper/corporate-governance-engagement.pdf>.

<sup>55</sup> *Id.*

<sup>56</sup> See Grind & Lublin, *supra* note 46.

## 1. Voting Guidelines

Proxy advisory firms convey their recommendations through voting guidelines and position papers. Although these positions are generally described by the proxy advisors as “best practices” to create shareholder value, they are often grounded in an ideology that the discretion and judgment of the board must be limited, that relationships between boards and management must be curtailed and that restraints on shareholder decision-making in the company’s business are counterproductive. While proxy advisory guidelines, especially those published by ISS, historically have tended to provide a generalized recommendation for each type of proposal, the Recent updates to ISS policies on a number of issues represented a welcomed, measured, company-specific approach to corporate governance practices, reflecting a move, however limited, away from one-size-fits-all policies and recommendations. For ISS, the shift to a “case-by-case” approach was most apparent with respect to circumstances in which ISS would make “withhold” recommendations against the full board, committee members or individual directors.<sup>57</sup> Where a board does not adopt a majority-supported shareholder proposal, ISS will consider whether to make a “withhold” recommendation on a case-by-case basis, considering mitigating factors in cases involving less than full implementation, disclosed shareholder outreach efforts by the board in the wake of the vote, the level of support and opposition for the proposal, actions taken and the continuation of the underlying issue as a voting item on the ballot.<sup>58</sup>

Despite these recent positive shifts towards a “case-by-case” approach, proxy advisory firms continue to articulate rigid, generalized views on various important and nuanced governance matters. Notably, in recent years, ISS and Glass Lewis have been advancing a shareholder-centric position that will potentially punish a board that amends the bylaws of a company without seeking shareholder approval even though boards have the authority to do so. Both proxy advisors warn that they may use the significant power of their withhold vote recommendations in response to a unilateral bylaw amendment that in their view materially diminishes or removes shareholders’ rights or that could adversely impact the rights of shareholders.<sup>59</sup> Additionally, ISS recently adapted its unilateral bylaw and charter amendment voting guidelines to apply to newly public companies. ISS will make adverse recommendations for directors at the first shareholder meeting of a newly listed public company if that company has bylaw or charter provisions that are “adverse to shareholder rights.” And, unless the adverse provision is reversed or submitted to a vote of public shareholders, ISS will vote case-by-case on director nominees in subsequent years. When updating bylaws, companies should consider explaining the board’s rationale for the bylaws via appropriate disclosure in order to ensure that proxy advisory firms and shareholders understand why particular changes are deemed appropriate and to facilitate discussion with investors.

Even when applying a “case-by-case” approach, proxy advisory firm methodologies tend towards “scoreboards,” checklists, formulae and tabulations and cannot by their nature do justice to the complexities of corporate governance at individual companies. For example, ISS’ “Equity Plan Scorecard” bases recommendations with respect to equity plan proposals on a combination

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<sup>57</sup> See, e.g., ISS, *U.S. Corporate Governance Policy, 2014 Updates* 4-5 (2013); ISS, *2016 Americas Proxy Voting Guidelines Updates* 5-6 (2015).

<sup>58</sup> ISS, *2016 U.S. Concise Voting Guidelines* 5 (2015).

<sup>59</sup> See ISS, *2016 U.S. Summary Proxy Voting Guidelines* 13-14; Glass Lewis, *Proxy Paper Guidelines, 2015 Proxy Season* 14.

of weighted factors with relative weights varying by index.<sup>60</sup> While this more nuanced approach is preferable to the more rigid test it replaced, any evaluations using scorecards run the risk of becoming mechanical and do not permit the appropriate exercise of judgment and flexibility to consider the situation of each particular company in this complex area.

Gradual shifts away from the one-size-fits-all approach to the “case-by-case” or “holistic” approaches in proxy firm recommendation is a welcome admission by proxy advisors that generalized advice does not serve the best interests of companies. Yet, these shifts fall short of stemming the tide of ideological generalizations advanced by proxy advisory firms and shareholder rights activists that have eroded the governance provisions that have facilitated long-term growth at many companies. Nominating and corporate governance committees should be cognizant of the views of proxy advisory firms, but must exercise their own judgment when confronted with corporate governance matters and resist the temptation to passively defer to the judgment of proxy advisory services.

## 2. QuickScore

One feature of the corporate governance landscape that members of nominating and corporate governance committees need to be aware of is the governance grades or ratings generated by certain members of the governance industry. The most prominent of these is the Governance QuickScore product produced by ISS (and another is GMI Ratings). Starting in the 2013 proxy season, ISS replaced its former corporate governance scoring system, Governance Risk Indicators (“GRIDs”), with Governance QuickScore.<sup>61</sup> In October 2014, ISS announced its third iteration of the QuickScore product: QuickScore 3.0. QuickScore uses an algorithm to score companies on four “pillars”—Audit, Board Structure, Compensation and Shareholder Rights—and to provide an overall governance rating. QuickScore incorporates a number of factors that affect scoring, namely, director tenure, director approval rates, compensation of outside directors, alignment on pay and total shareholder return and say-on-pay support. QuickScore 3.0 has added new factors, including whether the board has failed to address issues underlying majority director withhold votes and whether the board recently took actions that in ISS’s view materially reduce shareholder rights.<sup>62</sup> QuickScore reports also include numerous informational factors that do not affect scoring. These include: board size; percentage of board members who are immediate family members of majority shareholders, executives and former executive or former or current employees; and the length of the employment agreement with the CEO. Certain factors that were informational in QuickScore 2.0 contribute to scoring cards under QuickScore 3.0. These include board-level gender diversity and number of financial experts on the audit committee.<sup>63</sup>

Scores are presented on a 1 to 10 scale and rely upon “decile” comparisons of a company’s raw scores against those of others in the same index or region. Through this ranking, ISS

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<sup>60</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 43.

<sup>61</sup> ISS, *ISS Governance QuickScore 2.0, Overview and Updates* (Jan. 2014), available at <http://issgovernance.com/files/ISSGovernanceQuickScore2.0.pdf>.

<sup>62</sup> For a review of changes presented by QuickScore 3.0, see Wachtell, Lipton, Rosen & Katz, *ISS QuickScore 3.0* (Oct. 24, 2014), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23593.14.pdf>.

<sup>63</sup> ISS, *ISS Governance QuickScore 3.0, Overview and Updates* (Rev. May 2015), available at [http://www.issgovernance.com/file/products/quickscore\\_techdoc.pdf](http://www.issgovernance.com/file/products/quickscore_techdoc.pdf).

aims to “provide an at-a-glance view of each company’s governance risk.”<sup>64</sup> ISS asserts that QuickScore is an improvement from GRId because QuickScore is quantitatively-driven by correlations between governance factors and financial metrics, with a secondary policy-based overlay.<sup>65</sup> However, the specific weightings and balancing between quantitative and qualitative factors remain undisclosed. Consequently, the soundness of these purported correlations cannot be tested, and companies are not able to calculate scores on their own.

We remain very skeptical of the notion that a board’s effectiveness can be quantified and correlated to one-size-fits-all best practices. But even leaving aside the dubiousness of these correlations, QuickScore is problematic in a number of respects. Ranking companies can be misleading and counterproductive, as half of all companies, by definition, will be below the median. Given the success of best-practices advocates in imposing uniformity of corporate governance structures, it is likely that minor differences will separate the deciles, particularly in the Board Structure and Shareholder Rights areas. As a result, many companies with no serious governance concerns face the unwarranted taint of a below-average score.

Because of ISS’s outsized influence, nominating and corporate governance committees cannot disregard QuickScore, whatever its shortcomings. However, while directors should understand the QuickScore implications of different governance structures, they must also remember that a high score should not be an end in itself. Rather, directors have a fiduciary duty to exercise their informed business judgment to adopt the policies they believe will best serve their company. No single metric or bundle of metrics can substitute for the informed business judgment of a well-advised board as to what is necessary and appropriate in dynamic, real-world circumstances.

### **3. Shareholder Activism**

Shareholder activism is currently running at unprecedented levels, with close to \$300 billion in activist funds<sup>66</sup> and, according to recent data, 596 activist campaigns in 2015, representing a 22 percent increase over 2014.<sup>67</sup> Shareholder activism can be broadly separated into two categories. The first is corporate governance-related activism, which focuses on issues like board structure, executive compensation, takeover defenses and social concerns. The second is economically motivated activism, which seeks to alter the strategic direction of the company—typically with the intent of causing a near-term event, such as prompting a sale of part or all of the company or the return of capital to shareholders. To achieve such a change, economic activists will often advocate for the replacement of directors or senior managers, both as leverage to settle proxy contests in favor of their economic agendas and as a strategy to influence board decisions through board representation after a proxy fight is completed.<sup>68</sup> Between 2012 and 2015,

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<sup>64</sup> *Id.* at 3.

<sup>65</sup> ISS, *ISS Governance QuickScore 2.0, Overview and Updates* 3 (Jan. 2014).

<sup>66</sup> Includes reported equity assets under management of activists included in the FactSet “SharkWatch50,” as of January 6, 2016.

<sup>67</sup> SharkRepellent. Including governance-based campaigns and 13D filings but excluding activism against fund companies, there were 400, 488 and 596 campaigns in 2013, 2014 and 2015 respectively.

<sup>68</sup> For example, a member of Third Point LLC’s slate at the Yahoo! 2012 annual meeting was elected to the company’s board of directors only to resign a little more than a year later, shortly after the conclusion of Yahoo!’s repurchase of Third Point’s stake, a transaction in which Third Point make a significant profit and which has been characterized by industry commentators as “greenmail” and “insider trading.” See Steven Davidoff Solomon, *Yahoo’s*

high-profile activists pursued 289 campaigns for board seats and successfully gained at least one board seat 78 percent of the time. Of these 127 successful campaigns, only 16 percent went to a vote. Settlements were reached 84 percent of the time.<sup>69</sup>

Over the last few years, companies have been under increased pressure from activist investors to return supposedly excess capital to shareholders, put into place new capital allocation plans, sell or spin-off assets, increase merger consideration, replace managers or directors and reform compensation structures, among other actions. However, whether this pressure will continue will likely be, to a certain extent, driven by macroeconomic market trends. Further, some large institutional investors have explicitly rebuffed any activist investment strategies and tactics.<sup>70</sup> The 2015 activism trends included contesting pending transactions, pressuring companies to merge (after building stakes in both as part of the campaign), and lobbying for break-ups and divestitures. In 2015, activists also continued to attack companies that not long ago were considered too large or profitable to be susceptible to economic activism. In 2010, the number of large cap companies, with market capitalization greater than \$10 billion, targeted by activists was 17; this number rose to 21 in 2014 and 25 in 2015.<sup>71</sup> In 2015, 25 large cap companies,<sup>72</sup> and 11 mega-cap companies, with capitalizations greater than \$25 billion,<sup>73</sup> were targeted by activists. Even household-name companies with strong corporate governance and financial performance now find themselves under siege from shareholder activists, often represented by well-regarded advisors.

Activists have grown not only more ambitious in their objectives, but also more sophisticated in their tactics. The unprecedented partnership between activist hedge fund Pershing Square and Valeant Pharmaceuticals is one such example. The two parties formed a joint bidding entity and quietly amassed a 9.7 percent “beachhead” investment in Allergan, Inc. stock and options and publicly disclosed their interest on the same day that Valeant launched a \$45 billion unsolicited bid for Allergan. Although the bid was ultimately unsuccessful, the parties made a sizeable profit when Allergan struck a much higher deal with Actavis plc. Pershing Square will reap a profit of \$2.6 billion and Valeant will receive 15 percent of that, or about \$389 million, from the transaction<sup>74</sup> (subject to pending litigation alleging that these profits were derived from

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*Share Buyback is Legal, but Timing is Suspect*, N.Y. Times DealBook (Jul. 23, 2013), available at [http://dealbook.nytimes.com/2013/07/23/yahoos-share-buyback-is-legal-but-timing-is-suspect/?\\_r=0](http://dealbook.nytimes.com/2013/07/23/yahoos-share-buyback-is-legal-but-timing-is-suspect/?_r=0).

<sup>69</sup> Includes activist campaigns by activists included in FactSet’s “SharkWatch50” list that were announced between 2012 and 2015 and that targeted companies with an equity market cap of more than \$500 million.

<sup>70</sup> Letter from Warren E. Buffet to the Shareholders of Berkshire Hathaway Inc. (Feb. 27, 2016) (“Berkshire, however, will join only with partners making friendly acquisitions. To be sure, certain hostile offers are justified: Some CEOs forget that it is shareholders for whom they should be working, while other managers are woefully inept. . . . We, though, will leave these “opportunities” for others. At Berkshire, we go only where we are welcome.”).

<sup>71</sup> SharkRepellent; Matteo Tonello, *The Activism of Carl Icahn and Bill Ackman*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (May 29, 2014), <http://blogs.law.harvard.edu/corpgov/2014/05/29/the-activism-of-carl-icahn-and-bill-ackman/>.

<sup>72</sup> SharkRepellent.

<sup>73</sup> J.P. Morgan, *The Activist Revolution: Understanding and Navigating a New World of Heightened Investor Scrutiny* (Jan. 2015), available at [https://www.jpmorgan.com/cm/BlobServer/JPMorgan\\_CorporateFinanceAdvisory\\_MA\\_TheActivistRevolution.pdf?blobkey=id&blobwhere=1320667794669&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs](https://www.jpmorgan.com/cm/BlobServer/JPMorgan_CorporateFinanceAdvisory_MA_TheActivistRevolution.pdf?blobkey=id&blobwhere=1320667794669&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs).

<sup>74</sup> See David Gelles, *Allergan Escapes Valeant’s Pursuit, Agreeing to Be Bought by Actavis*, N.Y. Times DealBook (Nov. 17, 2014), [http://dealbook.nytimes.com/2014/11/17/allergan-agrees-to-be-sold-to-actavis/?\\_r=0](http://dealbook.nytimes.com/2014/11/17/allergan-agrees-to-be-sold-to-actavis/?_r=0).

illegal insider trading).<sup>75</sup> Although not to the same degree, in 2015, Pershing Square teamed up with a strategic acquiror—Canadian Pacific Railway—once again in Canadian Pacific’s unsolicited takeover bid for Norfolk Southern.<sup>76</sup> It remains to be seen whether we can expect to see more activist hedge funds and strategic corporate acquirors teaming up for hostile takeover bids in the future. Activists commonly use the two types of activism in tandem. Corporate governance changes serve as leverage to force economic or strategic changes, and a battle with economic activism may leave a company more vulnerable to corporate governance activism. Additionally, economic activists often cloak themselves with a corporate governance platform in hopes of gaining the support of proxy advisory services and institutional investors. Sections IV and V discuss two of activists’ most important tools, the shareholder proposal and the proxy fight, in greater detail.

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<sup>75</sup> See *Allergan, Inc. v. Valeant Pharmaceuticals Int’l, Inc.*, 2014 WL 5604539 (C.D. Cal. Nov. 4, 2014).

<sup>76</sup> See Svea Herbst-Bayliss, *Ackman Plays Big Role in Laying Out Canadian Pacific Rail Deal*, REUTERS CANADA, Dec. 8, 2015, <http://ca.reuters.com/article/businessNews/idCAKBN0TR2QN20151208>.

### III. Key Corporate Governance Topics

Whether periodically reviewing corporate governance policies or considering the appropriate response to a particular shareholder proposal, a nominating and corporate governance committee will benefit from a solid understanding of the fundamental building blocks of corporate governance and an ongoing effort to keep apprised of legal, economic and social changes that steer the ever-evolving thinking on corporate governance matters. By better appreciating the considerations underlying a decision to adopt—or not—a particular corporate governance feature, a nominating and corporate governance committee will be better equipped to develop and defend sound, cohesive and comprehensive corporate governance policies and procedures that enable directors and management to best perform their duties, do not unduly dampen or encourage risk taking, promote long-term value creation and are conducive to good corporate citizenship and social responsibility.

#### A. Classified Boards

Under a classified board, directors are divided into classes, typically three, with only one class up for election at each annual meeting. Thus, directors on a classified board are essentially elected to three-year terms. In addition to promoting board stability and enabling directors to think on a longer timeframe, a classified board provides an important structural defense against hostile takeovers. Whereas a hostile acquiror can seize control of a company without a classified board in one successful proxy contest, obtaining a majority of a classified board typically requires two elections.

Classified boards attract particularly great scrutiny due to the convergence of the interests of governance activists and economic activists: governance activists see classified boards as a barrier to board responsiveness, while economic activists see them as an impediment to forcing a sale or other short-term event. The percentage of S&P 500 companies with a staggered board has plummeted from over 60 percent to 10 percent in the past 12 years.<sup>77</sup> In recent years, Harvard Law School's "Shareholder Rights Project" has led the charge for declassification.<sup>78</sup> Now in its fifth year, the Shareholder Rights Project reportedly works with several large pension funds and a foundation to sponsor governance proposals at companies whose shares are owned by the funds and the foundation.<sup>79</sup> Although shareholder activists see board declassification as "improving" governance arrangements, there is no persuasive evidence that declassifying boards enhances shareholder value over the long term, and the absence of a staggered board makes it more difficult for a public company to fend off an inadequate, opportunistic takeover bid or to focus on long-term value creation. Supporting this proposition, a study by Citigroup Global Markets found that between 2001 and 2009 initial takeover bids were 28.7 percent higher for firms with a

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<sup>77</sup> SharkRepellent.

<sup>78</sup> Our firm has criticized this "clinical program" headed by Professor Lucian Bebchuk for engaging in advocacy advancing a narrow and controversial agenda that would exacerbate the short-term pressures under which U.S. companies are forced to operate, rather than more appropriate academic activity. See Wachtell, Lipton, Rosen & Katz, *Harvard's Shareholder Rights Project is Wrong* (Mar. 21, 2012), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.21664.12.pdf>; Wachtell, Lipton, Rosen & Katz, *Harvard's Shareholder Rights Project is Still Wrong* (Nov. 28, 2012), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.22209.12.pdf>.

<sup>79</sup> See Shareholder Rights Project, available at <http://srp.law.harvard.edu/index.shtml>.

staggered board in place and that staggered boards contributed an additional 13.5 percent in premium in subsequent negotiations, resulting in an aggregate 42.2 percent increase in takeover premiums.

In late 2015, Airgas, which had successfully resisted an opportunistic hostile takeover bid from Air Products about six years earlier, agreed to be sold to Air Liquide for more than double the final Air Products offer, even before considering substantial dividends paid in the intervening years, vindicating the Airgas board's judgment. Airgas would not have been able to defend itself without a classified board, which would have cost its shareholders billions of dollars in upside value.<sup>80</sup> Moreover, companies should be cautious of implementing changes—such as declassifying the board—that cannot be easily reversed. Unlike a rights plan, which the board can implement quickly as the need arises, a declassified board is a defense that once removed cannot be reinstated when a takeover threat materializes.

## **B. Majority Voting**

The corporate law of most states, including Delaware, provides that directors are to be elected by plurality voting unless otherwise provided in the company's certificate of incorporation or bylaws.<sup>81</sup> Under this default, if the nominees endorsed in the company's proxy statement run unopposed, they are assured of election regardless of the number of votes “against” or “withheld.” Under a majority voting standard, however, a director is not elected unless he or she receives at least a majority of the votes cast.

Historically, directors of virtually all companies were elected under a plurality standard. Beginning in 2004, activists began calling for majority voting, under which a nominee is elected only if the votes for his or her election exceed the votes against. Some form of majority voting is now used by almost 88 percent of S&P 500 companies and is well on its way to becoming universal among large companies.<sup>82</sup> ISS and Glass Lewis advise shareholders to generally vote to adopt the majority vote standard.<sup>83</sup>

Under state laws designed to ensure that there are always directors in place, a director who receives less than a majority of the votes cast in a majority voting election would not be elected but would continue to serve until his or her successor is elected and qualified. Many companies with majority voting address the matter of holdover directors by establishing a resignation policy for directors receiving less than a majority vote. In some cases, these policies call for directors to deliver resignation letters in advance, which are triggered automatically if a director receives less than a majority vote (thereby avoiding compelling a sitting director to tender

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<sup>80</sup> See Leo E. Strine, Jr., *Can We Do Better by Ordinary Shareholders? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 Colum. L. Rev. 449, 454 n.16 (2014) (“As it turns out, they were right and, within a few months, the stock was trading well above Air Products’ final bid of \$70.00 and has continued to trade above that threshold ever since.”). On November 18, 2015, Airgas agreed to be sold to Air Liquide at a price of \$143 per share, in cash, nearly 2.4 times Air Products’ original \$60 offer and more than double its final \$70 offer, in each case before considering the more than \$9 per share of dividends received by Airgas shareholders in the intervening years.

<sup>81</sup> See, e.g., 8 Del. C. § 215(c)(3).

<sup>82</sup> SharkRepellent.

<sup>83</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 22; Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 21-22.

a resignation after failing to receive the requisite vote). An example of such a resignation policy is attached as Annex B. The unconflicted members of the board (or perhaps of the nominating and corporate governance committee) would then deliberate over whether or not to accept the director's resignation. Delaware courts have confirmed that a board of directors is not required to accept the resignation of a director for failure to obtain majority support.<sup>84</sup> However, nominating and corporate governance committee members should understand that shareholders likely would not appreciate having a director they had rejected reinstated, absent special circumstances. (Indeed, activists have coined a colorful but unflattering description of such holdover directors, who are sometimes called "zombie directors.") Further, on October 27, 2015, Pfizer Inc. received a shareholder proposal that would require immediate removal of directors who failed to receive a majority vote in uncontested elections, perhaps foreshadowing future activist efforts to tighten majority voting standards even further.<sup>85</sup>

A company that adopts majority voting should draft its bylaws carefully (so that abstentions do not count as votes "against" the incumbent director) and to provide where possible that once the determination is made that an election is "contested," the plurality standard remains in place even if there is no competing slate at the time of the shareholders' meeting. The perils of not doing so were demonstrated in a proxy contest a few years ago, in which a dissident dropped its proxy contest and contended that the vote standard therefore reverted to majority, enabling a "withhold" vote campaign intended to result in the failure of directors to be elected.<sup>86</sup>

### **C. Shareholder Rights Plans**

A shareholder rights plan, popularly known as a "poison pill," is a mechanism that can be employed by board action that, while in place, effectively deters individuals or groups from acquiring more than a specified percentage of the company's stock. Rights plans do not interfere with negotiated transactions and do not preclude unsolicited takeover offers. Instead, they combat abusive takeover tactics by preventing an acquiror from gaining a controlling stake in a company without negotiating with the company's board to provide an adequate bid. Also, if a tender or exchange offer is launched, the rights plan will give the board and the shareholders time to properly evaluate the bid and potentially to pursue more attractive options that might not otherwise be available under the time pressure of a tender offer. Despite these salutary effects, shareholder rights plans have been the subject of intense debate since they were first used in the 1980s. Critics contend that rights plans discourage deal activity and entrench boards by limiting shareholders' ability to approve the sale of the company.

Because a rights plan (especially when coupled with a staggered board) is the single most effective defense against a hostile takeover bid, until the last decade most large companies had standing rights plans in place, typically with 10-year terms. In response to sustained criticism from activists that rights plans discourage deal activity and entrench boards by limiting shareholders' ability to approve a sale, most companies have allowed their rights plans to expire, preferring to hold in reserve the ability to adopt a rights plan in response to a takeover bid if one is

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<sup>84</sup> *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 1 A.3d 281 (Del. 2010).

<sup>85</sup> *Pfizer Inc.*, SEC No-Action Letter (Dec. 4, 2015). The SEC denied Pfizer's request to exclude this proposal, submitted by Kenneth Steiner, on the basis of substantial implementation under Rule 14a-8(i)(10).

<sup>86</sup> *Levitt Corp. v. Office Depot, Inc.*, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008), available at [http://courts.delaware.gov/opinions/\(ylqy0cetmgti2puq2mu4homz\)/download.aspx?ID=105260](http://courts.delaware.gov/opinions/(ylqy0cetmgti2puq2mu4homz)/download.aspx?ID=105260).

made (referred to as having a rights plan “on the shelf”). Indeed, the percentage of S&P 500 companies with a rights plan in place has decreased from about 60 percent to less than five percent in the last 12 years.<sup>87</sup> Proxy advisory voting policies have been a major driving force behind this change. Even the proxy advisors acknowledge the significant beneficial effects of a rights plan in providing time for the board and shareholders to respond to an actual threat, such as an inadequate hostile takeover bid, but they view it as a short-term delaying device, not a “show-stopper.” ISS recommends an “against” or “withhold” vote for directors who adopt a rights plan with a term of more than 12 months or renew any existing rights plan (regardless of its term) without shareholder approval, although a commitment to put a newly adopted rights plan to a binding shareholder vote may offset such a recommendation.<sup>88</sup> ISS also recommends voting on a case-by-case basis for boards adopting a rights plan without shareholder approval.<sup>89</sup> ISS and Glass Lewis also generally recommend, with limited exceptions, voting “for” shareholder proposals requesting that a company submit its rights plan to a shareholder vote or adopt a policy regarding the use of rights plans.<sup>90</sup>

Under pressure from activists, some companies have agreed not to implement a rights plan absent shareholder approval or ratification within some period of time, most commonly one year. Activist institutional investors, such as TIAA-CREF, have sponsored precatory shareholder proposals to adopt a policy requiring that rights plans be submitted for shareholder approval. In part, due to proxy advisory voting guidelines, such proposals routinely garner wide support, even at companies that do not have a rights plan in place. For those companies that have not adopted a policy that restricts the board’s ability to adopt a rights plan, they retain the ability to maintain an “on-the-shelf” rights plan that can be adopted quickly by the board should a specific threat arise. Unlike some other takeover defenses that once removed cannot practically be regained, such as a staggered board, a “shadow” rights plan provides a company the flexibility to respond to changing circumstances. A board may therefore conclude that it would be prudent to avoid the scrutiny that accompanies adopting a rights plan by waiting until it is needed to fend off a particular threat. A board should be wary, however, of policies or situations that would curtail its ability to employ this crucial component of effective takeover defense.

#### **D. Advance Notice Bylaw**

The advance notice bylaw is an important corporate housekeeping tool with the primary purpose of helping ensure orderly business at shareholder meetings. It requires a shareholder to submit “advance notice” of his or her intention to introduce business at a shareholder meeting, such as the nomination of director candidates or the introduction of a shareholder proposal. An advance notice bylaw serves three significant functions: first, to inform a company of shareholder business to be brought at the meeting an adequate time in advance of the meeting; second, to provide an opportunity for all shareholders to be fully informed of such matters an adequate time in advance of the meeting; and third, to enable a company’s board to make informed recommendations or present alternatives to shareholders regarding such matters. As a result, such advance notice bylaws typically require not only notice of shareholder business but also the in-

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<sup>87</sup> SharkRepellent.

<sup>88</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 12.

<sup>89</sup> *Id.*

<sup>90</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 26; Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 36.

formation necessary to determine that a shareholder-nominated director candidate is qualified to be elected, as well as other important information, such as records demonstrating that the person introducing business is actually a shareholder of the company. A common formulation of the timeframe in which proposals or nominations must be submitted is no later than 90 days and no earlier than 120 days prior to the anniversary of the prior year's annual meeting. However, some companies provide for different windows. For example, a number of companies have reconciled their advance notice bylaw with the SEC's timing requirements for Rule 14a-8 proposals (described in Section IV.A), which call for any proposal to be submitted at least 120 calendar days before the date on which the company released its proxy statement for the previous year's meeting.

Although the validity of advance notice bylaws has been established in many court decisions, such provisions are not immune to legal challenge. In 2012, for example, the Delaware Court of Chancery granted a motion to expedite a claim brought by Carl Icahn alleging that the board of Amylin Pharmaceuticals had breached its fiduciary duties by enforcing the company's advance notice bylaw provision and refusing to grant Mr. Icahn a waiver so he could make a nomination after the advance notice deadline and following the company's rejection of a third-party proposal.<sup>91</sup> In December 2014, however, the Delaware Court of Chancery alleviated some of the concerns raised by that decision, clarifying that in order to enjoin enforcement of an advance notice provision, a plaintiff would have to allege "compelling facts" (such as the board taking an action that resulted in a "radical" change between the advance notice deadline and the annual meeting) indicating that enforcement of the advance notice provision was inequitable.<sup>92</sup> In other recent cases in Delaware, judges have ruled in favor of activist shareholders based on ambiguities in the companies' advance notice bylaw provisions.<sup>93</sup> These decisions provided a sobering reminder of the importance of the advance notice bylaw as well as the need for clear and careful drafting. As a result of decisions such as these, advance notice bylaws continue to evolve. A model advance notice bylaw is attached as Annex C.

## **E. Separation of Chairman and CEO Roles**

As in many other areas of corporate governance, the prevalence of the same individual serving as both Chairman and CEO has seen a dramatic change in the last decade. A recent survey found that 48 percent of S&P 500 boards now separate the Chairman and CEO roles, compared with 37 percent in 2009 and only 23 percent 12 years ago.<sup>94</sup> This trend has been driven in large part by corporate governance activists who consider separation of the roles to be "best practice." In this vein, a survey of companies that had recently separated their Chairman and CEO roles found that 43 percent of respondents considered that separation of the roles represents

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<sup>91</sup> *Icahn Partners LP v. Amylin Pharmaceuticals, Inc.*, 2012 WL 1526814 (Del. Ch. Apr. 20, 2012).

<sup>92</sup> *AB Value Partners, LP v. Kreisler Mfg. Corp.*, 2014 WL 7150465, at \*5 (Del. Ch. Dec. 16, 2014).

<sup>93</sup> *Jana Master Fund, Ltd. v. CNet Networks, Inc.*, 954 A.2d 335 (Del. Ch. 2008), *aff'd*, 947 A.2d 1120 (Del. 2008); *Levitt Corp. v. Office Depot, Inc.*, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008); *Sherwood v. Chan Tsz Ngon*, 2011 WL 6355209 (Del. Ch. Dec. 20, 2011).

<sup>94</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 20, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>; Spencer Stuart, *Spencer Stuart Board Index 2014*, at 23, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2014>.

the best governance model.<sup>95</sup> Much more important than the form of board structure, however, is whether it works in practice for a particular company.

The traditional model of a combined Chairman and CEO generally offers a number of advantages. The CEO's thorough familiarity with the company, expertise in the industry and leadership skills may uniquely position him or her to have the credibility with constituencies that is essential to effectively chair the board. The CEO's leadership as Chairman may also help avoid the balkanization that may arise if directors split between those aligning with the CEO and those aligning with the Chairman. Further, combining the roles of CEO and Chairman avoids confusion over the scope of the Chairman's and CEO's respective responsibilities, thus potentially enhancing CEO accountability. A CEO's service as Chairman may also foster effective communication between management and the board.

Advocates for the separation of the Chairman and CEO positions typically contend that separation strengthens the board's independence and ability to oversee and evaluate management—and the CEO in particular—by reducing the CEO's control over the board agenda. Another common rationale is that separating the roles will allow for greater focus and an effective division of labor, with the CEO concentrating on running the company's business and the Chairman on leading the board. However, the validity of these arguments will vary depending on a company's specific circumstances and the dynamic of its leadership structure. Although the SEC requires a company to disclose its board leadership structure and, if the CEO and Chairman roles are combined, whether the company has a lead independent director and his or her specific role,<sup>96</sup> it should be noted that these are simply disclosure requirements—they are not a mandate for separation of the CEO and Chairman roles, and they are not an endorsement by the SEC of activists' view that separation of the roles is in all cases a “best practice.”

A company choosing to separate the Chairman and CEO positions should ensure that the respective roles of the two positions are clearly delineated to avoid duplication or neglect of certain responsibilities or damage to the cohesion of the board. Because of the risks to board cohesion from separating the positions if they are currently held by the same person, succession is the most common way for a Chairman/CEO split to come about. A recent survey found that nearly half of all companies facing a succession event choose to change their board leadership structure.<sup>97</sup> Similarly, nearly half of companies that had a combined Chairman/CEO in 2013 considered separating the positions upon their next CEO succession.<sup>98</sup> And 19 percent said that they expect that the board will split the roles within the next five years.<sup>99</sup> A split may be desirable if the incoming CEO is less familiar with the board and the company than was his or her predecessor. It is not uncommon for companies that separate the Chairman and CEO role during a CEO

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<sup>95</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 20, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>96</sup> Item 407(h) of Regulation S-K. 17 C.F.R. 229.407(h).

<sup>97</sup> Korn Ferry Institute and National Association of Corporate Directors, *Annual Survey of Board Leadership 2014 Edition* 18-19, available at <http://www.kornferryinstitute.com/reports-insights/korn-ferry-nacd-annual-survey-board-leadership-2014>.

<sup>98</sup> PricewaterhouseCoopers, *Boards Confront an Evolving Landscape: PwC's Annual Corporate Directors Survey* 8 (2013), <https://www.pwc.ie/media-centre/assets/publications/2014-pwc-ireland-annual-corporate-directors-survey-full-report.pdf>.

<sup>99</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 20, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

transitional period to later recombine the roles once the CEO has gained experience with the company. Some companies that separated the role of Chairman and CEO found the separation suboptimal and so later recombined the positions.<sup>100</sup>

A company with a combined Chairman and CEO should have a lead director (also sometimes called a presiding director). From a board-effectiveness perspective, it is not necessary to separate the roles of Chairman and CEO so long as there is an effective lead director in place. As one position paper succinctly put it, after a review of the academic literature, “[n]o structural attribute of boards has ever been linked consistently to company financial performance.”<sup>101</sup> Indeed, a combined CEO and Chairman teamed with a capable independent lead director may enable the board to enjoy the benefits of both the CEO’s expertise and a strong independent voice.

All but eight boards of S&P 500 companies have either an independent Chairman or an independent lead/presiding director.<sup>102</sup> The full board selects the lead/presiding director according to 71 percent of respondents from S&P 500 companies recently surveyed, while 14 percent of respondents said that a lead/presiding director is selected by the nominating and corporate governance committee and another 12 percent said that independent directors select the lead/presiding director.<sup>103</sup> The responsibilities of a lead director should be clearly delineated and will include many of the responsibilities assumed by an independent Chairman. The traditional responsibilities of the lead director include presiding at and having the authority to call executive sessions, setting meeting agendas for executive sessions, and being available for consultation and direct communication with major shareholders where appropriate. In recent years, there has been an increasing focus on the role of the lead director, which has in many cases expanded to include leading the board’s annual self-assessment process, cooperating with the CEO in setting the agenda for full board meetings and sometimes also approving materials for full board meetings. The lead director’s role should be tailored to the company’s needs, which depend on a number of factors, such as the company’s history and the personalities of those serving on the board.

While the nominating and corporate governance committee should make an independent judgment as to the appropriate leadership structure, it should remain mindful of the powerful influence of proxy advisory firms. Glass Lewis will typically encourage support of proposals to separate the roles of Chairman and CEO on the grounds that a CEO as Chairman makes it difficult for a board to fulfill its role as overseer and policy setter.<sup>104</sup> ISS will generally recommend a vote in favor of a shareholder proposal to require that the Chairman’s position be filled by an independent director, taking into consideration various factors, such as the scope of the proposal, the company’s current board leadership structure, governance structure and practices and com-

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<sup>100</sup> Examples include Dell Inc., Walt Disney Corp., General Motors and Southwest Airlines. See Korn Ferry International and National Association of Corporate Directors, *Annual Survey of Board Leadership 2013 Edition* 30, available at <http://www.kornferryinstitute.com/reports-insights/kornferry-nacd-annual-survey-board-leadership-2013>.

<sup>101</sup> Richard Leblanc & Katharina Pick, The Conference Board, *Director Notes, Separation of Chair and CEO Roles* 3 (Aug. 2011).

<sup>102</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 23, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>103</sup> *Id.* at 24.

<sup>104</sup> Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 6.

pany performance.<sup>105</sup> ISS has conceded, however, that “attempts to correlate the separation of position with market performance have been inconclusive.”<sup>106</sup>

## **F. Ability of Shareholders to Act by Written Consent**

Under Delaware law, unless a corporation’s charter provides otherwise, any action that may be taken by shareholders at a meeting may instead be taken by written consent at the same approval threshold as would be required to take such action at a meeting of shareholders.<sup>107</sup> Over 70 percent of S&P 500 companies have charter provisions prohibiting action by written consent, while other companies permit action by written consent only if unanimous (which, for broadly held public companies, is effectively equivalent to a prohibition).<sup>108</sup>

Permitting shareholder action by written consent is considered by some institutional and activist groups an important shareholder right. Having largely achieved their initial goals of eliminating standing shareholder rights plans and classified boards, and facilitating shareholder-called special meetings in between annual meetings (at ever decreasing thresholds), action by written consent is one of the next targets of the activist groups. Because the prohibition on action by written consent must be included in the charter (in Delaware at least), shareholder activists are proposing an increasing number of precatory resolutions calling on the board to permit such action. Institutional investors often support these proposals and ISS will generally support them as well unless the company allows special meetings to be called by 10 percent of their shareholders, a majority vote standard in uncontested elections, no non-shareholder-approved poison pill and an annually elected board. Companies generally resist these proposals, pointing out that action by written consent is more appropriate for a closely held corporation with a small number of shareholders than for a widely held public company. Action by shareholder meeting provides many benefits not available in a written consent context, including: the meeting and the shareholder vote taking place in a transparent manner on a specified date that is publicly announced well in advance, giving all interested shareholders a chance to express their views and cast their votes; a forum for open discussion and full consideration of the proposed action; distribution in advance of detailed information by both sides about the proposed action; and the ability of the board to analyze and provide a recommendation with respect to proposed actions to be taken. Action by written consent, on the other hand, effectively disenfranchises all of those shareholders who do not have the opportunity to participate in the consent.

The only “benefit” to public company shareholders of action by written consent (if one considers it a benefit) is that a company that does allow such action is particularly vulnerable to a hostile takeover bid. A raider’s ability to conduct a consent solicitation and effectively “ambush” a target with little or no warning may limit a target company’s ability to mount an effective defense. Naturally, the smaller the market capitalization of the company, the greater the threat becomes.

Unfortunately for companies today, it is unlikely that shareholders would support a charter amendment to prohibit action by written consent, and many companies are being pressured by

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<sup>105</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 20-21.

<sup>106</sup> ISS, *2015 U.S. Proxy Voting Manual* 52.

<sup>107</sup> 8 Del. C. § 228(a).

<sup>108</sup> SharkRepellent.

their shareholders and the proxy advisors to give up that protection if they have it. A company that under its charter permits shareholders to act by written consent may limit its vulnerability by adopting a bylaw that enables the board to control the setting of the record date for a shareholder's solicitation of written consents.<sup>109</sup> The form of bylaw adopted generally adheres to the standards that have been upheld by the Delaware Court of Chancery, sometimes referred to as the "10 + 10" bylaw, which requires the board to take action to set a record date for the written consent solicitation within 10 days of receiving notice from a shareholder seeking to solicit consents, and requiring the board to then set a record date within 10 days of taking action. This means that the record date for the consent solicitation cannot be more than 20 days after the shareholder requests that the board set a record date, effectively giving the board a three-week "heads-up" before a hostile party can solicit consents.<sup>110</sup> Some companies that permit action by written consent impose an ownership threshold requirement to request action by written consent (ranging from 10 to 40 percent, with 20 to 25 percent being fairly common) and require a delay "before consents can be delivered (*e.g.*, 50 or 60 days) to ensure that shareholders have sufficient time to consider the matters subject to the consent."<sup>111</sup> To best position itself in the event that this approach is challenged, a company adopting such a bylaw should build as strong a record as possible as to why the restriction is necessary and appropriate.

### **G. Ability of Shareholders to Call a Special Meeting**

The right to call special meetings in between annual meetings is another activist investor hot button. From the company's perspective, it is better to have a predictable window of vulnerability around the annual meeting. The right to call special meetings—particularly when combined with a declassified board—has the potential to seriously inhibit the ability of a board to defend against an opportunistic takeover bid that undervalues the company. On the other hand, shareholder rights activists consider the right to call special meetings an important element of "shareholder democracy," because if shareholders are permitted to call a special meeting, they do not have to wait for an annual meeting to seek to effect change, but instead can act throughout the year, including to submit shareholder proposals or seek removal of directors. In our view, there is no reason to consider "California-style" recall elections a better model of democracy than the traditional republican model, in which voters elect representatives periodically, entrust them to do the job and can remove them from office at the end of their term if they are dissatisfied. However, activist pressure (powered by shareholder resolutions and ISS withhold recommendations) is extremely hard to resist.

Under activist pressure, over 60 percent of S&P 500 companies now permit shareholders to call special meetings in between annual meetings.<sup>112</sup> Among the companies that permit shareholders to call special meetings, there is variation with respect to the minimum threshold required to call a special meeting. Many shareholder rights activists consider 10 percent the gold standard and will initiate shareholder proposals even at companies that already permit shareholders to call special meetings at a higher percentage.

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<sup>109</sup> *Edelman v. Authorized Distrib. Network, Inc.*, 1989 WL 133625 (Del. Ch. Nov. 3, 1989); *see also Nomad Acquisition Corp. v. Damon Corp.*, 1988 WL 383667 (Del. Ch. Sept. 16, 1988).

<sup>110</sup> *Edelman v. Ackerman*, C.A. No. 11104 (Del. Ch. Nov. 3, 1989).

<sup>111</sup> Sullivan & Cromwell LLP, *2014 Proxy Season Review*, 9 (June 25, 2014).

<sup>112</sup> SharkRepellent.

## H. Removal of Directors

As a general rule, directors may be removed, with or without cause, by the holders of a majority of the shares entitled to vote.<sup>113</sup> As a notable exception, Delaware corporate law provides that, unless the charter provides otherwise, directors of a corporation with a classified board may be removed only for cause.<sup>114</sup>

Some companies' charters still have supermajority vote requirements to remove directors without cause. These supermajority provisions are generally disfavored by shareholder activists and other institutional investor groups. Supermajority vote requirements have themselves often been the subject of precatory proposals and tend to receive substantial shareholder support, leading to their elimination to avoid a withhold vote campaign under ISS's implementation policy. As the number of companies with classified boards and supermajority vote requirements decreases, directors become more vulnerable to removal at any time, and companies become more vulnerable to takeovers.

## I. Exclusive Forum Provisions in Organizational Documents

The increasing volume of duplicative, costly and often frivolous shareholder litigation brought simultaneously in multiple courts in multiple states has led many companies to adopt an "exclusive forum" provision. These provisions, which can be included either in a company's charter or bylaws, typically designate specific courts in the state of incorporation (Delaware for many public companies) to serve as the exclusive venues for particular types of shareholder and intracorporate litigation, most commonly (1) derivative lawsuits; (2) actions asserting breaches of fiduciary duty; (3) actions arising pursuant to any provision of the corporate statute of the state of jurisdiction (Delaware General Corporation Law for many public companies); and (4) actions asserting claims governed by the internal affairs doctrine. Such provisions serve multiple objective, including preventing the waste that inevitably occurs when duplicative lawsuits asserting the same claims on behalf of the same constituencies seeking the same relief are commenced at the same time by multiple shareholders in multiple courts and ensuring that fiduciary duty and internal affairs claims are adjudicated by the courts most familiar with the underlying corporate law and capable of authoritatively interpreting the law. These provisions also allow companies to better plan and manage the litigation landscape by imposing order and consistency before litigation begins.

Exclusive forum provisions contained in bylaws and adopted unilaterally by the board have been legally tested and upheld. Although a 2011 case in a California federal district court initially refused to enforce a company's board-adopted exclusive forum bylaw where it was put

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<sup>113</sup> Notably, in a recent transcript ruling, the Delaware Court of Chancery invalidated charter and bylaw provisions providing that directors of a company without a staggered board and cumulative voting could only be removed for cause. The stockholder plaintiffs argued—and the court agreed—that under § 141(k) of the Delaware General Corporation Law, stockholders have the right to remove directors without cause unless the company has a staggered board or cumulative voting. Companies with unclassified boards whose charters allow director removal only "for cause" should consult with counsel as these charter provisions may be unenforceable and plaintiffs' firms will be seeking to compel companies to amend their charters to eliminate them, in order to earn a fee. *In re Vaalco Energy S'holder Litig.*, C.A. No. 11775-VCL (Dec. 21, 2015).

<sup>114</sup> 8 Del. C. § 141(k)(1).

in place after alleged board-level malfeasance,<sup>115</sup> the Court of Chancery ultimately upheld forum selection bylaws as a matter of Delaware law in an important June 2013 decision involving a bylaw adopted by Chevron,<sup>116</sup> and reaffirmed the validity of the bylaws in December of 2014, noting that such bylaws reflect a company's legitimate interest in rationalizing shareholder litigation.<sup>117</sup>

The number of companies adopting exclusive forum provisions has risen dramatically in recent years. Exclusive forum provisions in certificates of incorporation or corporate bylaws were first proposed in 2007<sup>118</sup> and began to be adopted more broadly in 2010, following mention of the provisions by the Delaware Court of Chancery as a possible solution to the multiforum duplicative litigation problem.<sup>119</sup> Before the *Chevron* opinion, approximately 250 publicly traded corporations had adopted an exclusive forum provision in some form; the overwhelming majority (approximately 175) in the form of a charter provision adopted in circumstances where public shareholder approval was not required (e.g., in connection with an IPO, a spin-off or bankruptcy reorganization). Since *Chevron*, over 575 public companies have adopted an exclusive forum provision, with the overwhelming majority—over 90 percent—in the form of a board-adopted bylaw.<sup>120</sup> In 2015, the Delaware General Assembly gave statutory backing to forum selection bylaws by adopting a new provision of the Delaware General Corporation Law, which allows a company, in its certificate of incorporation or bylaws, to provide that “any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State.”<sup>121</sup> Notably, the new provision also provides that a forum selection bylaw may not divest stockholders of the right to bring suit in Delaware, overturning prior Delaware case law.<sup>122</sup> Jurisdictions outside Delaware are increasingly enforcing forum selection bylaws that provide that shareholder litigation must be conducted in Delaware.<sup>123</sup> The Court of Chancery, however, has consistently stated that it is reluctant to grant an anti-suit injunction against proceedings in a sister jurisdiction to uphold these bylaws, and instead still requires litigation filed outside of the

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<sup>115</sup> *Galaviz v. Berg*, 763 F. Supp. 2d 1170 (N.D. Cal. 2011).

<sup>116</sup> *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

<sup>117</sup> *United Techs. Corp. v. Treppel*, 109 A.3d 553 (Del. Dec. 23, 2014).

<sup>118</sup> Theodore N. Mirvis, *Anywhere But Chancery*, *The M&A Journal* 17 (May 2007).

<sup>119</sup> *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 960-61 (Del. Ch. 2010).

<sup>120</sup> According to SharkRepellent, between June 25, 2013 and March 1, 2016, 577 public companies adopted exclusive forum bylaws. During the same period, ISS reports that 43 proposals to add an exclusive forum provision were passed by public companies. Consequently, approximately 92.5 percent of exclusive forum bylaw adoptions since *Chevron* were not put to a shareholder vote. As of March 1, 2016, 568 of the 577 companies adopting exclusive forum bylaws since *Chevron* still have the provision in effect under their current bylaws.

<sup>121</sup> 8 Del. C. § 211.

<sup>122</sup> Previously, the Court of Chancery had ruled that a company could validly adopt a bylaw providing that all litigation must be brought in its non-Delaware headquarters state. *City of Providence v. First Citizens BancShares, Inc.*, 99 A.2d 229 (Del. Ch. 2014).

<sup>123</sup> E.g., *In re CytRX Corp. S'holder Derivative Litig.*, No. CV-14-6414, 2015 WL 9871275 (C.D. Cal. Oct. 30, 2015); *Brewerton v. Oplink Commc'ns, Inc.*, No. RG14-750111 (Cal. Super. Ct. Dec. 14, 2014); *Groen v. Safeway, Inc.*, No. RG14-716651, 2014 WL 3405752 (Cal. Super. Ct. May 14, 2014); *Miller v. Beam, Inc.*, No. 2014 CH 00932, 2014 WL 2727089 (Ill. Ch. Ct. Mar. 5, 2014); *Genoud v. Edgen Grp., Inc.*, No. 625,244, 2014 WL 2782221 (La. Dist. Ct. Jan. 17, 2014); *Collins v. Santoro*, No. 154140/2014, 2014 WL 5872604 (N.Y. Sup. Ct. Nov. 10, 2014); *HEMG Inc. v. Aspen Univ.*, C.A. No. 650457/13, 2013 WL 5958388 (N.Y. Sup. Ct. Nov. 14, 2013); *North v. McNamara*, 47 F. Supp. 3d 635 (S.D. Ohio 2014); *Roberts v. TriQuint Semiconductor, Inc.*, 358 Or. 413, 415 (2015); see also *City of Providence v. First Citizens BancShares*, 99 A.3d 229 (Del. Ch. 2014) (enforcing a North Carolina forum-selection bylaw).

contractually selected forum to be challenged in that jurisdiction.<sup>124</sup> Currently, over 26 percent of Fortune 500 companies have an exclusive forum provision in their bylaws or charter.<sup>125</sup>

Although exclusive forum bylaws are becoming very mainstream and their legal validity is now beyond question, they remain unpopular with some shareholder activists who consider them an infringement of shareholder rights. ISS takes a case-by-case approach to recommendations on exclusive venue provisions, taking into account the company's stated rationale for adopting the bylaw, the company's disclosure of past harm from shareholder lawsuits outside the state of incorporation, the breadth and application of the bylaw, as well as certain features of the company's governance practices.<sup>126</sup> However, ISS notes that unilateral adoption by the board of an exclusive forum bylaw will be evaluated under its unilateral bylaw/charter amendment voting policy, as discussed in II.D.1 above. As a practical matter, however, ISS routinely opposes these provisions. Glass Lewis will generally recommend against any exclusive forum provision but may change that recommendation if a company puts forth a compelling argument as to how the provision would benefit shareholders, provides evidence of abusive litigation in other jurisdictions, narrowly tailors such provision to the risks involved and has strong corporate governance practices generally.<sup>127</sup> Furthermore, Glass Lewis will generally recommend "against" the chairperson of the company's nominating and corporate governance committee if a company's board adopted during the past year an exclusive forum provision without shareholder approval or if the board is currently seeking shareholder approval of such provision pursuant to a bundled bylaw amendment rather than as a separate proposal.<sup>128</sup> Additionally, the AFL-CIO and the Council of Institutional Investors ("CII") have each expressed their opposition to exclusive forum provisions.<sup>129</sup>

## **J. Dissident Director Compensation Bylaws**

In recent years, activist hedge funds engaged in proxy contests have increasingly offered special compensation to their dissident director nominees. In about one-quarter of proxy fights over the past few years, dissident nominees have been paid a relatively modest flat fee (typically around \$25,000 to \$40,000) for agreeing to stand as candidates. In a few high-profile cases, these arrangements provide for large payouts, in the millions of dollars, contingent on the nominee being elected and the activist's goals being met within specified near-term deadlines. Prominent examples included the proxy contests at Hess Corp. and Agrium.

These contingent compensation schemes (which have been referred to as "golden leash" arrangements) are troublesome in a number of respects. They create incentives to maximize short-term returns, whether or not doing so would be in the best interests of all shareholders. They can lead to a multi-tiered and dysfunctional board in which a subset of directors is compen-

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<sup>124</sup> Order, *Centene Corp. v. Elstein*, C.A. No. 11589-VCL (Del. Ch. Oct. 8, 2015); Tr. of Rulings of the Ct., *Edgen Grp. Inc. v. Genoud*, C.A. No. 9055-VCL (Del. Ch. Nov. 5, 2013).

<sup>125</sup> SharkRepellent.

<sup>126</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 25-26.

<sup>127</sup> Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 38.

<sup>128</sup> *Id.* at 14.

<sup>129</sup> AFL-CIO, *Proxy Voting Guidelines*, Section D.16, at 20 (2012), available at [www.aflcio.org/content/download/12631/154821/proxy\\_voting\\_2012.pdf](http://www.aflcio.org/content/download/12631/154821/proxy_voting_2012.pdf); Council of Institutional Investors, *Corporate Governance Policies*, Section 1.9, at 5 (Oct. 1, 2014), available at [http://www.cii.org/files/policies/10\\_01\\_14\\_corp\\_gov\\_policies\(1\).pdf](http://www.cii.org/files/policies/10_01_14_corp_gov_policies(1).pdf).

sated and motivated significantly differently from other directors. Leading commentators share these concerns. For example, Columbia School of Law Professor John C. Coffee, Jr. has written that “third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk,”<sup>130</sup> and Professor Stephen Bainbridge of UCLA has concurred, saying “[i]f this nonsense is not illegal, it ought to be.”<sup>131</sup> The CII has also noted that these arrangements “blatantly contradict” its policies on director compensation,<sup>132</sup> and has called on the SEC to consider interpretive guidance or an amendment to the proxy rules to require disclosure of compensation arrangements between nominating shareholders and their director candidates.<sup>133</sup> We support CII’s call and, moreover, advocate that companies include robust disclosure requirements in their advance notice bylaws to support transparency in dissident nominations. A company and its shareholders should have a clear understanding of economic arrangements between dissidents and their activist backers.

In May 2013, we issued a memorandum alerting clients to the growing threat posed by “golden leashes.”<sup>134</sup> The memorandum recommended that companies might consider implementing a bylaw that established a default standard (amendable by shareholder resolution as are all bylaws) that would disqualify from service as a director any person party to such an arrangement (with exceptions for indemnification, expense reimbursement and preexisting employment relationships not entered into in contemplation of director candidacy). In the months following publication of the memorandum, dozens of companies adopted a similar bylaw to address the threats posed by these arrangements.

However, in January 2014, ISS released an FAQ warning that it “may” recommend a withhold vote against director nominees if a board adopts “restrictive director qualification bylaws” designed to prohibit “golden leashes” without submitting them to a shareholder vote.<sup>135</sup> Predictably, ISS’s threat has had a chilling effect, with very few companies adopting, and most that had adopted repealing, such bylaws to avoid a confrontation with ISS, despite the risks posed by “golden leash” schemes. As we noted at that time, although we continue to believe that such a bylaw is not only legal but consistent with good corporate governance, it is entirely ra-

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<sup>130</sup> John C. Coffee, Jr., *Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?*, The CLS Blue Sky Blog (Apr. 29, 2013), available at <http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/>.

<sup>131</sup> Stephen Bainbridge, *Can Corporate Directors Take Third Party Pay from Hedge Funds?*, ProfessorBainbridge.com (Apr. 8, 2013), available at <http://www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html>.

<sup>132</sup> Council of Institutional Investors, *CII Governance Alert, Special Pay Plans for Hedge Fund Nominees Spark Controversy*, Vol. 18, No. 18 (May 16, 2013).

<sup>133</sup> Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Keith F. Higgins, Dir., Division of Corp. Finance, SEC (May 31, 2014), available at [http://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2014/03\\_31\\_14\\_CII\\_letter\\_to\\_SEC.pdf](http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_31_14_CII_letter_to_SEC.pdf).

<sup>134</sup> Wachtell, Lipton, Rosen & Katz, *Shareholder Activism Update: Bylaw Protection Against Dissident Director Conflict/Enrichment Schemes* (May 9, 2013), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.22470.13.pdf>. Additionally, ISS’s 2016 voting guidelines state that it will vote case-by-case on board proposals that establish director qualifications taking into account the reasonableness of the criteria and the degree to which they may preclude dissident nominees from joining the board. ISS, *2016 U.S. Summary Proxy Voting Guidelines* 20.

<sup>135</sup> ISS, *Director Qualification/Compensation Bylaw FAQs* (Jan. 13, 2014), available at <http://www.issgovernance.com/files/directorqualificationcompensationbylaws.pdf>; see also ISS Proxy Advisory Services, *Report on Provident Financial Holdings, Inc.* (Nov. 12, 2013).

tional for companies not to incur the disfavor of ISS over a theoretical issue by adopting the bylaw to discourage “golden leash” arrangements. Any dissident who implemented a golden leash compensation scheme would likely weaken its proxy contest, and so it makes sense to contest this issue on a case-by-case basis.

Some companies may still wish to protect themselves from the threats posed by “golden leash” arrangements through appropriate bylaws and, in that case, may wish to consider bylaws that permit payment of a reasonable candidacy fee. Companies may also want to consider seeking shareholder approval of such bylaws, although it is still too early to predict what level of shareholder support they would likely receive. Further, another option available to companies is to prohibit golden leashes for proxy access nominated directors in their proxy access bylaws. At least 25 companies have adopted proxy access with this sort of prohibition, although most companies continue to take a disclosure-based approach. At a minimum, all companies should require full disclosure of any third-party arrangements that director candidates may have, which has long been a common practice and does not (at least given ISS’s current position) raise the risk of an ISS withhold recommendation. Additionally, on January 28, 2016, Nasdaq proposed a change to its listing rules that, if implemented, would require Nasdaq-listed companies to publicly disclose golden leash arrangements.<sup>136</sup>

An important lesson from the “golden leash bylaw” affair is that ISS and other members of the shareholder activist community are becoming increasingly resistant to board-adopted bylaws on anything other than pure housekeeping matters. Their primary objection to the bylaw was not with its substance—they generally agreed that “golden leash” arrangements are inconsistent with good corporate governance—but to the fact that boards implemented these bylaws without shareholder approval or engagement. This is a significant development. The adoption of bylaws that the board considers to be in the best interests of the company has traditionally been within the board’s prerogative. Boards should still do what they think is right, but they must be aware of the increasingly strident call for shareholder engagement regarding all things that may affect shareholder rights and interests and engage with key shareholders on any change that may be controversial.

## **K. Proxy Access**

The year 2015 will be remembered as the year in which “proxy access” finally became a reality. “Proxy access” is the term (or rather the slogan) that has come to stand for the right of shareholders to put their own director candidates on the company’s proxy card and in the company’s proxy statement, rather than having to use their own proxy card and statement. Over the past decade, this has been a fertile area for activism, discussion, rule-making and litigation.<sup>137</sup> These events culminated in a U.S. Court of Appeals vacating the SEC’s promulgated mandatory proxy access rule, called Rule 14a-11. The SEC did, however, amend Rule 14a-8 (which had previously regarded proxy access proposals as excludable because they related to an election contest) to allow shareholders to submit proxy access proposals to companies. As a result of this

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<sup>136</sup> The text of Nasdaq’s proposed rule change is available at, <http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2016/SR-NASDAQ-2016-013.pdf>.

<sup>137</sup> The SEC proposed a proxy access rule in 2003 and in 2007, approving the final rule in 2010.

change, approximately 105 companies faced proposals seeking proxy access in 2015; 75 of these proposals were submitted by the New York City Comptroller’s “2015 Boardroom Accountability Project.”<sup>138</sup> Consequently, proxy access was the most frequent issue formally raised by shareholders in 2015, accounting for 22 percent of shareholder contacts.<sup>139</sup> As of March 1, 2016, over 28 percent S&P 500 companies had some form of proxy access bylaw.<sup>140</sup> Many more companies have been pursuing a “wait and see” approach toward proxy access, allowing the many issues and parameters to settle before adopting their own policies.

With the recent increase in proxy access proposals, a consensus as to the headline terms of such proposals has begun to emerge, among both large institutional shareholders and the market more generally: particularly, that shareholders holding at least three percent of a company’s shares continuously for three years should be able to nominate candidates for up to 20 or 25 percent of the company’s board with up to 20 or so shareholders permitted to group and aggregate continuously held shares in order to meet the 3% threshold, so called “3-3-20-20%” or “3-3-20-25%” proposals.<sup>141</sup> The headline terms of these proposals largely are consistent with the SEC’s now-vacated Rule 14a-11 which had proposed to adopt the “3-3-25%” model. Because consensus has begun to emerge on headline terms, the beginning of the 2016 proxy season has shown an increased focus on other terms of proxy access bylaw provisions including, among others, beneficial ownership definitions, limitations on shareholder group size and proxy access-nominated-director qualifications. General trends in proxy access are discussed in more detail in Section IV.E.3. and the excludability of such proposals through no-action relief (as it relates to both headline and other terms) is discussed in more detail in Section IV.A.2.

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<sup>138</sup> SharkRepellent. See also David A. Katz, *Proxy Access Proposals for the 2015 Proxy Season*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Nov. 7, 2014), available at <http://blogs.law.harvard.edu/corpgov/2014/11/07/proxy-access-proposals-for-the-2015-proxy-season/>.

<sup>139</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 22, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>140</sup> SharkRepellent.

<sup>141</sup> In early 2015, both Blackrock and Vanguard made statements generally in favor of proxy access, and since then, many other large institutional investors have adopted their own policies regarding proxy access proposals. See *infra* nn. 194-196 and accompanying text.



## IV. Shareholder Proposals

Given its corporate governance expertise and familiarity with the company's corporate governance rules and policies, the nominating and corporate governance committee is often called upon to consider the appropriate response to a shareholder proposal. In fulfilling this function, the nominating and corporate governance committee must not only understand the substance of the proposal but also the procedural and technical requirements applicable to shareholder proposals, the consequences of proxy advisory voting policies and the prevailing trends in shareholder sentiment.

### A. Shareholder Proposals Under Federal Law

Under SEC Rule 14a-8, shareholder proposals must be included in a company's proxy statement and submitted to a shareholder vote unless they fail to meet eligibility and procedural requirements of Rule 14a-8, or the proposal falls within one of 13 subject matter exclusions under the rule. If a company intends to exclude a shareholder proposal under Rule 14a-8, the company must submit its reasons for excluding the proposal to the SEC. In general, a company will not exclude a shareholder proposal unless the SEC accepts the company's position that the proposal may be excluded.

There has been substantial and growing criticism of late that the low eligibility requirements have led to an epidemic of shareholder proposals that are not only wasteful and distracting for companies but are a major drain on the SEC staff's resources. In 2014, then-SEC Commissioner Daniel Gallagher stated that "[a]ctivist investors and corporate gadflies have used these loose rules [under Rule 14a-8] to hijack the shareholder proposal system."<sup>142</sup> In response to an essay by a leading shareholder rights advocate, Delaware Chief Justice Leo Strine wrote that "[i]t simply raises the cost of capital to require corporations to spend money to address annually an unmanageable number of ballot measures that the electorate cannot responsibly consider and most investors do not consider worthy of consideration."<sup>143</sup> Both Commissioner Gallagher and Chief Justice Strine have proposed various reforms to the Rule 14a-8 requirements, as discussed further under Section IV.D, and it is possible that the requirements to submit a shareholder proposal may be heightened in the future.

#### 1. Eligibility and Procedural Requirements

In order to be eligible to submit a proposal, a shareholder must have continuously held at least \$2,000 in market value, or one percent, of the company's securities entitled to vote for at least one year at the time of the proposal and must continue to hold those securities through the meeting date. A proposal must not exceed 500 words, and each shareholder may submit only one proposal per meeting. Also, a proposal may be excluded if in the past two calendar years the

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<sup>142</sup> Daniel M. Gallagher, former Comm'r, SEC, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541315952#.VQfYE9J0xMw>.

<sup>143</sup> Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 Colum. L. Rev. 449, 483 (2014).

shareholder submitted a proposal but failed to appear and present such proposal at a meeting or failed to maintain the required stock ownership through the date of a meeting.

Rule 14a-8 also imposes notice requirements. For a regularly scheduled annual meeting, a proposal must be submitted at least 120 calendar days before the date on which the company released its proxy statement for the previous year's meeting. However, if the company did not hold an annual meeting the previous year, or if the date of this year's annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and send its proxy materials. For a meeting other than a regularly scheduled annual meeting, the deadline is a reasonable time before the company begins to print and send its proxy materials. Very little guidance or precedent is available to clarify the meaning of "reasonable time" in this context.

## **2. Substantive Requirements**

In addition to eligibility and procedural requirements, Rule 14a-8 provides 13 substantive bases for exclusion:

- *Improper under state law*: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization;
- *Violation of law*: If the proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject;
- *Violation of proxy rules*: If the proposal or supporting statement is contrary to any of the SEC's proxy rules, including the rule prohibiting materially false or misleading statements in proxy soliciting materials;
- *Personal grievance; special interest*: If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to the submitting shareholder, or to further a personal interest, which is not shared by the other shareholders at large;
- *Relevance*: If the proposal relates to operations that account for less than five percent of the company's total assets at the end of its most recent fiscal year, and for less than five percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;
- *Absence of power/authority*: If the company would lack the power or authority to implement the proposal;
- *Management functions*: If the proposal deals with a matter relating to the company's ordinary business operations;
- *Director elections*: If the proposal: (i) would disqualify a nominee who is standing for election; (ii) would remove a director from office before his or her term expired; (iii) questions the competence, business judgment or character of one or more nomi-

- nees or directors; (iv) seeks to include a specific individual in the company's proxy materials for election to the board of directors; or (v) otherwise could affect the outcome of the upcoming election of directors;
- *Conflicts with company's proposal*: If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting (although as discussed below, the SEC is currently reviewing its position on this basis for exclusion);
  - *Substantially implemented*: If the company has already substantially implemented the proposal;
  - *Duplication*: If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting;
  - *Resubmissions*: If the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company's proxy materials within the preceding five calendar years, a company may exclude it from its proxy materials for any meeting held within three calendar years of the last time it was included if the proposal received: (i) less than three percent of the vote if proposed once within the preceding five calendar years; (ii) less than six percent of the vote on its last submission to shareholders if proposed twice previously within the preceding five calendar years; or (iii) less than 10 percent of the vote on its last submission to shareholders if proposed three times or more previously within the preceding five calendar years; and
  - *Specific amount of dividends*: If the proposal relates to specific amounts of cash or stock dividends.

Of these bases for exclusion, four have dominated no-action requests in recent years: violation of proxy rules because the proposal includes materially false or misleading statements, "management functions" because the proposal deals with ordinary business operations, substantial implementation by the company and conflicts with a company proposal that is to be submitted for a vote at the same meeting. For example, of the 213 no-action requests in which the SEC staff concurred that a shareholder proposal could be excluded during the 2015 proxy season, 55 percent pertained to these reasons—32 percent of exclusions were based on ordinary business arguments, 21 percent on substantial implementation, and two percent because the proposal was vague or false and misleading.<sup>144</sup> Additionally, with the recent proliferation of shareholder proxy access proposals, the start of the 2016 proxy season has seen a sharp increase in no-action requests based on substantial implementation grounds under Rule 14a-8(i)(10) from companies that have already adopted some form of proxy access bylaw but received a subsequent share-

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<sup>144</sup> Gibson, Dunn & Crutcher LLP, *Shareholder Proposal Developments During the 2015 Proxy Season* 2-3 (July 15, 2015), available at <http://www.gibsondunn.com/publications/pages/Shareholder-Proposal-Developments-During-the-2015-Proxy-Season.aspx> [hereinafter *GDC Shareholder Proposal Developments During the 2015 Proxy Season*].

holder proposal often seeking to change, among other things, the minimum ownership threshold, minimum ownership time period or board representation cap.

The SEC has required companies that seek to exclude proposals on the grounds that they violate proxy rules to demonstrate that the statements in question are objectively materially false and misleading, and the SEC has articulated a preference that companies address these statements in their “statements of opposition” included in proxy materials rather than excluding the proposal from the proxy statement altogether.<sup>145</sup> Consequently, in 2014 and 2015, no-action requests under Rule 14a-8(i)(3) were the most frequently rejected arguments with the SEC tending to decide in favor of proponents.<sup>146</sup> The policy implications of this position are difficult to ignore—misstatements in a shareholder proposal may influence how other shareholders vote, even if a company refutes them in its response; they may also spread misinformation if they are distributed through channels that the company cannot police. Notably, in February 2014, a federal court recognized this difficulty when it ruled in favor of a company seeking to exclude a shareholder proposal on the basis that the proposal included material, factual misstatements about the amount of executive compensation paid by the company, the voting standard adopted by the company, the existence of a clawback policy and the number of negative votes received by a director.<sup>147</sup> Despite this court ruling, in 2015, the SEC continued to be reluctant to permit exclusions on this basis: only one “materially false and misleading” argument was accepted by the SEC as compared to four in 2014.<sup>148</sup> Consequently, because the SEC has been a difficult forum in which to succeed in excluding proposals on this basis, an increased number of companies may decide to turn to federal courts when faced with misleading proposals.

Companies often rely on the “deals with ordinary business operations” exclusion in seeking no action relief from shareholder proposals relating to social issues, such as health, financial and environmental risks or human rights and healthcare. This reason has also been used, to varying levels of success, to exclude proposals relating to commercial practices, such as direct deposit financial lending and fair lending.<sup>149</sup> In evaluating these requests, the SEC has focused on the nature of the proposals—where the proposal transcends basic business operations and raises broad policy issues for the company, it may not be excluded.<sup>150</sup> With respect to health and environmental risks, since 2009 the SEC has distinguished between excludable proposals that focus on the internal assessment of the risks and liabilities that a company faces as a result of its operations, and non-excludable proposals that focus on a company minimizing or evaluating operations that may adversely affect the environment or public health.<sup>151</sup> During the 2015 proxy season, approximately 108 no action requests sought exclusion on the basis of Rule 14a-8(i)(7), of

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<sup>145</sup> SEC Staff Legal Bulletin No. 14B, *Shareholder Proposals* (Sept. 15, 2004), available at <http://www.sec.gov/interps/legal/cfslb14b.htm>.

<sup>146</sup> *GDC Shareholder Proposal Developments During the 2015 Proxy Season* at 3.

<sup>147</sup> See *Express Scripts Holding Co. v. Chevedden*, 2014 WL 631538 (E.D. Mo. Feb. 18, 2014).

<sup>148</sup> Based on analysis of no-action letters submitted to the SEC between June 1, 2014 and January 1, 2015, 105 no action requests were submitted on the basis of Rule 14a-8(i)(3) during the 2015 proxy season. 18 of these letters were withdrawn and three were granted. Of the three granted, two were granted exclusion under Rule 14a-8(i)(3) on the basis that the proposal was “vague and indefinite,” not on the basis that the proposal was “materially false and misleading.”

<sup>149</sup> ISS, *2013 U.S. Proxy Season Review: Environment & Social Issues* 10.

<sup>150</sup> SEC Staff Legal Bulletin No. 14E, *Shareholder Proposals* (Oct. 27, 2009), available at <http://www.sec.gov/interps/legal/cfslb14e.htm>.

<sup>151</sup> *Id.*

which 50 were granted on the basis of Rule 14a-8(i)(7), 26 were withdrawn and 18 were denied.<sup>152</sup>

Recently, a federal district court and a federal appellate court ruled on the exclusion of a social proposal in reliance on the ordinary business exception. A shareholder of Wal-Mart Stores, Inc. proposed that the board assign to one of its committees the responsibility of overseeing the formulation, implementation and public reporting of policies that determine whether a company should sell products that could endanger public safety, impair the company's reputation or would be considered offensive to the values of the company's brand.<sup>153</sup> The SEC did not object to Wal-Mart's exclusion of this proposal on the basis that the proposal dealt with the ordinary business operations, but the U.S. District Court in Delaware disagreed. The court decided that because the proposal merely sought oversight of the development and implementation of a company policy and left day-to-day aspects to the company's management, it did not interfere with management's fundamental ability to run the company and so could be subject to shareholder oversight.<sup>154</sup> However, the Third Circuit quickly overturned the District Court's decision, calling the shareholder proposal "a sidestep from a shareholder referendum on how Wal-Mart selects its inventory."<sup>155</sup> The Third Circuit also found that the shareholder proposal did not raise a significant policy issue that transcended Wal-Mart's day-to-day business operations qualifying it for the social policy exception to exclusion.<sup>156</sup> The court held that for retailers with diverse product lines, a policy issue "must target something more than the choosing of one among tens of thousands of products [that the retailer sells]" for it to transcend ordinary business operations.<sup>157</sup>

Often, companies also seek to exclude proposals on the basis that they were substantially implemented by the company. A no-action request on this basis must not only demonstrate that the relevant action by the company compares favorably with the proposal at issue but also address each element of the proposal.<sup>158</sup> However, the relevant action need not be taken by management or the board, and effects of court decisions, business developments, corporate events and third-party requirements may render the proposal moot.<sup>159</sup> While trends vary across proposals, the SEC has increasingly made it more difficult to exclude a proposal on the basis of sub-

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<sup>152</sup> Data are based on analysis of no-action letters available as of March 6, 2016 that were submitted between October 1, 2014 and August 1, 2015 seeking no action relief for a 2015 annual meeting.

<sup>153</sup> *Trinity Wall Street v. Wal-Mart Stores*, 75 F. Supp. 3d 617 (D. Del. 2014).

<sup>154</sup> *Id.* In contrast, in analyzing whether a proposal requesting the formation of a special committee is excludable under the ordinary business exception, the SEC has stated that "the key is to consider whether the underlying subject matter of the committee involves an ordinary business matter." Keith F. Higgins, Dir., Div. of Corp. Finance, SEC, *Rule 14a-8: Conflicting Proposals, Conflicting Views*, Practising Law Institute Program on Corporate Governance (Feb. 10, 2015), available at <http://www.sec.gov/news/speech/rule-14a-8-conflicting-proposals-conflicting-views.html#.VPn3W2d0zPs>.

<sup>155</sup> *Trinity Wall Street v. Wal-Mart Stores*, 792 F.3d 323, 343 (3d Cir. 2015).

<sup>156</sup> There is a significant social policy exception to the default rule of excludability for proposals that relate to a company's ordinary business operations. According to the SEC staff, the exception is available if "a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote . . ." *Staff Legal Bulletin No. 14E (CF)*, SEC Release No. SLB – 14E (Oct. 27, 2009); see also, *Trinity Wall Street* 792 F.3d at 345-51 (discussing the exception in detail as it applies to retailers).

<sup>157</sup> *Trinity Wall Street*, 792 F.3d at 352.

<sup>158</sup> Amy Goodman, *et al.*, *A Practical Guide to SEC Proxy and Compensation Rules* § 12.08 (2014).

<sup>159</sup> *Id.*

stantial implementation. In the past, for example, the SEC granted requests that argued that special meeting proposals were substantially implemented even where a company's provision imposed additional conditions on calling a special meeting so long as these conditions were not restrictive. However, in 2014 the SEC denied no action requests where a proposal called for an amendment to the bylaws that would allow 10 percent of the stockholders to call a special meeting and the bylaws included a 25 percent standard.<sup>160</sup> During the 2015 proxy season 104 no action requests sought exclusion on the basis of Rule 14a-8(i)(10), 26 were granted on the basis of Rule 14a-8(i)(10), 26 were withdrawn and 24 were denied.<sup>161</sup>

During the 2015 proxy season, the scope and application of Rule 14a-8(i)(9), which permits companies to exclude a proposal if it directly conflicts with one of the company's proposals, received considerable scrutiny. In late 2014, Whole Foods requested no-action relief to exclude a proxy access proposal that would have permitted shareholders holding at least three percent of outstanding stock for at least three years to nominate up to 20 percent of directors for inclusion in the company's proxy statement. It did so on the grounds that the proposal conflicted with the company's own proposal that would permit shareholders holding at least nine percent of outstanding stock for at least five years to nominate 10 percent of directors in the company's proxy statement. The SEC granted relief, but the shareholder proponent sought review by the commissioners, and institutional investors lobbied the SEC to review the staff's position.<sup>162</sup> On January 16, 2015, the chairperson of the SEC instructed the Division of Corporation Finance to review the scope and application of this basis for exclusion, and the SEC during the 2015 proxy season, the SEC suspended its review of no-action request on this basis and reversed its view with respect to the Whole Foods request.<sup>163</sup>

On October 22, 2015 the SEC released new guidance on Rule 14a-8(i)(9) to clarify the scope of the exclusion.<sup>164</sup> Historically, many of the SEC's response letters granting no-action relief under Rule 14a-8(i)(9) allowed exclusion of shareholder proposals if inclusion could present "alternative and conflicting decisions for the shareholders" and create the potential for "inconsistent and ambiguous results."<sup>165</sup> However, based on a review of the history of the rule, the SEC concluded that its intended purpose is to prevent shareholders from circumventing the proxy rules governing solicitations.<sup>166</sup> Consequently, a proposal will only be excludable on the

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<sup>160</sup> *Id.*

<sup>161</sup> Data are based on analysis of no-action letters available as of March 6, 2016 that were submitted between October 1, 2014 and August 1, 2015 seeking no action relief for a 2015 annual meeting.

<sup>162</sup> Letter from Ann Yerger, Exec. Dir., Council of Institutional Investors, to Kenneth F. Higgins, Dir., Division of Corp. Finance, SEC (Jan. 9, 2015), available at [http://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2015/01\\_09\\_15\\_CII\\_to\\_SEC\\_re\\_Whole\\_foods.pdf](http://www.cii.org/files/issues_and_advocacy/correspondence/2015/01_09_15_CII_to_SEC_re_Whole_foods.pdf).

<sup>163</sup> Public Statement, Mary Jo White, Chair, SEC, *Statement of Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposal* (Jan. 16, 2015), available at <http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html#.VQffxdJ0xMz>; Announcement, SEC, *Division of Corporation Finance Will Express No Views under Exchange Act Rule 14a-8(i)(9) for Current Proxy Season* (Jan. 16, 2015), available at <http://www.sec.gov/corpfin/announcement/cf-announcement---rule-14a-8i9-no-views.html#.VQfm4tJ0xMw>.

<sup>164</sup> SEC Staff Legal Bulletin No. 14H (CF) (Oct. 22, 2015), available at [https://www.sec.gov/interps/legal/cflb14h.htm#\\_ednref11](https://www.sec.gov/interps/legal/cflb14h.htm#_ednref11).

<sup>165</sup> *Id.*

<sup>166</sup> The SEC's conclusion stemmed from the additional procedural and disclosure requirements imposed on shareholder solicitations in opposition to a management proposal by Regulation 14A that are not required by Rule 14a-8. See, e.g., 17 C.F.R. 240.14a-6.

basis that it directly conflicts with a management proposal if “a reasonable shareholder could not logically vote in favor of both proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal.” This articulation is a higher burden for exclusion than under the SEC’s previous formulation of the rule.

As an example, the SEC noted that it would not view a shareholder proxy access proposal permitting holders of at least three percent of the company’s outstanding stock for at least three years to nominate up to 20 percent of the directors as conflicting with a management proxy access proposal allowing holders of at least five percent of the company’s stock for at least five years to nominate up to 10 percent of the directors. In the SEC’s view, these proposals do not conflict because (i) they “generally seek a similar objective, to give shareholders the ability to include their nominees for director alongside management’s nominees” and (ii) “they do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals” (*i.e.*, a shareholder concerned that the lower standard may not receive requisite support could vote for both if generally in favor of some form of proxy access).<sup>167</sup> Further, the SEC noted that although in the event both hypothetical proposals were approved the company’s board might have to consider the effects of both proposals, this type of decision does not represent “the kind of ‘direct conflict’ [Rule 14a-8(i)(9)] was designed to address.”<sup>168</sup> As a final piece of guidance, the SEC noted that the new standard for directly conflicting proposals does not take into account whether a shareholder proposal is precatory or binding.<sup>169</sup>

On February 12, 2016, the SEC responded to 18 no-action requests seeking to exclude proxy access shareholder proposal based on substantial implementation under Rule 14a-8(i)(10), and granted relief in 15 instances. This wave of no-action letters is of particular importance in light of the significant limitations placed on exclusion of such proposals under the SEC’s new interpretation of Rule 14a-8(i)(9), as described above. As a general matter, previous SEC no-action letters granting relief under Rule 14a-8(i)(10) have permitted exclusion of a proposal when a company has demonstrated that actions it has already taken address the essential elements of a proposal. More specifically, the staff has stated that “a determination that the company has substantially implemented [a] proposal depends upon whether [the company’s] particular policies, practices and procedures compare favorably with the guidelines of the proposal.”<sup>170</sup>

With regards to proxy access, the SEC’s February 12 letters have made certain principles clear. First, conformity between the ownership threshold adopted by the company and the ownership threshold in the proposal is a critical factor in obtaining no-action relief. In each of the 15 grants of relief, both the shareholder proposal and the company’s bylaw had the same 3 percent ownership threshold and in all three denials, the company’s ownership threshold exceeded the

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<sup>167</sup> The SEC staff provided three additional examples. First, a management proposal asking shareholders to approve a merger directly conflicts with a shareholder proposal to vote down the merger. Second, a management proposed bylaw to require the CEO to always serve as Chairperson directly conflicts with a shareholder proposal seeking separation of the positions. And, third, a management proposal allowing the compensation committee to determine vesting of equity awards in its sole discretion *does not conflict* with a shareholder proposal requiring all equity awards to be subject to a minimum four-year vesting requirement. SEC Staff Legal Bulletin No. 14H (CF) (Oct. 22, 2015), available at [https://www.sec.gov/interps/legal/cfs1b14h.htm#\\_ednref11](https://www.sec.gov/interps/legal/cfs1b14h.htm#_ednref11).

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Texaco Inc.*, SEC No-Action Letter (Mar. 28, 1991).

proposed ownership threshold in the shareholder proposal. Second, a lower cap on shareholder nominees in the company’s bylaw than in a shareholder proposal did not preclude the grant of no-action relief.<sup>171</sup> Third, a company’s addition of reasonable eligibility requirements on proxy access nominees—including, in the case where such requirements were not imposed on board nominated directors—did not prevent the SEC from granting no-action relief on the basis of substantial implementation.<sup>172</sup> Finally, companies that imposed aggregation limits on shareholder groups for purpose of proxy access were not precluded from obtaining relief under Rule 14a-8(i)(10) even where the shareholder proposal requests that group formation be in no way limited.<sup>173</sup>

### **3. Curable and Non-Curable Deficiencies**

A deficiency may be either curable or non-curable. For example, an untimely submission is not curable because the deadline has passed, whereas an overly wordy proposal is curable through revision and resubmission. Similarly, a proposal that is improper under state law because it mandates a particular action may be cured by reformulating it as a precatory proposal. If a deficiency is curable, a company must notify the proponent within 14 calendar days of receiving the proposal of any procedural or eligibility deficiencies, as well as of the time frame for responding. The proponent’s response must be postmarked no later than 14 days from the date of receipt of the company’s notification. If a deficiency is non-curable, a company need not provide the proponent notice.

### **4. No-Action Requests**

If a company wishes to exclude a proposal from its proxy materials, it must seek a no-action letter by filing its reasons with the SEC no later than 80 calendar days before it files its definitive proxy statement and form of proxy, although this requirement may be waived for good cause. No-action letters issued by the SEC in response to these requests provide useful guidance both to shareholders submitting proposals and to nominating and corporate governance committees in determining their response to shareholder proposals. In 2015, the percentage of no-action letters seeking exclusion of a shareholder proposal for which the SEC granted relief fell to 61 percent from 71 percent in 2014.<sup>174</sup>

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<sup>171</sup> See, e.g., *Target Corporation*, SEC No-Action Letter (Feb. 12, 2016). Target’s proxy access bylaw limited the number of proxy access nominees that will be included in the company’s proxy materials to the greater of two directors or 20 percent of the number of directors in office. The shareholder proposal called for the limit to be set at the greater of two directors or 25 percent of the number of directors in office.

<sup>172</sup> See, e.g., *Northrop Grumman Corporation*, SEC No-Action Letter (Feb. 12, 2016). The shareholder proposal provided that “[n]o additional restrictions that do not apply to other board nominees should be placed on these [proxy access] nominations or re-nominations. In its response, Northrop noted that “The Company provides in its Proxy access Provision a number of other requirements . . . . While certain of these requirements are not explicitly set out in the Company’s governing documents with respect to director nominees generally, each requirement is a fundamental to the Company and applied by the nominating committee in determining which candidates to recommend as nominees for election to the Board.”

<sup>173</sup> See, e.g., *Target Corporation*, SEC No-Action Letter (Feb. 12, 2016). Target’s bylaw limited the size of groups to no more than 20 shareholders and the shareholder proposal sought to make proxy access available for “any person nominated for election to the board by a shareholder or an unrestricted number of shareholders forming a group . . . .”

<sup>174</sup> *GDC Shareholder Proposal Developments During the 2015 Proxy Season* at 2.

## **5. Including Proposal in Proxy Materials**

A company may include in its proxy materials a statement of reasons why it believes that shareholders should vote against a proposal. The company's response or "opposition statement" is not subject to the 500-word limit for shareholder proposals. The company must provide a copy of this statement to the proponent no later than 30 calendar days before it files definitive copies of its proxy statement and form of proxy, or, if the SEC's no-action response requires the proponent to make revisions to the proposal as a condition of its inclusion, then the company must provide the proponent with a copy of its opposition statements no later than five calendar days after the company receives a copy of the revised proposal.

## **6. Precatory and Mandatory Proposals**

The corporate law of most states, including Delaware, provides that the business and affairs of a company are to be managed under the direction of the board.<sup>175</sup> Under this structure, with the exception of a few specific items provided for by statute (such as the content of the company's bylaws and approval of mergers and sales of all or substantially all of the company's assets), running the company is left to the company's directors and the management team appointed by those directors, rather than to shareholders. The avenue for shareholders to directly affect the company's operations is primarily confined to replacing the board or amending the company's bylaws. A shareholder proposal mandating that the board take a particular action would run afoul of this fundamental division of power. Thus, shareholder proposals calling for a specific action (other than seeking to amend the company's bylaws), must, in general, be submitted as precatory suggestions to the board. The board can then decide whether or not to implement the resolution adopted by the shareholders. As a practical matter, however, boards may face significant pressure to implement precatory proposals supported by shareholders. (See Section IV.C.) In Delaware and most other states, the board of directors must submit to the shareholders any changes in the charter, and the shareholders may not amend the charter without board approval. Accordingly, any shareholder efforts to amend the charter (for example, to eliminate a classified board or allow action by written consent) must be brought by precatory resolution.

### **B. Shareholder Proposals Under State Law**

In addition to having a proposal included in the issuer's proxy statement under Rule 14a-8, shareholders may submit proposals under state law. A key distinction between the two is that, whereas a qualifying Rule 14a-8 proposal must be included in the company's proxy statement, a shareholder submitting a proposal under state law must ordinarily do so in his or her own proxy statement. Thus, making a proposal under state law requires a shareholder to bear the expense of printing and mailing proxy materials. As a result, such proposals are most common in the context of a hostile takeover bid or a proxy fight where the stockholder seeks a fundamental change in corporate direction, including by proposing a competing slate of director nominees for election. State law is particularly important for director nominations because, as noted above, director nominations are generally excludable from proxy access under Rule 14a-8, leaving state law as the only avenue.

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<sup>175</sup> See 8 Del. C. § 141(a).

Director nominations and other shareholder proposals must comply with a company's advance notice bylaws governing the deadline for submission of such proposals. In addition to submission deadlines, bylaws typically require that the proponent be a shareholder as of the record date of the meeting and call for a number of disclosures by the proponent. Examples of these disclosures include background information about the proponent, the amount of the proponent and its affiliates' beneficial ownership (including derivative instruments) and any voting agreement with other stockholders. If a proposal nominates a director candidate, bylaws often require that the proposal include a questionnaire and all information about the nominee that would be required for election of directors in a contested election pursuant to federal securities laws. Increasingly, bylaws also require that the nomination disclose any material arrangements or relationships between the proponent and the nominee. For submissions other than nominations, bylaws typically require the text of the proposal and a brief description of the matter desired to be brought, including any material interest of the stockholder in the matter.

### **C. Responding to Shareholder Proposals**

The appropriate response to receipt of a proposal will vary depending on the facts and circumstances. If a 14a-8 shareholder proposal does not comply with certain procedural and substantive requirements, it may be excludable under SEC rules. If a state-law (that is, a non-14a-8) proposal does not comply with the company's bylaws, then it may generally be excluded under the bylaws from being raised at the meeting. In other cases, the company may engage in a dialogue with the shareholder to find a mutually acceptable compromise. In still other cases, it may make sense to implement the proposal, or to formulate an alternative proposal that will achieve largely the same effect. In responding to voted-upon shareholder proposals, boards should be cognizant that their actions will likely be closely monitored by proxy advisory services and activist investors. A board that declines to implement a supported shareholder proposal may find itself subject to scrutiny and perhaps even election challenges or withhold-the-vote campaigns. Increasingly in these situations, proxy advisory services are recommending "no" votes for members of the nominating and corporate governance committee. While directors cannot be dismissive of the influence of proxy advisory services and large shareholders, directors also should not blindly succumb to their mandates. Care should be taken to consider shareholder concerns and articulate the board's reasoning, but ultimately corporate governance is a core function of the board, and directors must bear in mind that they are best positioned to select the best policies for the company.

#### **1. Deciding Whether to Implement a Precatory Shareholder Proposal**

Neither federal nor state law imposes any legal obligation on the board to act upon precatory shareholder proposals that receive majority support. To the contrary, it is the board's responsibility to carefully evaluate such proposals and implement them only if it believes doing so is in the best interests of the company. Provided that the board has deliberated with care and acted to further the company's best interests, any determination should be protected by the deferential business judgment rule.

Although the board's decision not to implement a shareholder proposal will not be vulnerable to legal challenge, there may be other consequences. A board that declines to implement a shareholder proposal that garnered substantial support may find itself subject to criticism and

perhaps even election challenges or withhold-the-vote campaigns from proxy advisory services or institutional investors. This can be particularly significant if the company's directors are elected by majority voting (as most directors now are).

## **2. Proxy Advisory Policies Regarding Response to Shareholder Proposals**

ISS recommends voting on a case-by-case basis on individual directors, committee members or the entire board if the board failed to act on a shareholder proposal that received the support of a majority of votes cast the previous year.<sup>176</sup> Among the factors ISS will consider are the subject matter and level of support of the proposal, the actions taken by the board in response and its engagement with shareholders and the rationale provided in the company's proxy statement for the level of implementation.<sup>177</sup> Glass Lewis takes a more aggressive position, stating that any time a shareholder proposal receives at least 25 percent support, the board should, depending on the issue, "demonstrate some level of responsiveness," which will be evaluated on a case-by-case basis.<sup>178</sup> These ISS and Glass Lewis positions are more moderate than ISS's former position that it would automatically recommend that shareholders withhold votes from directors who declined to implement expressed shareholder desires. ISS's withhold policy, coupled with the shift to majority voting, were strong contributors to the erosion of takeover protections, such as shareholder rights plans and staggered boards over the past decade.

## **3. Responding to Pressure from Shareholders and/or Proxy Advisory Services**

Despite the changing dynamics between the board and shareholders, the board must remember that it has the responsibility to exercise its own business judgment in determining what course will best serve the company. A board need not, and should not, accede to every corporate governance "best practice" promulgated by proxy advisory services and other governance activists. That said, without abdicating its responsibilities, the board should be mindful of governance policies and shareholder concerns and consider the potentially disruptive impact of scrutiny from shareholders and proxy advisory services as one factor in determining the company's best interests. When the board chooses to depart from the approach called for by corporate governance activists, it must be prepared to articulate clear and thoughtful explanations for its decisions. This approach will build the board's credibility with shareholders and also help it formulate policies that may be acceptable to all parties. In the current corporate governance environment, the challenge for directors is to base their decisions on what they believe will best serve the company while at the same time maintaining sufficient awareness and sensitivity of shareholder concerns to avoid an attack that could undermine the board's ability to serve the company's best interests.

## **D. Effect of Shareholder Proposals**

Corporate governance has undergone a dramatic transformation over the last decade, in no small part as a result of activists who brought shareholder proposal after shareholder proposal until nearly every company had succumbed; in short, the putative aspirational "best practices" of a decade ago have been so widely adopted or codified that there is now a period of relative stasis in corporate governance. Among S&P 500 companies in 2015: only 10 percent had staggered

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<sup>176</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 15.

<sup>177</sup> *Id.*

<sup>178</sup> Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 7-8.

boards, compared to 47 percent in 2005;<sup>179</sup> the CEO was the only non-independent director on 61 percent of boards, compared to 39 percent in 2005;<sup>180</sup> 88 percent had some form of majority voting for directors, compared to virtually none in 2003; and four percent had a poison pill in place, compared to 45 percent in 2005.<sup>181</sup> Nevertheless, pressure from corporate governance activists remains acute, partly due to increased scrutiny of the remaining holdouts and partly as a result of ever-evolving standards from those who make their living in the corporate governance industry.

S&P 500 companies received 630 shareholder proposals in 2015 as compared to 636 in 2014, 663 in 2013 and 494 in 2005; the figures for the Russell 3000 were 864 in 2015, 853 in 2014, 844 in 2013 and 592 in 2005.<sup>182</sup> In 2015, almost 15 percent of the shareholder proposals submitted to S&P 500 companies and voted on received majority support, compared to about 13 percent in 2014, 19 percent in 2010, and 24 percent in 2009.<sup>183</sup> This is attributable in large part to a shrinking proportion of the core corporate-governance related proposals that typically receive strong support, as companies have conformed to “best practices” mandates, and an increase in socially oriented proposals that typically receive less support.

Even when unsuccessful in changing a company’s corporate governance, shareholder proposals are not without impact. As Delaware Chief Justice Strine observed, shareholder proposals can distract managers from running companies and impose unnecessary costs on companies, with virtually no cost to the shareholder proponents.<sup>184</sup> In order to minimize such costs—or at least to provide some assurance that the proposal warrants such costs, Chief Justice Strine suggests that proponents of economic proposals be required pay a filing fee and own a substantial equity stake in the company and that companies be permitted to exclude proposals that have been submitted to a vote in the past and failed to receive a minimum level of shareholder support.<sup>185</sup> In his keynote address at the Tulane Corporate Law Institute, then-SEC Commissioner Daniel Gallagher expressed similar concerns about Rule 14a-8 and likewise suggested increasing the ownership requirement and lengthening the holding period for bringing shareholder proposals, banning or limiting “proposal by proxy” (where a person with no shares acts on behalf of another holder), more carefully policing the subject matter of proposals and raising the voting thresholds required for proposals to be resubmitted after receiving low shareholder support in prior years.<sup>186</sup>

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<sup>179</sup> SharkRepellent.

<sup>180</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 12.

<sup>181</sup> SharkRepellent. Includes all shareholder proposals received for inclusion at an annual meeting for companies in the S&P 500 index at the time the proposal was received, including non-U.S. companies.

<sup>182</sup> *Id.* Includes all shareholder proposals received for inclusion at an annual meeting for companies in the Russell 3000 index at the time the proposal was received, including non-U.S. companies.

<sup>183</sup> *Id.* Includes all shareholder proposals received for inclusion at an annual meeting for companies in the S&P 500 index at the time the proposal was received, including non-U.S. companies.

<sup>184</sup> Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 Colum. L. Rev. 449, 475 (2014).

<sup>185</sup> *Id.* at 499.

<sup>186</sup> Daniel M. Gallagher, Comm’r, SEC, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541315952#.VQfYE9J0xMw>.

## **E. Major Topics for Shareholder Proposals**

### **1. Classified Boards**

Given the large number of companies that have already eliminated their classified boards, it is not surprising that declassification proposals are at a five-year low. Twenty-seven proposals were submitted to S&P 500 and Russell 3000 companies in 2015, compared to 23 in 2014, 53 in 2013, 103 in 2012 and 87 in 2011.<sup>187</sup>

Over the past few years, shareholder activist groups, in particular, the Harvard Law School's Shareholder Rights Project, have played a significant role in the adoption of declassification proposals. During 2012, 2013 and first half of 2014, this Harvard clinical program, submitted declassification proposals to 129 companies, 121 of which agreed to move toward annual elections after engaging with the project.<sup>188</sup> We believe that it is extremely regrettable that shareholder activists and some academics have succeeded in largely eliminating classified boards from large-cap American companies. A classified board combined with a shareholder rights plan is the best hope a company has of fending off an opportunistic hostile takeover attempt. Value-creating defenses, such as that of Airgas against the predations of Air Products a few years ago, would not have been possible had Airgas not had a staggered board. All that said, one must be realistic and accept that a company facing a precatory proposal to eliminate its staggered board has little hope of convincing shareholders to vote against it. Once the shareholders have approved the resolution calling for its repeal, unless the board is willing to accept a high withhold vote and a measure of shareholder opprobrium, the question is whether to eliminate the classification at one time or to roll it off over a three-year period, as many companies have done.

### **2. Separation of Chairman and CEO Positions**

S&P 500 companies received the most proposals to separate the Chairman and CEO roles in 2015 than in any other year since 2005. Sixty-four proposals to separate the Chairman and CEO roles were submitted to S&P 500 companies in 2015, compared to 57 in 2014, 62 in 2013, 58 in 2012, and 26 in 2005. And 54 (roughly 84 percent) went to a vote; the figures for Russell 3000 companies are 76 proposals submitted and 65 voted on (roughly 86 percent).<sup>189</sup> Despite this uptick in proposals, it is possible that the successful model of independent lead or presiding directors has dampened the enthusiasm for separation. Support for these proposals was strikingly low: for S&P 500 companies, only two proposals that went to a vote received majority support, and the average level of support was only 30 percent, consistent with 2014 where three proposals received majority support and the average level of support was 31 percent.<sup>190</sup> It must be recognized, however, that many institutional investors support independent board leadership as a

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<sup>187</sup> SharkRepellent. Includes all board declassification shareholder proposals received for inclusion at an annual or special meeting for U.S. companies in the S&P 500 or Russell 3000 index at the time the proposal was received.

<sup>188</sup> Matteo Tonello & Melissa Aguilar, The Conference Board, *Proxy Voting Analytics (2010-2014)*, at 160, *available at* <http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2857>.

<sup>189</sup> SharkRepellent. Includes all shareholder proposals for separation of CEO and Chairman positions received for inclusion at an annual or special meeting for U.S. companies in the S&P 500 or Russell 3000 index, as applicable, at the time the proposal was received.

<sup>190</sup> *Id.*

general rule, and a strong case will have to be made to retain a combined Chairman/CEO role if an effort is made to split those positions.

### 3. Proxy Access

Although proxy access became available to U.S. corporations after the SEC amended Rule 14a-8 in 2011, the high volume of proxy access proposals that was expected in the wake of the change did not materialize immediately. Only 22 shareholder proxy access proposals were received by companies in 2012. Nineteen were received in 2013 and 24 were received in 2014.<sup>191</sup> However, as previously noted in Section III.K, proxy access was the most common single issue for shareholder proposals in 2015: companies received approximately 105 proxy access shareholder proposals in 2015—75 of which were submitted by the New York City Comptroller’s “2015 Boardroom Accountability Project”—and 13 management sponsored proxy access proposals were put forward.<sup>192</sup> One hundred and three of the 118 total proxy access proposals were voted on in 2015 (87 percent) and 60 percent of voted-on proposals passed, receiving, on average, 55.2 percent support.<sup>193</sup> The overwhelming majority of passing proposals modeled proxy access on the terms of the SEC’s now-vacated Rule 14a-11: shareholders holding at least three percent of a company’s outstanding shares continuously for at least three years can nominate directors for up to 25 percent of the board.<sup>194</sup> Additionally, 63 companies adopted proxy access bylaws in 2015 without prompting from a shareholder proposal at their 2014 or 2015 annual meetings.<sup>195</sup> Some portion of these preemptive bylaw adoptions may have been spurred by public announcements supporting proxy access from many of the United States’ largest asset managers.<sup>196</sup>

Management responses to the receipt of a shareholder proxy access proposal varied in 2015. The majority of companies—69 percent—recommended against the shareholder proposal without proposing or adopting a different proxy access bylaw. However, this reaction was largely unsuccessful: 60 percent of these shareholder proposals still passed, averaging 55 percent

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<sup>191</sup> SharkRepellent.

<sup>192</sup> *Id.*

<sup>193</sup> *Id.* Percent support figure is calculated based on the number of votes cast, including abstentions.

<sup>194</sup> Ernst & Young LLP, *Four Takeaways from Proxy Season 2015* (June 2015), available at <http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015>.

<sup>195</sup> SharkRepellent.

<sup>196</sup> In early 2015, both Blackrock and Vanguard made statements generally in favor of proxy access. Blackrock evaluates proxy access proposals on a case-by-case basis by generally has been supportive of standard “3-3-25%” proposals. BlackRock, *Proxy Voting Guidelines for U.S. Securities* 4 (Feb. 2015), available at <http://www.blackrock.com/corporate/en-us/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; *Proxy Access: The 2015 Proxy Season and Beyond*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP 1 (June 23, 2015). Vanguard is supportive of proxy access bylaws but believes “that proxy access provisions should be appropriately limited to avoid abuse” by short term investors and generally believes that shareholders holding three percent of a company’s outstanding shares for at least three years should be able to nominate directors for up to 20 percent of the board. Vanguard, *Vanguard’s Proxy Voting Guidelines* (2016), available at <https://about.vanguard.com/vanguard-proxy-voting/voting-guidelines/>. Similarly, CalPERS and CalSTRS are generally supportive of proxy access bylaws. See, CalPERS, *Global Principles of Accountable Corporate Governance* 15 (Rev. March 16, 2015), available at <https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf>; CalSTRS, *Corporate Governance Principles* 13 (Apr. 3, 2015), available at [http://www.calstrs.com/sites/main/files/file-attachments/corporate\\_governance\\_principles\\_1.pdf](http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_principles_1.pdf).

support.<sup>197</sup> Fourteen percent of companies embraced shareholder proposals by adopting a bylaw, supporting the shareholder proposal or agreeing to submit a management proposal on the topic.<sup>198</sup> Seven percent of boards unilaterally adopted a proxy access bylaw with more restrictive terms than the shareholder proposals—generally, five percent ownership for at least three years and restricting group nominations to either 10 or 20 shareholders. In this segment, shareholder proposals that went to a vote averaged 48 percent support.<sup>199</sup> Finally, another seven percent of boards submitted a more restrictive counter proposal; however, average support for shareholder proposals in this segment exceeded average support for management proposals, 55 percent compare to 42 percent.<sup>200</sup>

However, approval of a shareholder proxy access proposal at the annual meeting is not the end of the story for boards. While shareholder proposals tend to be quite short and include only headline terms—*i.e.*, three percent continuous holders for three years can nominate up to 25 percent of directors—actual proxy access bylaws are quite long and extremely nuanced. For example, proxy access bylaws generally contain, among other things, extensive provisions: (i) defining beneficial ownership (sometimes limiting ownership to net long positions), (ii) dictating how many shareholders can join together as a group for purposes of meeting the required ownership threshold, (iii) limiting proxy access proposals in successive years to prevent directors nominated by proxy access from comprising a majority of the board and (iv) defining proxy-access-nominated director qualifications (*e.g.*, prohibitions on golden leashes). Consequently, the extent of additional provisions that boards may add to shareholder-approved proxy access proposals without being deemed “unresponsive” by ISS and other proxy advisory services is yet to be determined.<sup>201</sup> Of the 55 companies that had shareholder proxy access proposals pass in 2015, 19 are yet to adopt a proxy access bylaw as of March 1, 2016.<sup>202</sup>

Going forward, whether a 2016 shareholder proxy access proposal will pass remains a highly fact-specific question and likely will turn on, among other things, the terms of the proposal, the company’s recent performance, the company’s corporate governance profile and, most importantly, the company’s engagement with its shareholders. However, 2015’s proxy season did show that proxy access proposals are widely supported and that boards should be prepared to deal with receipt of a proxy access proposal. Like other governance issues, there is no one-size fits all approach. Boards should consider their existing governance profile, unique shareholder base and long-term strategy in formulating a response to a shareholder proxy access proposal or in consideration of unilateral adoption of a proxy access bylaw. Further, while proxy access may nominally increase a company’s vulnerability to an election contest, the reality is that, in most cases, the incremental increase in risk will be negligible. First, traditional activists are unlikely

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<sup>197</sup> Ernst & Young LLP, *Four Takeaways from Proxy Season 2015* (June 2015), available at <http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015>.

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* The remaining three percent of proposals were omitted or withdrawn.

<sup>201</sup> ISS will recommend on a case-by-case basis for directors if the board fails to act on a shareholder proposal that received the support of a majority of the votes cast in the previous year, considering, among other things, the outreach efforts of the board in wake of the vote, the rationale provided in the proxy statement for the level of implementation, the subject matter of the proposal, the level of past shareholder support for the proposal and the continuation of the underlying issue as a voting item on the ballot. ISS, *2016 Summary Proxy Voting Guidelines* 15 (Rev. Feb 23, 2016).

<sup>202</sup> SharkRepellent.

to use proxy access in a campaign for board control and the circumstances under which these well-funded activists would seek to include a proxy access nomination are the same circumstances under which they would launch a traditional proxy fight—the marginal cost savings of nomination through proxy access is unlikely to move this line in a meaningful way. Second, when ownership amount and duration thresholds are properly set with an eye towards avoiding abuse by investors who lack a meaningful long-term interest in the company, the shareholders best positioned to make use of these bylaws are institutional investors. Consequently, boards and management with a proven track record of delivering value should have little more to fear if they have developed a thoughtful long-term plan and clearly articulated it to shareholders by engaging in constructive dialogue.

#### **4. Succession Planning**

In 2009, the SEC reversed its position that shareholder proposals relating to succession planning were excludable on the grounds that succession planning related to the company’s ordinary operations. Since this reversal, a number of shareholder proposals have been submitted seeking to require development or disclosure of a company’s succession plan. These proposals typically urge a company to adopt detailed policies regarding succession planning, often in their corporate governance guidelines, and to make certain disclosures relating to succession planning. For example, in 2012, the AFL-CIO filed a proposal calling for Berkshire Hathaway to adopt a succession planning policy that would include developing criteria for the CEO, identifying internal candidates, and annually reviewing and publishing a report on the plan. The proposal received less than five percent of votes cast. No succession planning proposals were received by S&P 500 companies during the 2015 proxy season.<sup>203</sup>

#### **5. Executive Compensation**

The advent of say-on-pay in 2011 reduced, but did not eliminate, compensation-based shareholder proposals. A total of 92 compensation-related shareholder proposals were brought in 2015 at S&P 500 companies down from 95 in 2014 and 133 in 2013.<sup>204</sup> Of the proposals received, 34 targeted “golden parachutes” and sought to limit accelerated vesting of equity awards averaging support of 32.4 percent and 22 sought adoption or disclosure of clawback policies averaging support of 30.3 percent.<sup>205</sup> Only one compensation related proposal passed in 2015.<sup>206</sup>

#### **6. Exclusive Forum Bylaws**

Recent history suggests that, despite activists’ best efforts to the contrary, shareholders approve of exclusive forum provisions. In 2015, 25 companies sought ratification of an existing exclusive forum bylaw or put adoption of such a provision to shareholder vote and only six pro-

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<sup>203</sup> SharkRepellent.

<sup>204</sup> *Id.* Includes all management and director compensation related proposals other than say-on-pay proposals received for inclusion at an annual or special meeting for companies in the S&P 500 at the time the proposal was received.

<sup>205</sup> *GDC Shareholder Proposal Developments During the 2015 Proxy Season* at 5.

<sup>206</sup> SharkRepellent. Includes all shareholder proposals related to management and director compensation other than say-on-pay proposals received for inclusion at an annual or special meeting for companies in the S&P 500 at the time the proposal was received.

posals failed to pass despite ISS recommending “against” nearly all of the proposals.<sup>207</sup> Further, prior to 2015, only three management proposals to adopt an exclusive forum provision have failed—one in 2011 and two in 2012.<sup>208</sup> Similarly, during the 2012 proxy season, the two shareholder proposals to repeal exclusive forum bylaws that were brought to a vote were rejected, receiving less than 40 percent support, notwithstanding ISS’s recommendation for repeal in each case.

## 7. Social and Environmental Issues

Over 40 percent of all shareholder proposals in the 2015 proxy season were focused on social and environmental issues, representing the largest category of shareholder proposals submitted. Despite their prevalence, historically, average support for these proposals remains quite low on average (approximately 21 percent), although shareholder support varies widely by the proposal topic. Proposals receiving greater levels of shareholder support included those relating to political spending and lobbying, corporate sustainability and climate-change-related reporting and equal opportunity employment policies.<sup>209</sup> However, there may be an uptick in support for these proposal in the 2016 proxy season, as institutional investors, such as BlackRock, have recently advocated for social and environmental issues to be primary considerations in companies’ long-term plans for creating sustainable value and the U.S. Department of Labor has recently confirmed that social and environmental issues are proper components of a pension plan’s fiduciary’s primary analysis of the economic merits of competing investment choices.<sup>210</sup>

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<sup>207</sup> Shirley Wescott, *2015 Proxy Season Review*, THE ADVISOR 8 (August 2015), available at <http://www.governanceprofessionals.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=f562b4f3-d4ff-41f0-a90c-b92165d4ee68>. In 2015, exclusive forum bylaw proposals failed to garner the requisite support at Avery Dennison, Bristol-Myers Squibb, Caleres, Commercial Vehicle Group, DSP and Noravax.

<sup>208</sup> *Id.*

<sup>209</sup> SharkRepellent. Includes all shareholder proposals related to environmental and social issues received for inclusion at an annual or special meeting for companies in the S&P 500 at the time the proposal was received.

<sup>210</sup> On February 2, 2016, Larry Fink, CEO of BlackRock, sent a letter to the Chief Executives of S&P 500 companies and others noting that “Generating sustainable returns over time requires a sharper focus not only on governance, but also on environmental and social factors facing companies today. These issues offer both risks and opportunities, but for too long, companies have no considered them core to their business . . . . Over the long-term, environmental, social and governance issues have real and quantifiable financial impacts. . . . Blackrock has been undertaking a multi-year effort to integrate [social and environmental] considerations into our investment process.” Letter from Laurence D. Fink, Chairman and CEO of BlackRock Inc. (February 2, 2016) Letter, available at <http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2>. In October of 2015, the U.S. Department of Labor clarified that Social and Environmental issues “may have a direct relationship to the economic value of the plan’s investment. In these instances, such issues are not merely collateral consideration or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.” Economically Targeted Investments and Investment Strategies that Consider Environmental, Social and Governance Factors, 29 C.F.R. pt. 2509 (Oct. 26, 2015), available at <https://s3.amazonaws.com/public-inspection.federalregister.gov/2015-27146.pdf>.



## V. Proxy Contests

In a proxy contest, a shareholder solicits the proxies of other shareholders to support a matter up for shareholder vote in opposition to company management and the board. Most proxy fights are over the election of directors, but a dissident could also be contesting other issues, such as governance changes or a precatory proposal to sell or break up the company. Proxy fights also often accompany hostile takeover bids, as the raider needs to replace the board in order to eliminate the shareholder rights plan, or poison pill, to complete the acquisition. A proxy fight that is part of a takeover bid is not typically handled by the nominating and corporate governance committee, but by the full board. The nominating and corporate governance committee may, however, play a significant role in a stand-alone proxy fight (such as considering the qualifications of the dissident's candidates so that they can make a recommendation to the full board).

Unlike a shareholder proposal pursuant to Rule 14a-8 promulgated under the Exchange Act—in which the proponent seeks to include a proposal in the company's proxy statement—in a proxy contest, the dissident files its own separate proxy statement. Because the aim of a proxy contest is typically to replace a company's leadership and fundamentally alter the company's direction, the stakes are very high. A dissident may nominate a full slate, in which it proposes a candidate for each board seat, or a partial slate (a "short slate"), in which it nominates fewer candidates than there are available board seats, often stopping short of seeking to take control of the board. A dissident may run a partial slate because it has concluded that it could not garner support to replace the entire board or seize control, but may be able to elect a minority of directors to act as a catalyst for change in the boardroom.

With the recent increase in adoption of "proxy access" bylaws, over the next few years trends should begin to emerge giving companies insight into who will make use of these bylaws and for what purposes. It is not expected that well-capitalized activists that are strongly incentivized to place their candidates on a board will rely on proxy access instead of their own proxy materials. Proxy access is more likely to be used by smaller activist funds and corporate governance activists, as well as special interest groups (such as unions), that do not want to invest in a proxy contest. Proxy access may also be utilized by large institutional shareholders, although they already have (and have had for some time) the substantial ability to influence the board composition of their portfolio companies by direct engagement. Even where all a company is facing is a slate of proxy access candidates, and not a full-fledged counter solicitation, it is likely that companies will in many cases still see that as a "proxy fight" that threatens the corporation and will respond accordingly. Even if a company ultimately prevails in the proxy contest, it could suffer a high cost in terms of distraction and reputational damage (which some activists seek to exploit).

The number of proxy contests at S&P 500 and Russell 3000 companies modestly decreased in 2015, to 64 from 66 in 2014.<sup>211</sup> Notably, the trend of activists targeting large companies continued in 2015: 24 of the 64 targeted companies had market capitalizations of over \$1

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<sup>211</sup> SharkRepellent. Numbers include all proxy contests (not just those for board seats) at S&P 500 and Russell 3000 companies for each year.

billion, consistent with 27 in 2014 and 23 in 2013.<sup>212</sup> This indicates that even large companies once considered generally immune from activist investors are becoming targets. Interestingly, however, activist success rates have been dropping since 2013. In 2015, activists were successful in proxy contests or agreed to favorable settlements at S&P 500 and Russell 3000 companies 53 percent of the time compared to 64 percent in 2014 and 69 percent in 2013.<sup>213</sup>

Although they play an important role in corporate governance and are in some cases justified, proxy contests are expensive and distracting. All companies should have state-of-the-art advance notice bylaws to limit their time of vulnerability and improve predictability. (See Section III.D for a discussion on advance notice bylaws.) In addition to establishing the time period in which a shareholder may submit nominations or other business, the bylaws may also specify reasonable qualification requirements and solicit the disclosure of important information (such as information about potential conflicts) in a director nomination questionnaire.

Depending on the issue at stake, a proxy fight may well command the attention of the board and the highest echelons of management. It is most important that a company facing a proxy fight have a qualified and experienced team of advisors, including lawyers, bankers, public relations and investor relations professionals and proxy solicitors. Proxy fights involve many strategic decisions in a fast-changing environment. They can also be emotionally draining, given the high stakes and the fact that some shareholder activists specialize in personal attacks. A company faced with a proxy contest may wish to consider settling prior to the actual vote. A settlement may require considerable concessions from both the company and proponent but may also offer a better alternative to pursuing the fight all the way to the vote.

There are many negotiable elements that may be part of a settlement. A company may agree to expand its board and to support some or all of the proponent's nominees for election at the annual meeting or to increase the number of independent board members. A proponent who is running a slate after having expressed the desire for economic changes may agree to withdraw the slate in exchange for the implementation of these economic changes (or a promise to consider them). A company in turn may require that the proponent agree to a "standstill" provision that prohibits the proponent from engaging in proxy contests, submitting proposals or proposing various transactions, such as additional stock purchases or tender offers, for a specified period of time. In evaluating whether to settle or fight in a given proxy contest, a company may consider the actual costs and distractions of conducting a protracted contest against the likelihood of success, as well as the ability of the existing members of a company's management and directors to productively engage with the dissident's proposed nominees. A company may also evaluate the likely terms or parameters of a potential settlement and the impact on the company's ongoing business in engaging in an extended fight.

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<sup>212</sup> *Id.* Numbers include all proxy contests (not just those for board seats) at companies with a market capitalizations greater than \$1 billion for each year.

<sup>213</sup> *Id.* The numerator includes the sum of (i) all successful proxy contests and (ii) all proxy contests in which an activist agreed to a favorable settlement (not just those for board seats) at S&P 500 and Russel 3000 companies for each year.

## VI. Shareholder Engagement

Among the many changes in the corporate governance landscape seen in recent years, one of the most fundamental is companies', and particularly directors', relations with their shareholders. In addition to the other escalating demands of board service, directors are increasingly called upon—and shareholders increasingly expect directors—to meet with shareholders on corporate governance and other matters. One major impetus for this increased shareholder outreach was the enactment of mandatory say-on-pay voting. A recent survey by PricewaterhouseCoopers found that 69 percent of boards had direct communication with institutional investors in 2015, compared to 66 percent in 2014.<sup>214</sup> The same study also found an increased willingness to engage with institutional investors on say-on-pay issues—77 percent of boards felt that shareholder engagement on executive compensation was appropriate compared to 45 percent in 2013. Two-thirds of directors also stated that it is appropriate for companies to engage with shareholders on risk oversight issues, compared with 48 percent in 2013.<sup>215</sup> However, this trend has been increasing over many years, as institutionalization of share ownership has increased. Today, retail shareholders account for a minority of the float of most public companies.<sup>216</sup> The majority of the company stock is in the hands of institutional investors, who are themselves intermediaries representing the interests of the ultimate beneficial owners.

The SEC requires a company to disclose whether it has procedures for shareholders to communicate with the board of directors. If so, the company must describe how these communications may be sent to the board. If not, the company must disclose that it does not have such a policy and explain why the board believes it is appropriate for the company not to have such a process.<sup>217</sup> Companies are increasingly using their public filings as an opportunity to highlight their engagement with shareholders. A survey by Ernst & Young found that the percentage of S&P 500 companies disclosing these engagement efforts increased to over 56 percent in 2015 from only six percent in 2010.<sup>218</sup> Of companies making such disclosure, 46 percent disclose changes in practices or disclosure as a result of engagement and 18 percent disclose when board members are directly involved in engagement efforts.<sup>219</sup>

While a director's primary focus must remain on partnering with and overseeing management to enhance the long-term value of the company, the board must adjust to this new corporate governance landscape and be sensitive to shareholder demands. Shareholder concerns should be listened to and addressed in a constructive manner, and the nominating and corporate governance committee should ensure that the company maintains a shareholder relations program that clearly articulates the reasons for the company's strategies and engenders support from the company's major shareholders. Ordinarily, management should serve as the primary point of

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<sup>214</sup> PricewaterhouseCoopers, *2015 Proxy Season Wrap-Up 2* (Aug. 2015), <https://www.pwc.com/us/en/corporate-governance/publications/assets/pwc-proxy-pulse-third-edition-august-2015.pdf>.

<sup>215</sup> *Id.* at 7.

<sup>216</sup> Further, retail shareholders rarely vote. During the 2015 proxy season, retail shareholders voted only 28 percent of the shares they owned. *Id.* at 2.

<sup>217</sup> Item 407(f) of Regulation S-K. 17 C.F.R. 229.407(f).

<sup>218</sup> Ernst & Young LLP, *Four Key takeaways from Proxy Season 2015 2* (June 2015), [http://www.ey.com/Publication/vwLUAssets/EY-four-takeaways-from-proxy-season-2015/\\$File/EY-four-takeaways-from-proxy-season-2015.pdf](http://www.ey.com/Publication/vwLUAssets/EY-four-takeaways-from-proxy-season-2015/$File/EY-four-takeaways-from-proxy-season-2015.pdf).

<sup>219</sup> *Id.*

contact for shareholder outreach. However, the nominating and corporate governance committee may sometimes find it appropriate and beneficial for this outreach to include direct communication between directors and shareholders. In the event of such communication, management and the board should take care to coordinate their messages to avoid causing confusion among investors. The board and management should work out disagreements internally, and the company should speak to shareholders with a unified voice.

The importance of effective shareholder outreach has been amply demonstrated in recent proxy seasons. Most notably, DuPont, the largest corporation to ever engage in a proxy fight, defeated Nelson Peltz's campaign for four board seats even after ISS and Glass Lewis endorsed parts of the dissident slate. By highlighting its proven track record of value creation, clearly communicating its long-term plan to institutional investors—including BlackRock, Vanguard and State Street who all voted for the company—and noting the short-term focused, value destroying aspects of Peltz's plan to split the company in two (*e.g.*, it would have resulted in a loss of DuPont credit rating), DuPont convinced its shareholder base to stand by the board and rebuff Peltz's activist strategy.<sup>220</sup> Additionally, retail shareholders—representing approximately 30 percent of DuPont's shareholder base—played a significant role in this proxy contest. Further, shareholder engagement was critical in obtaining shareholder ratification at Bank of America's 2015 annual meeting of its unilateral bylaw change to permit Brian Moynihan to serve as both chief executive and chairman of the company.<sup>221</sup>

Additionally, there has been an increasing trend of firms disclosing both their shareholder engagement efforts and changes resulting from those efforts in their annual proxy statement. In 2015, a number of companies, including PepsiCo, The Coca-Cola Company, General Electric, Intel Corporation, Microsoft Corporation and Pfizer, Inc., made detailed disclosures in their proxy statements about reaching out to shareholders on corporate matters. For example, after receiving “valuable feedback from shareholders and other stakeholders,” PepsiCo decided to, among other changes, amend its corporate governance guidelines and committee charters to specify duties regarding management succession planning and adopt a new 100 percent performance-based long-term incentive plan.<sup>222</sup> General Electric determined to, “after considering feedback received from investors,” among other things, implement proxy access and increase the Board's oversight of corporate political spending with the Governance and Public Affairs Committee of the board approving an annual budget.<sup>223</sup> Pfizer reported engaging its institutional shareholders both within and outside the U.S. representing approximately 40 percent of its outstanding share capital on compensation, the board's oversight of cybersecurity risks, the ability

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<sup>220</sup> See, Ronald Orol, *Why DuPont Beat Nelson Peltz in the Biggest Proxy Fight in Years*, THESTREET.COM (May 20, 2015), <http://www.thestreet.com/story/13158047/1/why-dupont-beat-nelson-peltz-in-the-biggest-proxy-fight-in-years.html>.

<sup>221</sup> See, Christina Rexrode, *Bank of America's Brian Moynihan Survives Chairman-CEO Vote*, THE WALL ST. J. (Sep. 22, 2015), <http://www.wsj.com/articles/bofas-moynihan-survives-chairman-ceo-vote-1442931646?cb=logged0.4272247084646549>.

<sup>222</sup> PepsiCo., Definitive Proxy Statement (Schedule 14A) at 18 (Mar. 25, 2015), available at <https://apps.intelligize.com/SECFilings?key=9h3qNqOHjdGxzt74s4CyQ==#:Home-2016-03-09-10-32-46>.

<sup>223</sup> General Electric Co., Definitive Proxy Statement (Schedule 14A) at 13, available at [http://www.ge.com/ar2014/assets/pdf/GE\\_2015\\_Proxy\\_Statement.pdf](http://www.ge.com/ar2014/assets/pdf/GE_2015_Proxy_Statement.pdf).

of shareholders to act by written consent, proxy access and board oversight over political spending.<sup>224</sup>

The impact of shareholder engagement was also seen in the say-on-pay context. Georgetson reported that almost all of the 39 companies that successfully passed their say-on-pay vote in 2013 after failing to do so in 2012 disclosed a shareholder outreach effort in their 2013 proxy statements, and many described the number of top shareholders that they contacted and/or the percentage of shareholdings that were covered in their outreach efforts.<sup>225</sup> A study by The Conference Board noted that “companies that were in the 70-percent-or-less category in 2012 were rewarded for their subsequent efforts to improve investor relations with an increase in 2013 in average shareholder support of nearly 16 percentage points.”<sup>226</sup> However, for 2014, The Conference Board observed that “[t]here is a significant year-over-year turnover in failed votes . . . and all the companies that failed their say-on-pay votes in 2014 had successful votes in 2013, in most cases by wide margins,” and that consequently, “companies cannot lower their guard when it comes to compensation oversight and need to ensure ongoing transparency.”<sup>227</sup>

Effective shareholder engagement is particularly important when the company finds itself under attack from activist investors or facing a hostile takeover bid or other corporate crisis. In an activist situation, including one culminating in a proxy fight, well-established relationships with large shareholders can prove outcome determinative. These relationships should be cultivated on a continual basis as part of the company’s advance preparedness for an activist situation. A board that begins a dialogue with shareholders only when it is under attack puts itself at a significant disadvantage.

Constructive discussions with the activist and other shareholders may allow the board to reach a compromise resulting in the withdrawal of a shareholder proposal. Indeed, an Ernst & Young survey found that as of April 2015, 17 percent of shareholder proposals had been withdrawn from 2015 meetings, consistent with 18 percent for the same period in 2014. Further, 70 percent of these withdrawn proposals were the result of constructive dialogue between the company and its shareholders, sometimes coupled with actions by the company.<sup>228</sup> Even if an accommodation is not reached, good-faith discussions with the activist will strengthen the company’s position with respect to other shareholders and proxy advisory firms. This can be particularly valuable if the company solicits other shareholders and proxy advisory firms to vote against the proponent’s proposal.

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<sup>224</sup> Pfizer, Inc., Definitive Proxy Statement (Schedule 14A) (Mar. 12, 2015), available at <http://www.pfizer.com/system/files/presentation/ProxyStatement2015.pdf>.

<sup>225</sup> See Georgetson Report, *Facts Behind 2013 “Turnaround” Success for Say on Pay Votes* 4 (Aug. 28, 2013), available at <http://www.georgetson.com/us/resource/Pages/sayonpay.aspx>.

<sup>226</sup> Melissa Aguilar, et al., The Conference Board, *Proxy Voting Analytics (2009-2013)*, at 10 (Sept. 2014), available at <http://www.conferenceboard.org/proxy2013>.

<sup>227</sup> Melissa Aguilar & Matteo Tonello, The Conference Board, *Proxy Voting Analytics (2010-2014) Executive Summary* 13, available at <http://www.conference-board.org/competencies/publicationdetail.cfm?publicationid=2828&competencyID=3>.

<sup>228</sup> Ernst & Young, *2015 Shareholder Proposal Landscape* 1 (April 2015), [http://www.ey.com/Publication/vwLUAssets/EY-shareholder-proposal-landscape/\\$FILE/EY-shareholder-proposal-landscape.pdf](http://www.ey.com/Publication/vwLUAssets/EY-shareholder-proposal-landscape/$FILE/EY-shareholder-proposal-landscape.pdf).

Although the need for shareholder engagement is felt most acutely during a proxy fight or in response to a specific crisis, the nominating and corporate governance committee must recognize that, in this new corporate governance landscape, shareholder outreach is best seen as a regular, ongoing initiative. As part of this ongoing initiative, the nominating and corporate governance committee should track the composition of the company's shareholders and stay abreast of any reports on the company by proxy advisory services. Majority voting standards, changes to stock exchange policies regarding discretionary broker votes, board declassification and other changes to best practices have reduced the predictability in voting outcomes. In this environment, strong shareholder relations and a robust explanation of the company's corporate governance policies are perhaps more important than ever before. Dialogue with shareholders can help to increase the board's credibility, enhance the transparency of governance decisions, preempt shareholder resolutions and proxy fights and otherwise navigate potentially contentious issues with shareholders.

In 2014 the chief executive of one of the world's largest institutional investors, Vanguard, suggested, in letters sent to many companies that company boards should create "shareholder liaison committees" to provide investors with a direct line of communication to the board.<sup>229</sup> The Vanguard suggestion offers an intriguing alternative for meaningful engagement between directors and shareholders, but might be more appropriately and flexibly effectuated through a board subcommittee, perhaps a subcommittee of the nominating and governance committee. Such a subcommittee need not have set membership with fixed terms but could instead remain flexible. For example, where shareholders voice concerns about compensation matters, the board could add compensation committee members to the subcommittee. If shareholders later begin a dialogue about environmental matters, directors with that expertise could be brought on. In this way, a board of directors can ensure that, at any given time, the subcommittee consists of those directors most readily equipped to engage on matters of actual shareholder concern. Of course, in many instances, shareholder engagement may be most efficient and appropriate between shareholders and members of a company's management or investors-relations team, without the need to involve directors each and every time a shareholder wishes to express its view.

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<sup>229</sup> Stephen Foley & David Oakley, *Vanguard Calls for Boardrooms Shake-up*, Fin. Times (Dec. 4, 2014), <http://www.ft.com/cms/s/0/543c3b72-7b4c-11e4-87d4-00144feabdc0.html#axzz3UJIeYq3d>.

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**PART TWO:**

**THE “NOMINATING” FUNCTION OF THE NOMINATING AND  
CORPORATE GOVERNANCE COMMITTEE**

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## **VII. Building an Effective Board**

Traditionally, identification and recommendation of board candidates constituted the primary roles of the nominating committee. Although, as discussed, this committee now has assumed a much greater role in formulating appropriate governance mechanisms and policies, its role in populating the board is still a core and vitally important function. Before the nominating and corporate governance committee goes about the work of identifying individual director candidates or formulating specific corporate governance policies, it should first have a strong understanding of the role of the board of directors.

### **A. The Role and Responsibilities of the Board of Directors**

#### **1. The Dual Role of the Board**

The board of directors serves as both a monitor and a partner of the management team it selects to run the day-to-day affairs of the company. To be effective, a board must find the right balance between its monitoring and advising functions; and between engaging in a “hands-on” approach to oversight and giving management the latitude necessary to operate the business. To properly oversee management, directors must maintain a thorough understanding of the company by asking the right questions and cultivating dialogue, transparency and robust information-sharing between the board and management. At the same time, the board must take care that this oversight does not encroach into areas better reserved for the company’s management.

While boards have always played the dual role of monitor and partner, increased political and regulatory pressure for enhanced risk management have combined with a shift towards a more shareholder-centric model of corporate governance to tilt the balance. Specifically, many companies have reacted to those changes by emphasizing more heavily the board’s monitoring function at the expense of the board’s equally important advisory role. Although the board must diligently oversee management and be prepared to step in when necessary, most often a company is best served when directors and management work together to set and achieve the company’s goals. So long as directors exercise their independent judgment, it is not only perfectly appropriate for directors and management to develop relationships of mutual trust and friendship, it is vital. Such relationships enable management to draw on the insights and judgment of directors and facilitate the board’s oversight and partnership functions by fostering greater communication, thereby allowing the board to provide more meaningful input into key decisions. Indeed, if a director does not trust and respect management, the director should reconsider whether she or he is a good fit for the company, or, if enough other directors share this view, the board should consider whether changes to the management team might be in order.

#### **2. Tone at the Top**

Setting the right tone at the top is one of the most critical functions of an effective board. The board’s culture and priorities, if properly instilled and communicated, will ripple through the company and its interactions with its various constituencies. The board should work with senior management to cultivate a corporate culture of integrity, compliance and professionalism. Transparency and communication are key to the board’s ability to set the right tone at the top. Even the most involved boards will find that they are unable to micromanage conformance to the

company's standards. Rather, the board should focus on setting the right tone and ensuring that monitoring programs are in place and regularly assessed. The company's code of conduct should not be a mere formality: The code must be an ethos that is ingrained in the company's strategy and operations. Trends among boards in recent years support this notion. PricewaterhouseCoopers' 2015 Annual Corporate Director Survey found the most common board action taken to reduce fraud risk in 2015 was to hold discussions regarding tone at the top with 68 percent of surveyed board reporting such discussions, up 22 percent from 2012.<sup>230</sup>

### 3. Risk Management

In addition to its many other corrosive effects, a failure to instill the right corporate culture creates the risk of serious reputational, regulatory or legal consequences. This has been underscored in recent years by disasters such as the financial crisis and the BP oil spill, which have resulted in tens of billions of dollars in liabilities and brought an unprecedentedly bright spotlight on the board's role in overseeing risk management. In 2009, the SEC amended its rules to require disclosure of the extent of the board's role in risk oversight of the company.<sup>231</sup> Among many other changes targeting risk management, Dodd-Frank requires each publicly traded bank holding company with \$10 billion or more in assets to establish a stand-alone, board-level risk committee. While these crises and their backlash demonstrate the need for vigilant oversight, they do not change the fundamental principle of corporate governance that the proper role of the board in managing the company's risk is one of *oversight* rather than direct implementation. Through proper oversight and setting the right tone at the top, the board can ensure that the company has an appropriate risk profile and that its officers and employees view risk management not as an impediment but as an important part of the company's success. In fulfilling its oversight duty, the roles and responsibilities of different board committees in overseeing specific categories of risk should be reviewed to ensure that, taken as a whole, the board's oversight function is coordinated and comprehensive.

Further, the board's focus on risk management is a top governance priority of institutional investors. A 2014 survey found that approximately 70 percent of investors thought that risk management should be a high priority area of short-term board focus<sup>232</sup> and a 2015-2016 National Association of Corporate Directors survey revealed that risk oversight was one of the top three issues discussed with institutional investors at large cap companies.<sup>233</sup> Likely stemming from the heightened shareholder focus on the topic—and of particular interest to nominating and governance committee members—nearly 80 percent of investors think that risk management expertise is a critical and desirable attribute on boards, second only to financial expertise.<sup>234</sup>

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<sup>230</sup> PricewaterhouseCoopers, *2015 Annual Corporate Director Survey* 32 (2015), <http://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-2015-annual-corporate-directors-survey.pdf>.

<sup>231</sup> Item 407(h) of Regulation S-K. 17 C.F.R. 229.407(h).

<sup>232</sup> PricewaterhouseCoopers, *Investor Perspectives: How Investors are Shaping Boards Today. . . and into the Future* 8 (October 2014), <http://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-investor-survey-2014.pdf>.

<sup>233</sup> National Association of Corporate Directors, *2015-2016 NACD Public Company Governance Survey* 13 (2015).

<sup>234</sup> PricewaterhouseCoopers, *Investor Perspectives: How Investors are Shaping Boards Today. . . and into the Future* 1 (October 2014), <http://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-investor-survey-2014.pdf>.

Recently, regulators have focused on cybersecurity as an issue that companies must be prepared to address. In March 2014, the SEC hosted a roundtable on cybersecurity topics and the following month began to review the cybersecurity preparedness of dozens of registered broker-dealers and investment advisors.<sup>235</sup> In June 2014, SEC commissioner Luis A. Aguilar stressed that “the capital markets and their critical participants, including public companies, are under a continuous and serious threat of cyber-attack, and this threat cannot be ignored.”<sup>236</sup> According to Mr. Aguilar, effective board oversight of management’s efforts to address threats from cyber-attacks “is critical to preventing and effectively responding to successful cyber-attacks and, ultimately, to protecting companies and their consumers, as well as protecting investors and the integrity of the capital markets.”<sup>237</sup> Certain highly publicized cybersecurity breaches, and the potentially serious reputational and other consequences of such breaches (notably including those at Sony Corporation), have highlighted the need for board involvement in such matters. As a result, boards have begun to become more engaged on the topic: in 2015, 66 percent of boards discussed the company’s cyber risk disclosures, up from 38 percent in 2014.<sup>238</sup> However, despite the increased focus, a recent survey found that only 14 percent of directors believe that their respective boards have a high level of understanding of the risks associated with inadequate cybersecurity, and 43 percent of directors feel that the board does not receive enough information from management regarding cybersecurity and IT risk.<sup>239</sup>

Boards should not assume that cybersecurity is too technical for meaningful director input or that the issue is best left to a company’s IT function. Additionally, while the board should be actively involved in overseeing and advising efforts to prevent cyber-attacks, the board should also be actively involved in preparing for and putting into place a process for effectively managing the effects of any cyber-attack. A board must provide effective oversight over cybersecurity through risk and crisis management by ensuring that cybersecurity is well integrated into enterprise risk management and that the company has in place systems that enable it to respond effectively to cyber-attacks and cyber-breaches.<sup>240</sup>

#### 4. Crisis Management

Closely related to its role in risk management, the board must also be prepared to meet effectively any crisis that may confront the company. Examples of possible crises include an

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<sup>235</sup> See SEC, Office of Compliance Inspections and Examinations, *National Exam Program Risk Alert, OCIE Cybersecurity Initiative* Vol. IV, Issue 2 (Apr. 15, 2014), available at <http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix++4.15.14.pdf>.

<sup>236</sup> See Public Statement, Luis A. Aguilar, Comm’r, SEC, *The Commission’s Role in Addressing the Growing Cyber-Threat* (Mar. 26, 2014), available at <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370541287184#.VEUXBfldWvg>.

<sup>237</sup> *Id.*

<sup>238</sup> PricewaterhouseCoopers, *2015 Annual Corporate Director Survey* 43 (2015), <http://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-2015-annual-corporate-directors-survey.pdf>.

<sup>239</sup> Additionally, 31 percent of directors reported being dissatisfied with the quality of information they receive from management regarding cybersecurity risks facing their respective companies. National Association of Corporate Directors, *2015-2016 Public Company Governance Survey* 7 (2015), <https://www.nacdonline.org/files/2015-2016%20NACD%20Public%20Company%20Governance%20Survey%20Executive%20Summary.pdf>.

<sup>240</sup> For more detailed advice on board oversight of cybersecurity, see David A. Katz & Laura A. McIntosh, *Corporate Governance Update: The Risky Business of Cybersecurity*, N.Y. L.J. (Oct. 30, 2014), available at <http://www.newyorklawjournal.com/id=1202674985401?keywords=risky+business+of+cybersecurity&publication>.

unexpected departure of the CEO or other key members of management, rapid deterioration of business conditions or liquidity, risk management or product failures, government investigations and major disasters. Crises, almost by definition, are unexpected. That said, a board can prepare itself by thoroughly understanding the company's business and industry, with an eye towards anticipating what challenges the company is most likely to face.<sup>241</sup> When a crisis does strike, the CEO generally should lead the company's response, with guidance and input from the board. However, if the CEO has been compromised, the board must be ready to take a more active role in navigating the company through the crisis.

## **B. Board Composition**

The most important factors in determining the effectiveness of a board are the quality of the people who serve as directors and their ability to work together. This is one reason that the nominating and corporate governance committee's role in identifying director nominees is so critical to a company's success. What is needed from directors is an emphasis on integrity, character, commitment, judgment, energy, competence and professionalism, and the right mix of industry savvy and financial expertise, objectivity and diversity of perspectives and business backgrounds, among other qualities. Almost as crucial as the caliber of the directors as individuals is how well they function as a group. Although a director's qualifications may be discerned easily from a resume or profile, the dynamics of a board can only be understood by those directors and officers (and advisors) who actually participate in its meetings. A collegial board with mutual trust and complementary skill sets can add value to the corporate enterprise that is greater than the sum of its parts, while a balkanized board will usually be ineffective regardless of the quality of its individual directors. Unfortunately, board culture and cohesiveness are not easily captured and categorized on paper. The result is that such values are often underappreciated, especially in this age of one-size-fits-all "best practices."

The ever-increasing pressure from shareholder proxy advisory services, institutional investor groups, activist shareholders and other commentators for companies to conform to continuously evolving and escalating standards for so-called "best practices" has made the task of assembling a well-rounded board even more difficult in recent years. If proxy access becomes widely implemented and actually used by shareholders, the process of designing and building a balanced and effective board will become that much more complicated. One aspect of these "best practice" standards involves an intense, arguably even excessive, focus on director independence at the expense of other skills and qualifications. The combination of attributes, experiences and personalities that constitute an effective board is intrinsically difficult, if not impossible, to boil down to bright-line checklists or off-the-shelf mandates. Undeniably, these mandates, oversimplified governance grades and "best practices" are increasingly difficult to resist. Ultimately, however, directors serving on the nominating and corporate governance committee must be prepared to explain to shareholders that it is more important to have directors and governance policies that will best serve the company than to blindly conform to one-size-fits-all mandates.

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<sup>241</sup> In 2015, 77 percent of surveyed directors reported that their board had actively discussed management's plan to respond to a major crisis and 62 percent of boards discussed testing the company's crisis response plan. PricewaterhouseCoopers, *2015 Annual Corporate Director Survey* 31 (2015), <http://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-2015-annual-corporate-directors-survey.pdf>.

## 1. Director Qualifications

The nominating and corporate governance committee's search for nominees naturally begins with an analysis of the qualities that the committee seeks in a candidate. This analysis should consist of both an assessment of the skills and experiences possessed by current board members and a vision of the ideal mix of director skills and experiences, given the company's circumstances. By comparing the skills and experiences already represented on the board with the ideal complement of skills and experiences, the nominating and corporate governance committee will be well positioned to create a candidate profile and also to assess how well current board members fit the company's needs.

All directors should possess certain qualities, such as integrity, sound judgment and a commitment to representing all shareholders. But the nominating and corporate governance committee's greatest challenge in composing a board is to find the right complement of abilities and experiences among the directors that best serves the company. This requires a thorough understanding of the company, its business, its competitive landscape and its strategy. Attributes and experiences typically sought by a nominating and corporate governance committee include financial or risk assessment expertise, background in the company's industry, familiarity with the company, diversity, legal or regulatory compliance knowledge, valuable international or local connections, experience in academia or government and service as an executive officer or director of a public company.<sup>242</sup> Among other sources of data, committee members can consider previous board and committee reviews and director self-evaluations as indicators of skills, experiences and other traits that may be desired on the board.

Although it is more common today for the chief executive officer to be the only member of management on the board, the nominating and corporate governance committee may consider adding a second member to ensure that the board includes directors intimately familiar with the company and to provide an additional source of direct input on the company's operations to the rest of the board. The nominating and corporate governance committee should continually evaluate the composition of the board to ensure that its combination of attributes fits the company's strategy and direction. For example, a company suddenly finding itself in financial or competitive difficulties may seek to add a turnaround expert, while a company confronted with a scandal or government investigation may benefit from additional expertise in compliance, government or public relations. The importance of frequently reassessing the alignment of the board's composition with the company's needs is underscored by the remarkable pace of economic, technological and regulatory changes in recent years.

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<sup>242</sup> A 2014 study found that shareholders believe financial expertise, risk management expertise, operational expertise and industry expertise to be the most important attributes to have represented on a corporate board. PricewaterhouseCoopers, *Investor Perspectives: How Investors are Shaping Boards Today. . . and into the Future* 1 (October 2014), <http://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-investor-survey-2014.pdf>. However, a 2015 survey of directors found that industry specific experience, leadership experience and strategic development know-how are the most desirable attributes for boards in evaluation of potential director candidates. National Association of Corporate Directors, *2015-2016 NACD Public Company Governance Survey* 26 (November 2014).

## 2. Skills Matrices

One increasingly popular tool for analyzing board composition against previously established criteria is the skills matrix. A skills matrix is a boxed chart with one axis listing each director or nominee and the other axis listing the attributes that the nominating and corporate governance committee desires to be represented on the board. These may include attributes that every director should possess as well as attributes that should be represented by some subset of the board. Examples of the latter include financial or risk assessment expertise, background in the company's industry, and legal or regulatory compliance knowledge.

A skills matrix can serve as a visual, straightforward way of understanding the strengths of the board and identifying any areas in which it may need improvement. It may also assist the nominating and corporate governance committee both in analyzing the areas in which current directors could benefit from additional training or exposure and also in evaluating which new candidate would best complement the board's current composition. However, when using a skills matrix, the nominating and corporate governance committee should be mindful of the less tangible characteristics of directors, like individual personalities, that may not be easily represented in the matrix but are nonetheless crucial in achieving a healthy board dynamic. Because the company's need for particular attributes will change over time, it is also essential that the nominating and corporate governance committee assess on an ongoing basis the mix of skills and experiences that is desired and that is represented on the board.

A recent survey by Ernst & Young reported that nine percent of S&P 500 companies included such a matrix in their 2015 proxy statements, up from six percent in 2014.<sup>243</sup> Including a skills matrix in the company's proxy statement can be helpful in preempting or responding to pressures for board refreshment and providing greater objectivity and transparency to the nomination process. Whether or not a nominating and corporate governance committee chooses to utilize or disclose a skills matrix, the focus remains the same: the committee should identify nominees who will best contribute to the formation of a well-rounded and effective board.

## 3. Diversity

The issue of boardroom diversity—particularly gender diversity—has become increasingly prominent in recent years in the United States and abroad. Several European countries have adopted mandatory quotas for gender diversity, and a pending proposal by the European Commission would require large public companies to introduce a new director selection procedure that gives priority to qualified female candidates unless at least 40 percent of the board's non-executive directors are already women.<sup>244</sup> In the United States, the California state legislature adopted a resolution in 2013 urging every California public company to have one to three women on its board by the end of 2016,<sup>245</sup> and the state of Massachusetts approved a similar resolu-

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<sup>243</sup> Ernst & Young LLP, *2016 Proxy Statements*, Section 4.1 (Nov. 2015), available at [http://www.ey.com/Publication/vwLUAssets/2016ProxyStatements\\_CC0427\\_11November2015/\\$FILE/2016ProxyStatements\\_CC0427\\_11November2015.pdf](http://www.ey.com/Publication/vwLUAssets/2016ProxyStatements_CC0427_11November2015/$FILE/2016ProxyStatements_CC0427_11November2015.pdf).

<sup>244</sup> Press Release, European Commission, *Women on Boards: Commission Proposes 40% Objective* (Nov. 14, 2012), available at [http://europa.eu/rapid/press-release\\_IP-12-1205\\_en.htm](http://europa.eu/rapid/press-release_IP-12-1205_en.htm).

<sup>245</sup> S. Con. Res. 62, 2013-14 Leg. Sess. (Cal. 2013) ("Legislature . . . urges that, within a three-year period from January 2014 to December 2016, inclusive, every publicly held corporation in California with nine or more director

tion in 2015.<sup>246</sup> While the numerous legislative and non-legislative initiatives aimed at promoting diversity are not producing change at the speed that their proponents may desire, progress is being made: according to a recent survey, female representation among new directors has increased to 31 percent in 2015 from 17 percent in 2009, and recruiting minorities and women is among the top priorities identified by directors.<sup>247</sup>

Since 2010, the SEC has required public companies to disclose in their proxy statements whether their nominating and corporate governance committee considers diversity in identifying director nominees. If there is such a policy, the company must describe how this policy is implemented, as well as how the nominating and corporate governance committee or the board assesses the effectiveness of its policy.<sup>248</sup> Thus, any company stating that diversity is taken into account in identifying nominees may be requested to explain how the consideration of diversity is implemented and assessed. The SEC does not define “diversity” and notes that some companies may conceptualize diversity expansively and others more narrowly. The vast majority of large companies opts for the former expansive approach, considering diversity to encompass characteristics ranging from age, race, gender and geographic origin, to diversity of viewpoints and experience. A 2013 survey found that 97 percent of Fortune 100 companies disclosed that they seek diversity broadly defined, while 57 percent specifically included gender and ethnicity in their diversity considerations.<sup>249</sup> Interestingly, activist investors don’t seem to share the view of most large companies that diversity has a positive impact on the functioning of their boards. Since 2011, five of the U.S.’s largest activist funds have sought over 170 board seats but nominated women only seven times.<sup>250</sup> Of the 108 seats won by these activists, only five were filled by women.<sup>251</sup>

Focusing on diversity can have a number of salutary effects, such as bringing a wider range of experiences and perspectives to the board and ensuring that the nominating and corporate governance committee selects from the largest pool of potential candidates. However, diversity is only one of many components of an effective board, and the nominating and corporate governance committee should be cautious not to adopt policies that will bind it to promoting diversity at the expense of other important components. Board policies must be carefully articulat-

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seats have a minimum of three women on its board, every publicly held corporation in California with five to eight director seats have a minimum of two women on its board, and every publicly held corporation in California with fewer than five director seats have a minimum of one woman on its board.”), *available at* [http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb\\_0051-0100/scr\\_62\\_bill\\_20130920\\_chaptered.pdf](http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0051-0100/scr_62_bill_20130920_chaptered.pdf).

<sup>246</sup> Res. S. 107, 189th Gen. Ct., 2015-16 Leg. Sess. (Mass. 2015). The resolution was unanimously adopted by both the Massachusetts Senate on July 29, 2015 and the Massachusetts House of Representatives on October 21, 2015.

<sup>247</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 8, *available at* [https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015\\_110215-web.pdf?la=en](https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf?la=en).

<sup>248</sup> Item 407(c)(2)(vi) of Regulation S-K. 17 C.F.R. 229.407(c)(2). *See also* Proxy Disclosures Enhancements, Exchange Act Release Nos. 33-9089 and 34-61175 (Dec. 16, 2009), *available at* <http://www.sec.gov/rules/final/2009/33-9089>.

<sup>249</sup> Ernst & Young LLP, *Key Developments of the 2013 Proxy Season 5* (June 2013), *available at* [http://www.ey.com/Publication/vwLUAssets/Key\\_developments\\_of\\_the\\_2013\\_proxy\\_season/\\$FILE/Key-developments-of-the-2013-proxy-season.pdf](http://www.ey.com/Publication/vwLUAssets/Key_developments_of_the_2013_proxy_season/$FILE/Key-developments-of-the-2013-proxy-season.pdf).

<sup>250</sup> Carol Hymowitz, *Icahn, Loeb and Other Activists Overlook Women for Board Seats*, BLOOMBERGBUSINESS (March 8, 2016), <http://www.bloomberg.com/news/articles/2016-03-08/activists-from-icahn-to-loeb-overlook-women-for-board-positions>.

<sup>251</sup> *Id.*

ed to avoid creating absolute standards that may be difficult or imprudent to meet at particular times. For instance, boards of directors are ordinarily small enough that the departure of one or two directors could significantly alter the demographic makeup of the board. An absolute commitment to a certain level of diversity could restrict the nominating and corporate governance committee to considering only those potential candidates with the same diversity characteristics as the departing director. Determining board composition requires an individualized approach that takes all factors into account, rather than a one-size-fits-all requirement. The nominating and corporate governance committee should reexamine its diversity policies annually, perhaps in conjunction with reviews of the company's committee charters and governance guidelines.

#### **4. Regulatory Requirements**

As part of the process of forming the right mix of directors, the nominating and corporate governance committee must be mindful of all applicable regulatory requirements. For example, the SEC requires disclosure of any specific qualifications that a company's nominating and corporate governance committee believes must be met by a nominee and any specific qualities or skills that the committee believes are necessary for one or more of the company's directors to possess.<sup>252</sup> The SEC also requires disclosure of the specific experience, qualifications, attributes or skills that led to the conclusion that the nominee should serve as a director in light of the company's business and structure.<sup>253</sup> Combined, these two disclosures enable shareholders to compare a nominee's qualifications to the company's previously identified criteria. Additionally, SEC rules require companies to disclose whether their audit committee includes at least one qualified "financial expert" and, if the committee does not include at least one "financial expert," to provide an explanation.<sup>254</sup>

In addition to SEC requirements, the securities exchanges may have additional requirements. For instance, both the NYSE and Nasdaq require that all members of the audit committee be financially literate,<sup>255</sup> and provide additional rules for independent director oversight of executive compensation and the director nomination process.<sup>256</sup> The NYSE requires its listed companies to include in their corporate governance guidelines director qualification standards that, at a minimum, reflect the NYSE's independence requirements.<sup>257</sup> These standards may address other substantive qualification requirements, including limitations on the number of boards on which a director may sit, and director tenure, retirement and succession standards.<sup>258</sup> However, neither listing requirements nor state or federal law impose substantive standards that must be applied in the search for and selection of candidates, leaving the nominating and corporate governance committee to exercise its independent judgment in setting candidate criteria. An exercise of this judgment may include the decision not to adopt specific or rigid policies regarding director qualifications. While a nominating and corporate governance committee should carefully consider the qualifications and attributes it seeks in a candidate, the committee will often find it advisable to maintain the flexibility to adjust to the company's changing circumstances by

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<sup>252</sup> Item 407(c)(2)(v) of Regulation S-K, 17 C.F.R. 229.407(c)(2)(v).

<sup>253</sup> Item 401(e)(1) of Regulation S-K, 17 C.F.R. 229.401(e)(1).

<sup>254</sup> Item 407(d)(5) of Regulation S-K, 17 C.F.R. 229.407(d)(5).

<sup>255</sup> Commentary to NYSE Listed Company Manual, Rule 303A.07(a); Nasdaq Listing Rule 5605(c)(2)(A)(iv).

<sup>256</sup> Nasdaq Listing Rule 5601.

<sup>257</sup> Commentary to NYSE Listed Company Manual, Rule 303A.09.

<sup>258</sup> NYSE Listed Company Manual, Rule 303A.09.

avoiding rigid qualification requirements. Such an approach allows the committee to nominate the candidate it feels will best serve the company, even if the candidate does not fit neatly into a previously identified category.

### **C. Director Independence**

In assessing a director's independence, the nominating and corporate governance committee should take into account a number of sources. Securities markets impose mandatory requirements regarding director independence, whereas the SEC focuses on disclosure. State law, while not legally requiring independent directors, will sometimes view with heightened scrutiny the decisions of directors who are not independent. In addition to these regulatory considerations, the nominating and corporate governance committee should also be mindful of the independence views of proxy advisory services.

#### **1. Securities Market Independence Requirements**

Director independence is, by far, the most significant regulatory requirement that the nominating and corporate governance committee must consider with respect to board composition. Subject to limited exceptions, both the NYSE and Nasdaq require boards to consist of a majority of independent directors and to have adopted specific rules as to who can qualify as an independent director. Both markets require the board of any listed company to make an affirmative determination, which must be publicly disclosed (along with the basis for such determination), that each director designated as "independent" has no material relationship with the company that would impair his or her independence.<sup>259</sup> Such disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude a board from determining that an individual is independent.<sup>260</sup> As a general matter, these independence rules ask whether the director is a non-management director free of any material business relationships with the company and its management in the past three years (other than owning stock and serving as a director). Even if a director satisfies each listed requirement, the board must still determine whether the director could exercise independent judgment given all the facts and circumstances.

##### **(a) The NYSE Per Se Bars to Independence**

A director is not independent under the NYSE rules if:

- in the last three years, the director has been an employee or executive of the listed company or an immediate family member<sup>261</sup> has been an executive of the listed company;<sup>262</sup>

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<sup>259</sup> NYSE Listed Company Manual, Rule 303A.02(a)(i); Nasdaq Listing Rules 5605(a)(2) and IM-5605.

<sup>260</sup> Commentary to NYSE Listed Company Manual, Rule 303A.02; Nasdaq Listing Rules IM-5605.

<sup>261</sup> "Immediate family member" is defined to include a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who share such person's home. General Commentary to NYSE Listed Company Manual, Rule 303A.02(b).

- in any 12-month period in the last three years, the director or an immediate family member has received more than \$120,000 in direct compensation from the listed company, other than as director or committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);<sup>263</sup>
- the director is a current partner or employee of the company's auditor, an immediate family member is a current partner of the company's auditor or an employee who personally works on the listed company's audit, or within the past three years the director or an immediate family member personally worked on the listed company's audit;<sup>264</sup>
- in the last three years, the director or an immediate family member has been employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee;<sup>265</sup> or
- the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount that, in any of the last three fiscal years, exceeded the greater of \$1 million, or two percent of such other company's consolidated gross revenues.<sup>266</sup>

(b) Nasdaq Per Se Bars to Independence

A director is not independent under Nasdaq rules if:

- in the last three years, the director has been employed by the listed company or a family member<sup>267</sup> has been an executive of the listed company;<sup>268</sup>

<sup>262</sup> NYSE Listed Company Manual, Rule 303A.02(b)(i). Employment as an interim chairman, CEO or other executive officer will not disqualify a director from being considered independent following that employment. Commentary to NYSE Listed Company Manual, Rule 303A.02(b)(i).

<sup>263</sup> NYSE Listed Company Manual, Rule 303A.02(b)(ii). This \$120,000 limit does not apply to compensation received for former service as an interim chairman, CEO or other executive officer; compensation received by an immediate family member for service as an employee of the listed company (other than as an executive officer); or pension or other forms of deferred compensation for prior service, provided that such compensation is not contingent in any way on continued service. Commentary to NYSE Listed Company Manual, Rule 303A.02(b)(ii).

<sup>264</sup> NYSE Listed Company Manual, Rule 303A.02(b)(iii).

<sup>265</sup> NYSE Listed Company Manual, Rule 303A.02(b)(iv).

<sup>266</sup> Contributions to tax-exempt organizations are excepted from this limitation, but such contributions must be disclosed either on the company's website or in its annual proxy statement. Despite this exception, contributions to tax-exempt organizations may in some circumstances constitute a material relationship that compromises director independence. Commentary to NYSE Listed Company Manual, Disclosure Requirement, Rule 303A.02(b)(v).

<sup>267</sup> "Family member" is defined to mean a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. Nasdaq Listing Rule 5605(a)(2).

- in any 12-month period in the last three years, the director or a family member has received more than \$120,000 in any compensation from the company, other than as director or committee compensation,<sup>269</sup>
- the director or a family member is a partner in, or a controlling shareholder or an executive officer of, any organization to which the listed company made, or from which the listed company received, payments that in any of the past three fiscal years exceeded the greater of \$200,000 or five percent of the recipient's consolidated gross revenue for that year,<sup>270</sup>
- the director or a family member is employed as an executive officer of another entity where at any time in the last three years any of the company's executive officers served on that entity's compensation committee,<sup>271</sup> or
- the director or a family member is a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit in the last three years.<sup>272</sup>

## 2. SEC Requirements

The SEC requires disclosure of the following information relating to director independence in either a company's Form 10-K or its proxy statement:

- Whether each director is independent under the company's independence standards. Unless the company has adopted its own set of independence standards, this refers to the independence standards of the applicable securities exchange. If the company has adopted its own set of independence standards, the company must either state that the standards are posted on its website (and provide its website

<sup>268</sup> Nasdaq Listing Rules 5605(a)(2)(A), 5605(a)(2)(C). Service as an interim executive officer will not render a director non-independent after the cessation of the employment, provided that the interim employment lasted less than one year. Nasdaq Listing Rule IM-5605.

<sup>269</sup> Nasdaq Listing Rule 5605(a)(2)(B). Note that, unlike the NYSE rules, Nasdaq rules include indirect compensation in this \$120,000 threshold. For example, Nasdaq provides that political contributions to the campaign of a director or a family member would be considered indirect compensation. Nasdaq Listing Rule IM-5605. However, this \$120,000 restriction does not apply to compensation paid to a family member who is an employee (other than an executive officer) of the company, or to benefits under a tax-qualified retirement plan or non-discretionary compensation. Nasdaq Listing Rule 5605(a)(2)(B)(ii)-(iii). It likewise does not apply to compensation received for former service as an interim executive officer, so long as that service did not last more than one year. Nasdaq Listing Rule IM-5605.

<sup>270</sup> Payments arising solely from investments in the company's securities or under a non-discretionary charitable contribution matching program are exempt from this restriction. Nasdaq Listing Rule 5605(a)(2)(D)(i)-(ii). However, except for the non-discretionary charitable contribution matching program, a director may not be considered independent if the director or a family member serves as an executive officer of a charitable organization to which the company makes payments in excess of the greater of five percent of the charity's revenues or \$200,000. Nasdaq Listing Rule IM-5605.

<sup>271</sup> Nasdaq Listing Rule 5605(a)(2)(E).

<sup>272</sup> Nasdaq Listing Rule 5605(a)(2)(F). In the case of an investment company, in lieu of these restrictions, a director's independence is determined by reference to the "interested person" definition provided in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee. Nasdaq Listing Rule 5605(a)(2)(G).

address) or include a copy of these independence standards as an appendix to its proxy statement once every three years. If the company relies on an exemption from a national securities exchange requirement for independence of a majority of the board, the company must disclose the exemption and explain the basis for its conclusion that the exemption is applicable.<sup>273</sup>

- For each independent director, the types of transactions and relationships that the board considered in making its determination that the director was independent.<sup>274</sup>

### 3. State Law

The board of directors should also be cognizant of the criteria for independence in its company's state of incorporation when selecting directors and committee members. Courts apply heightened scrutiny when reviewing actions taken by directors with perceived conflicts of interest; accordingly, a company should strive to select its nominating and corporate governance committee in a way that will avoid judicial second-guessing. Consideration of independence when selecting committee members is particularly important because certain decisions are sometimes delegated to a committee precisely because the board as a whole may be viewed as tainted by a conflict of interest.

States ordinarily determine a director's independence based on his or her economic and familial relationships. Thus, a director who qualifies as independent under the NYSE or Nasdaq standards will typically also be considered independent under state corporate law. However, boards should consider all of the facts and circumstances surrounding a director's relationship to the company and management, appreciating that non-economic relationships may sometimes be found relevant. While each case depends on its own facts, in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*,<sup>275</sup> the Delaware Supreme Court rejected the argument that a run-of-the-mill personal friendship, without more, casts doubt on a director's independence.<sup>276</sup> This decision accords with the long-standing principle of Delaware corporate law that a non-management director is presumed to be independent in the absence of real evidence suggesting otherwise.

Notably, in the 2013 *MFW* case, then-Chancellor Strine stated that directors' satisfaction of the NYSE independence standards was informative, although not dispositive, of their inde-

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<sup>273</sup> Item 407(a)(1)-(2) of Regulation S-K. 17 C.F.R. 229.407(a)(1)-(2).

<sup>274</sup> Item 407(a)(3) of Regulation S-K. 17 C.F.R. 229.407(a)(3).

<sup>275</sup> *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1051 (Del. 2004). Plaintiffs argued that certain board members were not independent from Martha Stewart because "Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board and described each other as 'friends' . . . ."

<sup>276</sup> In 2015, the Delaware Supreme Court clarified that *Beam* was not intended to suggest "that deeper human friendships could not exist that would have the effect of compromising a director's independence." *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017, 1022 (Del. Sup. 2015). Drawing on this notion, the Delaware Supreme Court questioned the independence of a director who: (i) had a close friendship of over 50 years with the controlling shareholder and chairman of the company; and (ii) was an executive at an insurance brokerage that is a wholly owned subsidiary of a separate corporation of which the same chairman is the largest stockholder. *Id.* at 1022-23.

pendence under Delaware law.<sup>277</sup> Then-Chancellor Strine observed that the NYSE independence standards “were influenced by experience in Delaware . . . [,] cover many of the key factors that tend to bear on independence, including whether things like consulting fees rise to a level where they compromise a director’s independence, and they are a useful source for this court to consider when assessing an argument that a director lacks independence.”<sup>278</sup> The *MFW* case provides valuable guidance to nominating and corporate governance committees by reaffirming that directors who satisfy listing requirements for independence will generally qualify as independent under Delaware law.

#### 4. Proxy Advisory Services

Proxy advisory services have developed definitions of director independence that differ in some respects from, and are stricter than, those of the NYSE and Nasdaq. While proxy advisors’ guidelines are not binding, they carry substantial influence among institutional investors, and the nominating and corporate governance committee should be cognizant of them when assessing director independence.

ISS categorizes director independence into three groups. The first is “inside director,” which includes controlling stockholders, current officers or employees of the company or its affiliates and directors named in the company’s summary compensation table (excluding former interim officers). The second is “affiliated outside director,” which includes certain former officers of the company, its affiliates or predecessors, as well as family members and those with certain transactional, professional, financial or charitable relationships with the company. These relationships include providing, or having certain relationships with an organization that provides, professional services to the company or to one of its affiliates in excess of \$10,000 per year. This \$10,000 threshold is well below the thresholds set by the NYSE and Nasdaq. The third is “independent outside director,” which is a director who has no material connection to the company other than a board seat.<sup>279</sup> ISS recommends a vote “against” any inside director or affiliated outside director serving on the audit, compensation or nominating and corporate governance committees, and against inside and affiliated outside directors when independent directors make up less than a majority of directors.<sup>280</sup>

Glass Lewis guidelines state that, in assessing director independence, it will consider both compliance with the applicable exchange listing requirements and the judgments made by the director.<sup>281</sup> Like ISS, Glass Lewis has three categories of director independence: independent director, affiliated director, and inside director. Glass Lewis will consider a non-inside director to be affiliated if, within the past three years, the director had a material financial, familial or other relationship with the company or its executives or if the director’s employer had a material financial relationship with the company. A director will also be considered an affiliate if the di-

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<sup>277</sup> *In re MFW S’holders Litig.*, 67 A.3d 496, 509 (Del. Ch. 2013), *aff’d sub nom. Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

<sup>278</sup> *Id.* at 511 (citation omitted).

<sup>279</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 17-18.

<sup>280</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 16.

<sup>281</sup> Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season 3*.

rector or the director's employer owns 20 percent or more of the company's voting stock.<sup>282</sup> Glass Lewis states that it will typically recommend voting "against" inside or affiliated directors serving on a company's audit, compensation or nominating and corporate governance committees, and against some inside or affiliated directors if the board is less than two-thirds independent.<sup>283</sup>

## 5. Balancing Independence Against Expertise

The financial crisis revealed that boards sometimes lack the industry expertise and intricate knowledge of their companies that is necessary to properly oversee businesses of tremendous complexity.<sup>284</sup> This realization, in part, prompted the SEC to adopt in 2009 disclosure rules requiring companies to discuss the specific experience, qualifications and skills that led to a director's nomination. *See* Section VII.B.4. However, these disclosure requirements have far from solved the problems that are created by mandatory independence requirements and undue focus on board refreshment as an end in and of itself. In a February 2016 letter, State Street noted that "[m]any boards lack the experience and expertise to engage effectively and critically with management with regard to a company's long-term planning."<sup>285</sup> While some individuals with expertise will satisfy the exchanges' stringent independence standards, these standards do preclude insiders—those with the most intimate day-to-day knowledge of the company—and often limit the ability to include industry experts who over their careers have developed networks and affiliations in the company's sector.<sup>286</sup> As stated in a 2009 study published by Professor Jay W. Lorsch and other members of the Harvard Business School's Corporate Governance Initiative, "[a]s a practical matter it is difficult, if not impossible, to find directors who possess deep knowledge of a company's process, products and industries but who can also be considered independent."<sup>287</sup> All boards can and should gain insight into the company's business through regular communication with management. Yet a board may find that even the most robust communications are an imperfect substitute for actual membership of those best positioned to understand the company. This was acknowledged in a report issued by the NYSE's Commission on Corporate Governance, which noted that "a minority of directors who possess in-depth knowledge of the company and its industry could be helpful for the board as it assesses the company's strategy,

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<sup>282</sup> A material financial relationship is one in which the director received over \$50,000 for services outside of service as a director or if the director's employer received over \$120,000 or an amount exceeding one percent of either company's consolidated gross revenue from other business relationships. *Id.* at 3-4.

<sup>283</sup> *Id.* at 5.

<sup>284</sup> A 2015 survey of directors found that industry expertise is viewed as the single most desirable characteristic that a candidate for director can possess. National Association of Corporate Directors, *2015-2016 NACD Public Company Governance Survey* 26 (2015).

<sup>285</sup> Letter from Ronald P. O'Hanley, President and CEO of State Street Global Advisors (Fe. 26, 2016), <https://www.ssga.com/investment-topics/environmental-social-governance/2016/SSGAs-Letter-to-Directors-and-Guidelines-on-Effective-Independent-Board-Leadership.pdf>.

<sup>286</sup> The effects of these independence requirements may have recently peaked. Average board independence may have peaked among S&P 500 companies: 81 percent of all directorships are held by independent directors and companies with fewer than average independent directors typically have governance structures that make near-term change unlikely. ISS, *2015 Board Practices: Directors and Boards at S&P 1500 Companies* 4 (Mar. 16, 2015).

<sup>287</sup> Jay W. Lorsch, *You Can't Know It All: Why Directors Have Such Difficulty Understanding Their Companies*, Directors & Boards, Annual Report, Summer 2012, at 64.

risk profile, competition and alternative courses of action,” and reminded companies that “a properly functioning board can include more than one non-independent director.”<sup>288</sup>

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<sup>288</sup> Report of the New York Stock Exchange Commission on Corporate Governance 5 (Sept. 23, 2010), *available at* <http://www1.nyse.com/pdfs/CCGReport.pdf>.



## **VIII. Director Selection**

### **A. Identifying and Recruiting Directors**

Recruiting a balanced board of highly qualified directors is the central challenge for the nominating and corporate governance committee. Achieving this balanced, high-quality board is complicated by a number of factors. First, as noted above, the emphasis on exacting standards of independence often comes at the expense of relevant experience and knowledge of the company's business and industry. Stock exchange standards and governance activists' "best practices" limit considerably the nominating and corporate governance committee's flexibility in managing this tradeoff. Second, the workload and time commitment required for board service has never been greater. Finally, highly qualified individuals who manage to clear the independence hurdle and are willing and able to shoulder the substantial time commitment of board service may nevertheless be dissuaded by the potential for withhold-the-vote campaigns, sensationalist publicity over executive compensation, shareholder litigation and other reputational risks. In the current corporate governance environment, even directors of impeccable reputation at highly successful companies may find themselves under attack from shareholder activists. These factors pose a very real danger that companies will struggle to fill board seats with the experienced and highly capable types of directors that have been such an essential element of the phenomenal success of the American corporation.

This reality makes all the more critical the nominating and corporate governance committee's ability to effectively identify and recruit actual candidates once it has developed a target profile. Identifying and recruiting candidates should be an ongoing process that takes into account both the immediate needs of the board and its anticipated longer-term needs based on expected director turnover. This will allow the nominating and corporate governance committee to prepare for the departure of key directors by either grooming internal replacements for leadership positions or recruiting new directors before a critical skills gap appears.

#### **1. Networking**

Networking remains one of the most fertile sources of director candidates. At many companies, new directors are sourced primarily from individuals already known to members of the nominating and corporate governance committee, the chairman, other directors or the CEO or who are recommended by internal or external advisors. This approach can be particularly effective if the members of the nominating and corporate governance committee have extensive experience in the company's industry or on other company boards. Personal familiarity with a candidate enables the nominating and corporate governance committee to assess more quickly and accurately the candidate's fit with the board's culture, which is especially important when there is a need to expedite a search process. Drawbacks of reliance on networking include the possible limiting of the nominating and corporate governance committee's range of candidates and the vulnerability to accusations of cronyism or a failure to value new viewpoints.

#### **2. Third-Party Search Firms**

To limit the downsides of relying on directors' networks, cast a wider net, and add an outside and arguably broader perspective, companies often engage third-party search firms to

assist them in identifying director candidates, although there is certainly no requirement to seek outside advice. Ordinarily, the nominating and corporate governance committee will be charged with engaging such advisors, and NYSE-listed companies are required to vest the committee with sole authority to retain, terminate and approve the fees of any firm used in the search process.<sup>289</sup> A third-party search firm can help identify a wider range of candidates and bring greater, more specialized resources to bear than the company possesses internally, which can be especially useful when searching for director candidates with particular attributes or specialized skills. Use of a third party may also have a benefit in terms of public perception in that it helps to confirm that the process is being driven by the nominating and corporate governance committee rather than by management. On the other hand, a search firm may in certain circumstances add unnecessary expense and complexity to the nomination process. The nominating and corporate governance committee should consider the needs and capacities of the company and make an independent determination as to whether retention of an outside advisor is appropriate. If a third-party advisor is retained, the nominating and corporate governance committee should be as specific as possible about its precise role and the relevant search parameters. For example, the third party may simply provide a list of prospects that meet specified criteria and have been checked for conflicts, or may actually interview candidates on behalf of the nominating and corporate governance committee. At minimum, a nominating and corporate governance committee would be well advised to engage a third party to perform background and reference checks of candidates before formally nominating them. The SEC requires disclosure of any fees paid to third parties to assist in identifying or evaluating potential nominees, as well as the function they performed.<sup>290</sup>

### **3. Input from Within the Company**

While the nominating and corporate governance committee should lead the search process, it should seek the input of others inside the company. Nothing in the requirement that a nominating and corporate governance committee consist entirely of independent directors precludes nonmembers from contributing to the committee's work. The NYSE rules provide that the nominating and corporate governance committee is to select director nominees "consistent with the criteria approved by the board," which of course includes the CEO and any other non-independent directors.<sup>291</sup> In most cases, the committee would struggle to perform effectively without the participation of senior management, particularly the CEO, who is uniquely positioned in his or her understanding of the company, its strategy and its challenges. Thus, unless unusual circumstances suggest otherwise, the nominating and corporate governance committee would be well advised to work closely with the CEO when identifying, vetting, interviewing and selecting candidates. Ultimately, however, the CEO's input should only be one factor in the process of the committee reaching an informed and independent judgment. The nominating and corporate governance committee should conduct regular executive sessions to avoid any perception that the CEO has unduly controlled the nomination process.

Among other negative consequences, such a misperception can result in a backlash from proxy advisory services. For example, in 2011, ISS recommended a "no" vote for the members

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<sup>289</sup> Commentary to NYSE Listed Company Manual, Rule 303A.04(b).

<sup>290</sup> Item 407(c)(2)(viii) of Regulation S-K. 17 C.F.R. 229.407(c)(2)(viii).

<sup>291</sup> NYSE Listed Company Manual, Rule 303A.04(b)(i).

of Hewlett Packard’s nominating and corporate governance committee based on ISS’s view that the committee’s search for new directors was tainted by the CEO’s involvement. While remaining cognizant of the policies of proxy advisory services, it is important that the nominating committee conduct its search in the way it deems most effective. And, absent unusual circumstances, a nominating and corporate governance committee is unlikely to find effective a search process that excludes the views of a director—particularly one uniquely positioned to understand the company’s needs.

#### **4. SEC Requirements**

For each nominee approved by the committee for inclusion on the company’s proxy card (other than executive officers and directors standing for reelection), the SEC requires companies to identify whether the nominee was recommended by a security holder, a non-management director, the CEO, another executive officer, a third-party search firm or another specified source.<sup>292</sup>

#### **B. Shareholder Nominations and Proxy Access**

As a general matter, the right of shareholders to nominate candidates to be considered for election to the board of directors is well established in state law. In Delaware, for example, then-Chancellor Leo Strine stated: “Put simply, Delaware law recognizes that ‘the right of shareholders to participate in the voting process includes the right to nominate an opposing slate . . . the unadorned right to cast a ballot in a contest for [corporate] office . . . is meaningless without the right to participate in selecting the contestants. As the nominating process circumscribes the range of choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise.’”<sup>293</sup>

As the body with primary responsibility for reviewing candidates for nomination to be elected as directors, and for making a recommendation to the full board, the nominating and corporate governance committee is the logical and appropriate forum for consideration of director candidates recommended by shareholders. As a general rule, shareholder nominees should be considered on the basis of the same criteria as are used to evaluate board nominees. Even if it may be readily apparent that some candidates are not adequately qualified, it is good practice for the record to reflect that these candidates were fairly evaluated.

#### **1. SEC Disclosure Requirements**

The SEC requires companies to disclose whether they have a policy regarding the consideration of director candidates recommended by shareholders. If it does have such a policy, the company must describe the material elements of its policy, including whether it will consider shareholder nominations, and, if so, the procedures that shareholders must follow to submit nominations. If a company’s nominating committee does not have a policy regarding shareholder recommendations for director, the company must state that fact and the basis for the view of its board of directors that it is appropriate for the company not to have such a policy. The company

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<sup>292</sup> Item 407(c)(2)(vii) of Regulation S-K. 17 C.F.R. 229.407(c)(2)(viii).

<sup>293</sup> *Harrah’s Entertainment, Inc. v. JCC Holding Co.*, 802 A.2d 294, 310-11 (Del. Ch. 2002) (citations omitted).

must disclose whether, and, if so, how, the nominating and corporate governance committee evaluates recommendations submitted by shareholders differently than it evaluates recommendations from other sources.<sup>294</sup> In certain circumstances, companies are additionally required to disclose director candidate recommendations received from shareholders that have beneficially owned at least five percent of the company's voting common stock for at least one year at the time of the recommendation.<sup>295</sup>

## **2. Restrictions on Shareholder Nomination Rights**

The right of shareholders to nominate director candidates is not unfettered. Many states, including Delaware, have strong policies favoring freedom of contract and allowing parties in contractual relationships to establish their own rules by contract. The certificate of incorporation (or charter) and bylaws of a corporation establish a contractual relationship between a company and its shareholders that may vary from, or even opt out of, the default voting and nominating rules. Most listed companies have adopted bylaws establishing advance notice requirements for shareholder nominations and other proposals by shareholders for business to be brought before annual and special shareholder meetings. For a discussion of advance notice bylaws, see Section III.D. In addition, many companies have adopted bylaws that include specified qualification requirements for nominees for the board.

Traditionally, it has been within the purview of the board to establish reasonable qualification standards for director candidates. Many companies have, for example, adopted bylaws that include age restrictions, residential requirements, or stockholding requirements. These sorts of qualification criteria have typically been implemented in bylaws adopted by the board. As with all bylaws, they are generally subject to amendment or elimination by the company's shareholders. The board's decision to adopt such bylaws could be challenged in court, and would generally be viewed as a matter of the board's business judgment, unless there was an indication that directors failed to satisfy their duties of care and loyalty.

Although advance notice and qualification bylaws have generally been adopted by the full board, their subject matter places them squarely in the area of focus of the nominating and corporate governance committee, which often makes recommendations to the board for their adoption, amendment or removal. More recently, institutional shareholders, proxy advisors and other activists have taken a more restrictive view of the board's right to implement these sorts of bylaws absent shareholder input and/or approval (or, from their perspective, a more protective view of shareholder rights). A telling recent example of this trend is to be found in the attempt by a number of companies (based on a recommendation this firm made in a memorandum to clients) to adopt bylaws that provided a default rule against differential director compensation "golden leash" schemes being increasingly promoted by some shareholder activists in their proxy fights. Even though most corporate governance watchers and commentators, including the proxy advisors, agreed that these "golden leash" arrangements were entirely inappropriate, there was nevertheless a very strong and visceral reaction against the board adopting a default bylaw that would have disqualified candidates who entered into them. For further discussion of this issue, see Section III.J.

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<sup>294</sup> Items 407(c)(2)(iii)-(iv), (vi) of Regulation S-K. 17 C.F.R. 229.407(c)(2)(iii)-(iv), (vi).

<sup>295</sup> Item 407(c)(2)(ix) of Regulation S-K. 17 C.F.R. 229.407(c)(2)(ix).

In light of this controversy, boards will need to think very carefully about adopting any form of restrictive qualification requirements in the future, such as a change to the advanced notice requirements discussed in Section III.D and may want to engage with significant shareholders regarding changes that may be controversial.

### **3. Proxy Access for Director Nominations**

#### **(a) SEC Rules**

SEC Rule 14a-8 previously allowed the exclusion from a company's proxy of any proposal relating to director elections. In August 2010, the SEC amended this exclusion and also adopted Rule 14a-11, which required companies to include in their proxy statements director nominations of shareholders meeting certain ownership criteria. Both of these changes were stayed pending the resolution of litigation challenging Rule 14a-11, which in July 2011 was struck down by the Circuit Court for the District of Columbia as an arbitrary and capricious exercise of the SEC's rule-making authority.<sup>296</sup> The SEC did not appeal the court's ruling,<sup>297</sup> and Rule 14a-11 is now vacated. With the dispute regarding Rule 14a-11 resolved, the amended version of Rule 14a-8(i)(8) took effect in September 2011. Under the amended Rule 14a-8(i)(8), a proposal can no longer be excluded simply because it "relates to" the election of directors. Instead, it is only excludable if it:

- would disqualify a nominee who is standing for election;
- would remove a director from office before his or her term expires;
- questions the competence, business judgment or character of one or more nominees or directors;
- seeks to include a specific individual in the company's proxy materials for election to the board of directors; or
- otherwise could affect the outcome of the upcoming election of directors.<sup>298</sup>

Of these five grounds for exclusion, the most significant pertains to the nomination of a "specific individual" for election. As a result of this exclusion, companies need not include shareholder nominations of directors in their proxy statements. Thus, unlike Rule 14a-11's proposed "direct access" to a company's proxy, amended Rule 14a-8(i)(8) requires a shareholder desiring to make such a nomination to proceed by way of a two-step process. First, a shareholder may make a proposal under Rule 14a-8(i)(8) to amend the company's bylaws concerning the procedures by which directors are nominated (for instance, by providing that the company must include in its proxy statement the nominations by shareholders meeting certain eligibility criteria). Second, if the proposal is successful, the shareholder may propose director nominees pursuant to the company's amended bylaws.

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<sup>296</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

<sup>297</sup> Press Release, SEC, *Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation* (Sept. 6, 2011), available at <http://www.sec.gov/news/press/2011/2011-179.htm>.

<sup>298</sup> 17 C.F.R. § 240.14a-8(i)(8).

(b) Delaware Law

In contrast to the one-size-fits-all approach to proxy access proposed by the SEC and ultimately struck down, Delaware has adopted a framework that allows companies to tailor proxy access to their particular circumstances. In 2009, Delaware amended its corporate law to provide that the board or shareholders of a Delaware company may adopt a bylaw requiring the inclusion of a shareholder's director nominees in the company's proxy solicitation materials.<sup>299</sup> The statute includes a non-exclusive list of conditions that the bylaws may impose on proxy access, including minimum ownership requirements, mandatory disclosures by the nominating shareholder and restrictions on nominations by persons who have acquired a specified percentage of the company's outstanding voting power. Another 2009 amendment to Delaware's corporate law provides that a company's bylaws may require the company to reimburse a stockholder for expenses incurred soliciting proxies in connection with an election of directors.<sup>300</sup> Again, a company may impose any lawful condition or procedure on such reimbursement, including limitations based on the amount of support the shareholder's nominee received. This private ordering approach to proxy access allows companies and their shareholders to adopt rules tailored to the specific circumstances of a company. Many consider this state law approach to be more appropriate than the federalization of the election process that the SEC was proposing. (*See* Sections III.K, IV.A.2 and IV.E.3 for more on proxy access.)

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<sup>299</sup> 8 Del. C. § 112.

<sup>300</sup> 8 Del. C. § 113.

## **IX. Director Orientation and Continuing Education**

### **A. Orientation**

The nominating and corporate governance committee should ensure that new directors are provided with a thorough orientation that will accelerate their adjustment to the board. If the board takes an annual retreat, the retreat may offer an opportunity to satisfy a large portion of this orientation. The content of director orientation should focus on enabling new directors to quickly gain a full understanding of the company's business and risk profile. If the director is to serve on a board committee or otherwise perform a specialized role, his or her orientation program should be customized to reflect those added responsibilities. Orientation programs should be regularly reviewed and modified to ensure that they are tailored to address the most important issues facing the company. As part of their orientation, new directors should be provided with the company's corporate governance documents, including committee charters, policies and ethics codes, biographies of the company's directors and executive officers, selected public documents of the company, including proxy statements and annual and quarterly reports, minutes of the board and its committees' recent meetings, and a calendar of upcoming meetings and key dates for the company. New directors should also meet with their fellow directors and with executive officers. If a physical inspection of one or more facilities or sites would aid in the new director's understanding of a company, the nominating and corporate governance committee should consider including a tour as part of its orientation program. A selection of key analyst reports by third-party analysts covering the company may also enhance a new director's appreciation for the company and how it is perceived.

Especially if it is the new director's first time serving on a public company board, orientation should also include a thorough briefing on applicable laws, including securities laws and a director's fiduciary duties. Director orientation must strike the right balance by providing substantive information that will allow a new director to "hit the ground running" without overwhelming him or her with a barrage of documents. Striking this balance requires an ongoing focus on and reassessment of the company's priorities by the nominating and corporate governance committee.

The importance of director orientation is greater now than ever before. Directors today not only serve in an environment of unprecedented complexity and time demands, but a large number of them are serving without any considerable experience with either the company or public company boards generally. Historically, over 30 percent of directors joining outside company boards were first-time directors and in 2014 the number grew to an all-time high of 39 percent.<sup>301</sup> And, as discussed at length in Section VII.C.5, the outsized emphasis placed on director independence by corporate governance "best practices" often precludes adding to the board the most experienced individuals with the strongest grasp of the company. The wisdom of ever-increasing reliance on individuals with limited familiarity with board service or the company is dubious and, perhaps, nominating and governance committees have begun to take notice:

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<sup>301</sup> Spencer Stuart, *Spencer Stuart Board Index 2014*, at 6, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2014>.

In 2015, only 26 percent of directors joining outside company boards were first-time directors.<sup>302</sup> However, to a certain extent, nominating and governance committees must accept that this has become a part of the corporate governance landscape and ensure that orientation programs are as robust as possible to get new directors up to speed.

## **B. Continuing Education**

Director education should not end once a new director is brought up to speed. While there is no legal requirement for directors to receive tutorials to satisfy their fiduciary obligations, such education can be very useful. Indeed, the complexity of the many financial, risk management and other issues facing companies today that was highlighted by the financial crisis has led to a renewed focus on the information and education programs provided to directors. In a constantly changing competitive and regulatory environment, continuing education is vital to ensure that directors remain aware of the challenges and opportunities the company faces. Even a long-serving director with an intimate familiarity with the company's industry and strategy will be unable to perform effectively if he or she does not stay abreast of many regulatory and other developments. To the extent that directors lack the knowledge required to maintain a strong grasp of current industry and company-specific developments and specialized issues, the nominating and corporate governance committee should consider periodic tutorials as a supplement to board and committee meetings.

Given the importance of continuing education, it is no surprise that over three quarters of directors participated in some form of board educational program during 2015 in order to stay apprised of trends in corporate governance and other areas.<sup>303</sup> And, at large cap companies, directors spent, on average, 23 hours participating in director educational programs during 2015.<sup>304</sup> Training and tutorials may consist of outside programs, training in the boardroom or some combination of the two and should be tailored to the issues most relevant and important to the company and its business. Outside experts, while not required, may be helpful for certain training and tutorials, although in many cases the company's own experts are better positioned than outsiders to explain the particular issues facing the company.

## **C. Information Received by Directors**

The ability of the board or a committee to perform its oversight role is, to a large extent, dependent upon the relationship and the flow of information between the directors, senior management and the risk managers in the company. In this vein, the board and management should together determine, and periodically reassess, the information the directors should receive so that the board can effectively perform its oversight function. As a starting point, the board should receive financial information that makes readily accessible the company's results of operations, variations from budgeted expenditures, trends in the industry and the company's performance relative to its peers, as well as copies of media and analyst reports on the company. However, in order for the board to properly fulfill its oversight role, companies should work to ensure that the

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<sup>302</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 9, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>303</sup> PricewaterhouseCoopers, *PwC's 2015 Annual Corporate Directors Survey 24*, available at <http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/downloads.html>.

<sup>304</sup> National Association of Corporate Directors, *2015-2016 NACD Public Company Governance Survey 23* (2015).

board is receiving information about all aspects of the company's operations. For example, while only about three percent and eight percent of directors thought that they did not receive enough information regarding corporate performance and financial risk, respectively, 44 percent of directors think that they receive insufficient information regarding the cybersecurity and IT risks facing their companies.<sup>305</sup> This, however, underscores an important point for directors, if directors do not believe that they are receiving sufficient information—including information regarding the external and internal risk environment, the specific material risk exposures affecting the company, how these risks are assessed and prioritized, risk response strategies, implementation of risk management procedures and infrastructure and the strengths and weaknesses of the company's overall risk management system—they should be proactive in asking for more.

Obtaining this information will not only aid directors in guiding the company but also will avoid the possibility of directors being accused of failing to be aware of discoverable facts that they should have known. The nominating and corporate governance committee should also promote lines of communication between the board, its committees and senior management that foster open and frank discussion of developments and concerns. As with director orientation, the key is to provide useful and timely information without overloading the board with, for example, all information that the CEO and senior management receive.

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<sup>305</sup> National Association of Corporate Directors, *2015-2016 NACD Public Company Governance Survey* 38 (2015).



## X. Restrictions on Director Service

### A. Other Directorships and “Overboarding”

The workload and time commitment required for board service has escalated dramatically in recent years: the 2015-2016 Public Company Governance Survey of the National Association of Corporate Directors reported that public company directors spent, on average, nearly 250 hours performing board-related activities in 2015, compared to the 155 hours reported in 2003.<sup>306</sup> As the time commitment of board service increases, so does the importance of ensuring that directors are able to shoulder this commitment. Therefore, the nominating and corporate governance committee should consider adopting a policy regarding additional directorships. The nominating and corporate governance committee may similarly choose to limit the directorships of the company’s officers. According to a 2015 Spencer Stuart survey, only 20 percent of S&P 500 companies’ corporate governance principles specifically limit the number of outside boards on which their CEO may serve. And, 95 percent of companies with restrictions limit CEOs to one or two outside boards.<sup>307</sup> Additionally, more than three-quarters of S&P 500 companies now impose some restriction on their directors’ service on other boards, up from only one-half in 2006.<sup>308</sup> Restrictions on additional directorships may apply across the board or only to a subset of directors, such as those serving on the audit committee or those fully employed by the company or another public company. For example, the NYSE requires that if an audit committee member simultaneously serves on the audit committee of more than three public companies, the board must disclose its determination that this would not impair the member’s ability to serve effectively on the company’s audit committee.<sup>309</sup> Fifty-nine percent of companies have set a numerical limit for additional directorships applying to all directors, with almost 70 percent of these companies setting the cap at three or four.<sup>310</sup> Among those companies without established numerical limits, 92 percent require directors to provide the company notice before accepting another directorship and/or encourage directors to reasonably limit their additional board service.<sup>311</sup>

As with many other issues confronting the nominating and corporate governance committee, the committee should be wary of establishing hard and fast rules regarding other directorships that limit its flexibility to exercise its best judgment based on particular circumstances. One approach is to eschew a numerical limit but require a director to seek approval of the nominating and corporate governance committee before accepting another directorship. Another approach is to adopt a numerical limit but provide that the nominating and corporate governance committee may waive this limit if it determines that the additional directorship will not impair

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<sup>306</sup> National Association of Corporate Directors, *2015-2016 Public Company Governance Survey* 8 (2015). National Association of Corporate Directors, *2014-2015 Public Company Governance Survey* 12 (2014).

<sup>307</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 13, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>308</sup> *Id.*

<sup>309</sup> Commentary to NYSE Listed Company Manual, Disclosure Requirement, Rule 303A.07(a).

<sup>310</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 13, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>311</sup> *Id.*

the director's ability to carry out his or her duties, or that his or her unique contributions to the board would be difficult to replace.

At a minimum, the nominating and corporate governance committee would be well advised to adopt a policy of prior notification regarding other directorships or employment. This is important not only to ensure that the director remains able to shoulder capably the responsibilities of board service but also to check for any conflicts. In particular, antitrust laws prohibit simultaneous service as a director or officer of two competing companies, subject to certain *de minimis* exceptions.<sup>312</sup> Companies should carefully weigh the costs and benefits of having directors who are associated with competitors, as this may become a lightning rod for activist criticism, even if the overlap falls well within the legal safe-harbors.

ISS recommends an “against” or “withhold” vote for “overboarded directors,” defined as, with regards to 2016 annual meetings those sitting on more than six public company boards and, with regards to annual meetings on or after February 1, 2017, more than five public company boards. Additionally, ISS recommends an “against” or “withhold” vote against CEOs sitting on more than two public company boards besides their own (although ISS recommends an “against” or “withhold” only with respect to the CEO's outside boards).<sup>313</sup> Similarly, Glass Lewis recommends, with respect to 2016 annual meetings voting “against” directors who serve on more than six public company boards and with respect to 2017 annual meetings, voting “against” directors who serve on more than five public company boards.<sup>314</sup> Additionally, Glass Lewis recommends voting against directors who serve as an executive officer of any public company while serving on more than two other public company boards.<sup>315</sup> Glass Lewis also recommends voting against a CFO being on the company's board.<sup>316</sup>

In their proxy voting guidelines, several institutional investors have also developed policies on “overboarding.” The Council of Institutional Investors suggests that companies should establish guidelines on how many other boards their directors may serve and states that directors with full-time jobs should not serve on more than two other boards, that independent directors should serve on no more than five for-profit company boards and that the CEO should not serve as a director of more than one other company, and then only if the CEO's own company is in the top half of its peer group.<sup>317</sup>

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<sup>312</sup> Clayton Act § 8, 15 U.S.C. § 19. Under the current thresholds, simultaneous service as director or officer of two corporations each with capital, surplus and undivided profits in excess of \$31,084,000 and “competitive sales” of \$3,108,400 or more is prohibited, subject to several exceptions. In particular, if the “competitive sales” of either corporation are less than two percent of that firm's total sales, or less than four percent of each firm's total sales, the interlock is exempt under the statute. In addition, the statute expressly prohibits service on competing corporations, not other business structures (*e.g.*, partnerships or limited liability companies). Finally, Section 8 does not apply to interlocks between banks. Section 8 provides a one-year grace period for an individual to resolve an interlock issue that arises as a result of entry into new markets through acquisition or expansion.

<sup>313</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 16.

<sup>314</sup> Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 1.

<sup>315</sup> Glass Lewis, *Proxy Paper Guidelines, 2016 Proxy Season* 16.

<sup>316</sup> *Id* at 15.

<sup>317</sup> Council of Institutional Investors, *Corporate Governance Guidelines*, Section 2.11 (Apr. 1, 2015), available at [http://www.cii.org/corp\\_gov\\_policies#BOD](http://www.cii.org/corp_gov_policies#BOD). CalPERS recommends that boards adopt and disclose guidelines in proxy statements “to address competing time commitments that are faced when directors, especially acting CEOs, serve on multiple boards.” CalPERS, *Global Principles of Accountable Corporate Governance* 17 (Rev. March 16,

## B. Term Limits and Mandatory Retirement Ages

The question of appropriate director tenure has become a hot topic in recent years. Corporate governance activists are increasingly calling for director term limits and mandatory retirement ages, both as a means of promoting “board refreshment” and because of a growing view that serving on a board for an extended period of time affects a director’s independence.

As in all matters, we do not believe that a one-size-fits-all rule is an appropriate method for making this determination. In some cases it may be appropriate for a particular director to leave after an extended period on the board, and it is certainly advisable to periodically bring new directors on to a board so that it can benefit from fresh (and more diverse) perspectives and ideas. However, directors who have served on a board for a long time have an intimate familiarity with the company and its business, history and values that cannot be easily or quickly replicated by a new candidate. Long-term directors provide continuity, cultural stability and institutional knowledge that can prove invaluable. We are also skeptical of the depiction of long-serving directors as categorically less independent, given that such directors are more likely to have preceded the current CEO (and thus not to have been chosen by him or her) and to have the deep knowledge of the company necessary to make independent judgments.

To date, only three percent of S&P 500 companies specify a term limit for director service—a decrease from five percent in 2010<sup>318</sup>—making this one of the few areas where calls for so-called best practices have gone largely unanswered. Companies’ policies in this area suggest they may see value in having more experienced directors. The average tenure of directors at S&P 500 companies in 2015 was 8.5 years, roughly stable in recent years.<sup>319</sup> The average director is 63.1 years old, compared with 60.5 in 2004, and 94 percent of companies with mandatory director retirement ages set it at 72 or older, compared with 56 percent ten years ago.<sup>320</sup>

Term limits and mandatory retirement ages are indeed one way to bring fresh perspectives and skills to the board. They may also in some cases relieve the nominating and corporate governance committee from the often difficult decision to recommend against a directors’ re-

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2015), available at <https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf>. While BlackRock reviews each situation on a case-by-case basis, it is most likely to withhold votes where “a director is: 1) serving on more than four public company boards; or 2) is a chief executive officer at a public company and is serving on more than two public company boards in addition to the board of the company where they serve as chief executive officer.” BlackRock, *Proxy Voting Guidelines for U.S. Securities* 4 (Feb. 2015), available at <http://www.blackrock.com/corporate/en-us/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>. State Street Global Advisors (“State Street”) states it may withhold votes from a director who sits on more than six public company boards or from any CEO of a public company who sits on more than three public company boards. State Street Global Advisors, *Proxy Voting and Engagement Guidelines—US* 2 (Mar. 2015), available at <https://www.ssga.com/investment-topics/environmental-social-governance/2015/Proxy-Voting-and-Engagement-Guidelines-United-States.pdf>. T. Rowe Price will generally vote against directors who sit on more than six public boards and against CEOs who sit on more than two other public company boards. T. Rowe Price, *Proxy Voting Policies* (Rev. Mar. 9, 2015), available at <http://corporate.troweprice.com/ccw/home/responsibility/conductingBusinessResponsibly/proxyVotingPolicies.do>.

<sup>318</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 14, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>319</sup> *Id.* at 16.

<sup>320</sup> *Id.* at 15. Additionally, there has been a recent trend of more companies setting mandatory retirement ages at 75 or older—34 percent in 2015 compared to 19 percent in 2010 and eight percent in 2005.

nomination. However, given the many potential negative consequences of such policies, these blunt instruments are a poor substitute for the considered judgment of the nominating and corporate governance committee. Increased turnover may needlessly disrupt the cohesion of an effectively functioning board. A board, like any organization, depends heavily on the trust and familiarity of its members. This cautions against adopting rigid policies, such as term limits, that make it more difficult to develop and maintain these relationships. Moreover, long-serving directors that have grown knowledgeable about the company and its industry are often the most valuable contributors to a board. A policy requiring such a director to depart after a certain number of years risks depriving the company of a valuable director who still has much to offer. An across-the-board rule may strike some as more expedient, but ultimately the company will best be served by the nominating and corporate governance committee making a determination based on the facts and circumstances of each situation.

ISS currently recommends voting against shareholder proposals imposing director term limits.<sup>321</sup> However, if the average tenure of a board's directors exceeds 15 years, ISS will consider in making recommendations whether directors are sufficiently independent from management and whether there has been sufficient turnover to ensure fresh perspectives in the boardroom.<sup>322</sup> ISS is considering whether it should classify directors with lengthy tenures as non-independent, and whether or not to consider the mix of director tenures on a board as a key factor in deciding whether to recommend a vote for the reelection of nominating and corporate governance committee members. Under ISS's new QuickScore governance ranking, tenure of more than nine years will be considered "excessive" on account of "potentially compromis[ing] a director's independence" and negatively factor into weightings, depending on the proportion of directors with such tenure.<sup>323</sup> Moreover, ISS may decide to revisit its voting policies with respect to the imposition of director term limits in light of a study released by ISS, which found correlations between long-tenured boards (an average of 15 or more years) and lower levels of board independence and independent board leadership, as well as lower levels of "positive" governance features, such as annual elections and a majority voting standard in director elections.<sup>324</sup>

Many institutional investors have their own views on these matters. While most favor board refreshment generally, institutional investors have taken varied positions on whether—and when—mandatory term limits or retirement ages are appropriate mechanisms for achieving such refreshment. The Council of Institutional Investors urges boards "to consider carefully whether a seasoned director should no longer be considered independent,"<sup>325</sup> and, in 2016, CalPERS's adopted a bright-line rule for how it views director tenure to impact independence: "[CalPERS] believe[s] director independence can be compromised at 12 years of service—in these situations a company should carry out rigorous evaluations to either classify the director as non-independent or provide a detailed annual explanation of why the director can continue to be clas-

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<sup>321</sup> ISS, *2016 U.S. Summary Proxy Voting Guidelines* 19.

<sup>322</sup> *Id.*

<sup>323</sup> ISS, *Governance QuickScore 3.0*, at 11 (Rev. May 26, 2015), available at [http://www.issgovernance.com/file/products/quickscore\\_techdoc.pdf](http://www.issgovernance.com/file/products/quickscore_techdoc.pdf).

<sup>324</sup> ISS, *Board Practices: The Structure of Boards at S&P 1500 Companies* 43 (2014).

<sup>325</sup> Amy Borrus, Council of Institutional Investors, *More on CII's New Policies on Universal Proxy and Board Tenure* (Oct. 1, 2003), available at [http://www.cii.org/article\\_content.asp?article=208](http://www.cii.org/article_content.asp?article=208).

sified as independent.”<sup>326</sup> In contrast, while BlackRock encourages boards to “routinely refresh their membership,” it does not believe that long board tenure is necessarily an impediment to director independence and that “a variety of director tenures within the boardroom can be beneficial to ensure board quality and continuity of experience . . . .”<sup>327</sup> It remains to be seen whether the evolving views of proxy advisory services and some institutional investors will lead to the adoption of bright-line policies on director tenure.

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<sup>326</sup> CalPERS, *Global Principles of Accountable Corporate Governance* 16 (Rev. March 16, 2015), available at <https://www.calpers.ca.gov/docs/board-agendas/201603/invest/item05a-02.pdf>. Additionally, CalSTRS also advocates that boards should have a mechanism to ensure that there is periodic refreshment but does not support limiting director tenure. CalSTRS, *Corporate Governance Principles* 3 (Feb. 2015). State Street will generally vote against age and term limits unless the company is found to have poor board refreshment and director succession practices and has a preponderance of non-executive directors with excessively long tenures serving on the board. State Street Global Advisors, *Proxy Voting and Engagement Guidelines—US* 4 (Mar. 2015).

<sup>327</sup> BlackRock, *Proxy Voting Guidelines for U.S. Securities* 4 (Feb. 2015).



## **XI. The Functioning of the Board**

### **A. Executive Sessions**

Whether or not a board has an independent chairman, its non-management directors should meet regularly outside the presence of management in executive sessions. Executive sessions allow for frank review of certain issues, such as management performance and succession planning, that may be better discussed at times outside the presence of management. They can also serve as a safety valve to deal with problems that directors may hesitate to bring up before the full board. However, boards should be careful that the use of executive sessions does not have a corrosive effect on board collegiality and its relations with the CEO. To guard against this danger, boards should not use executive sessions as a forum for revisiting matters already considered by the full board or to usurp functions that are properly the province of the full board. Board minute books should reflect when executive sessions of the board were held and who was in attendance, but it is not necessary and in some cases may be inappropriate to have detailed minutes of those sessions. Of course there may also be times when, for reasons of confidentiality or sensitivity, it is preferable for the independent directors to meet informally.

The NYSE requires listed companies to hold regular executive sessions of either non-management directors or independent directors and, if those sessions include directors who do not qualify as independent under the NYSE standards, the NYSE recommends that companies also schedule an executive session of independent directors at least once a year.<sup>328</sup>

Nasdaq requires regular executive sessions, contemplated to mean at least twice a year.<sup>329</sup> While many “best practices” proponents recommend holding an executive session along with every regularly scheduled board meeting, the board should tailor the frequency of and agenda for executive sessions to the particular needs of its company, rather than reflexively following the latest trend. Each executive session should have a presiding director, although it need not be the same director each time.

The SEC requires disclosure of the identity of the sole director chosen to preside over all executive sessions or, if the presiding director differs at each meeting, how the presiding director is chosen at each meeting.

### **B. Committees**

A large proportion of the “heavy lifting” of board service is performed on the board’s committees. In addition to the standing audit, compensation, and nominating and corporate governance committees that companies are required or expected to have, boards may choose to create other committees, either as standing committees or on an ad hoc basis, to deal with specific issues that arise. Board committees have whatever powers and authorities the board chooses to vest in them (subject to modest legal requirements; for example, a committee generally cannot agree to a merger or to sell the company). Their function is to enable the board to perform its many functions more efficiently and effectively.

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<sup>328</sup> Commentary to NYSE Listed Company Manual, Rule 303A.03.

<sup>329</sup> Nasdaq Listing Rules 5605(b)(2), IM 5602-2.

We commend readers to our separate guidebooks on the Audit Committee and Compensation Committee, but provide a brief description of the requirements for those committees below because ensuring that the board is properly populated so that each of the committees will be able to meet all requirements and perform its work well is central to the mission of the nominating and corporate governance committee.

## **1. Audit Committee**

### **(a) Independence**

In addition to qualifying as independent under the listing standards of the securities market(s) on which a company's securities are traded, audit committee members also must satisfy the more stringent definition of audit committee independence set forth in Sarbanes-Oxley and SEC Rule 10A-3. Both the NYSE and Nasdaq explicitly require compliance with those independence requirements.<sup>330</sup> Audit committee members may not, directly or indirectly, receive any compensation from the company—such as consulting, advisory or similar fees—other than their director fees, and may not be affiliates of the company. The affiliate disqualification covers any individual that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, the company. The prohibition on acceptance of compensatory fees precludes audit committee service if the company makes any such payments either directly to the director, or indirectly to an immediate family member, or to law firms, accounting firms, consulting firms, investment banks or financial advisory firms in which the director is a partner, member, managing director, executive officer or holds a similar position.

### **(b) Financial Literacy**

The major securities markets require that each member of an audit committee be able to read and understand fundamental financial statements. Under the NYSE listing standards, it is the board's duty to determine, in its business judgment, whether each member of the audit committee is financially literate. While Nasdaq requires that each member be financially literate upon joining the audit committee, the NYSE permits members to become financially literate within a reasonable period of time after joining.<sup>331</sup>

### **(c) Financial Expertise**

The NYSE requires that at least one member of the audit committee must have accounting or related financial management expertise as determined by the board in its business judgment. The expertise requirement generally is fulfilled by a background in finance that permits a board to conclude in good faith that the director is capable of understanding the most complex issues of accounting and finance that are likely to be encountered in the course of a company's business. The NYSE permits a board to presume that an individual who is an "audit committee financial expert" within the meaning of the SEC's rules (described below) has the requisite "accounting or related financial management expertise" to satisfy the NYSE's listing standards.<sup>332</sup>

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<sup>330</sup> NYSE Listed Company Manual, Rule 303A.01; Nasdaq Listing Rules 5605(c)(2), IM-5605-4.

<sup>331</sup> Nasdaq Listing Rule 5605(c)(2)(A)(iv); Commentary to NYSE Listed Company Manual, Rule 303A.07(a).

<sup>332</sup> Commentary to NYSE Listed Company Manual, Rule 303.07(a).

Under Nasdaq rules, at least one member of an audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication, including being or having been a CEO, CFO or other senior officer with financial oversight responsibilities. An individual who is an "audit committee financial expert" within the meaning of the SEC's rules is deemed to fulfill this latter requirement.<sup>333</sup>

(d) Audit Committee Financial Expert

Under the direction of Sarbanes-Oxley, the SEC issued rules requiring a public company to disclose in its annual reports (or annual proxy statements) whether any member of its audit committee qualifies as an audit committee financial expert, as determined by the board in its business judgment.<sup>334</sup> The SEC regulations define an "audit committee financial expert" as an individual who has *all* of the following attributes:

- an understanding of GAAP and financial statements;
- the ability to assess the general application of GAAP in connection with accounting for estimates, accruals and reserves;
- experience in preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.<sup>335</sup>

An individual must have acquired the five audit committee financial expert attributes listed immediately above through any one or more of the following:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;
- experience in actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience in overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

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<sup>333</sup> Nasdaq Listing Rules 5605(c)(2)(A), IM-5605-4.

<sup>334</sup> Item 407(d)(5)(i) of Regulation S-K. 17 C.F.R. 229.407(d)(5)(i).

<sup>335</sup> Item 407(d)(5)(ii) of Regulation S-K. 17 C.F.R. 229.407(d)(5)(ii).

- other relevant experience.<sup>336</sup>

## 2. Compensation Committee

Both the NYSE and Nasdaq impose additional independence requirements on directors that serve on a compensation committee. Also, in order for a listed company that is a U.S. taxpayer to take full advantage of available tax deductions for “performance-based compensation”<sup>337</sup> paid to certain of its executives under Section 162(m) of the Internal Revenue Code (the “Code”), at a minimum the compensation committee (or a designated subcommittee thereof) needs to satisfy certain independence requirements that differ somewhat from the NYSE and Nasdaq rules.

The NYSE rules require that, when evaluating the independence of any director who will serve on the compensation committee, a board consider all relevant factors that could impair independent judgments about executive compensation including, but not limited to, (a) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the company and (b) whether the director is affiliated with the company or one of its subsidiaries or affiliates.<sup>338</sup>

Nasdaq rules prohibit compensation committee members from accepting any consulting, advisory or other compensatory fees from the company or its subsidiaries (other than directors’ fees). Under Nasdaq listing standards adopted in response to Dodd-Frank as reflected in SEC Rule 10C-1, Nasdaq-listed companies are now required to have a compensation committee consisting of at least two independent directors. Nasdaq provides, however, that, if a compensation committee is composed of at least three members, then, under exceptional and limited circumstances and if certain conditions are met, one director who is not independent under its rules may be appointed to the compensation committee without disqualifying the compensation committee from considering the compensation matters that would ordinarily be entrusted to it had it been fully independent.<sup>339</sup> Additionally, a compensation committee or a company’s independent directors must approve equity compensation arrangements that are exempted from the Nasdaq shareholder approval requirement as a prerequisite to taking advantage of such exemption.<sup>340</sup>

Section 162(m) of the Code requires that the compensation committee (or a designated subcommittee thereof) be composed solely of two or more “outside directors.”<sup>341</sup> If a compensa-

<sup>336</sup> Item 407(d)(5)(iii) of Regulation S-K. 17 C.F.R. 229.407(d)(5)(iii).

<sup>337</sup> 26 U.S.C. § 162(m)(4)(C), I.R.C. § 162(m)(4)(C); 26 C.F.R. § 1.162-27(e), Treasury Regulation § 1.162-27(e).

<sup>338</sup> NYSE Listed Company Manual, Rule 303A.02(a)(ii).

<sup>339</sup> The specific conditions that must be met in order for such exemption to be available, as well as the precise contours of the Nasdaq definition of “independent,” are discussed in Appendix A and Section II.C.1 of this Guide, respectively.

<sup>340</sup> Nasdaq Listing Rules 5635(c)(2), (c)(4). Under these Nasdaq Rules, shareholder approval is required prior to the issuance of securities when an equity compensation plan is to be established or materially amended, except for, among other things, tax-qualified non-discriminatory employee benefits plans that are approved by the company’s compensation committee and certain “sign-on” equity compensation awards that are approved by the company’s compensation committee.

<sup>341</sup> 26 U.S.C. § 162(m)(4)(C), I.R.C. § 162(m)(4)(C); 26 C.F.R. § 1.162-27(e), Treasury Regulation § 1.162-27(e). The general test for determining whether an individual can qualify as an outside director for these purposes is set forth in Annex D the Directors’ and Officers’ Questionnaire, Part II, Item 12. If an individual cannot answer “No” to each of the questions listed in such Item 12, the individual should contact the company’s designated legal counsel

tion committee (or a designated subcommittee thereof) is comprised solely of two or more outside directors, then the company can, so long as certain other requirements of Section 162(m) of the Code are satisfied, structure compensation that is to be paid to certain of its executives in a manner that qualifies as fully tax deductible.

### **3. Risk Management Committee**

The growing complexity of companies and the fallout from the financial crisis have led to an increased focus on how boards are overseeing the management of their companies' risk. The NYSE rules require a company's audit committee to "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken." Accordingly the audit committee often takes the lead in risk management oversight. However, the NYSE rules permit a company to create a separate committee or subcommittee to be charged with the primary risk oversight function, as long as the audit committee reviews the separate committee's work in a general manner and continues to discuss policies regarding risk assessment and management. Given the audit committee's number of other responsibilities, the scope and complexity of a company's business risks may make a separate risk committee desirable. For some companies such a committee is mandated: Dodd-Frank requires each publicly traded bank holding company with greater than \$10 billion of assets to establish a stand-alone, board-level risk committee.

There is, however, no one-size-fits-all approach to risk management. Many boards choose not to create a separate risk committee, instead charging the audit committee with risk oversight, coupled with periodic review by the full board. In fact, a 2014 survey found that only eight percent of S&P 500 companies have a standalone risk management committee.<sup>342</sup> When this is the case, the audit committee must be sure to devote adequate time and attention to its risk oversight function, outside the context of its review of financial statements and accounting compliance. A board may also choose to allocate different areas of risk management among multiple existing committees, which may result in a more balanced workload and a wider appreciation of the company's risks. Moreover, specialized committees may be tasked with specific areas of risk exposure. Banks, for instance, often maintain credit or finance committees, while some energy companies have public policy committees largely devoted to environmental and safety issues. If responsibility for risk oversight is divided among multiple committees, however, care must be taken to coordinate the committees' work and to share information appropriately with each other and with the full board. The board and the nominating and corporate governance committee should carefully consider what approach makes the best sense for its particular company and ensure that risk management is treated as a priority throughout the organization.

### **4. Special Committees**

A company may want to form a special committee of the board of directors in the face of certain corporate situations. Generally, a special committee will be needed in situations where the majority of the directors on a board has, or could reasonably appear to have, a conflict of in-

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to discuss the facts and circumstances of the individual's answers, so that a more detailed determination can be made as to whether the individual constitutes an outside director for purposes of Section 162(m) of the Code.

<sup>342</sup> Ernst & Young LLP, *Let's Talk: Governance, Beyond Key Committees: Boards create committees to support oversight responsibilities* 1 (April 2014), available at [http://www.ey.com/Publication/vwLUAssets/EY\\_-\\_Lets\\_talk:\\_fovernance/\\$FILE/EY-lets-talk-governance.pdf](http://www.ey.com/Publication/vwLUAssets/EY_-_Lets_talk:_fovernance/$FILE/EY-lets-talk-governance.pdf).

terest in a transaction or matter. In such situations, a special committee comprised of independent, disinterested members of the board can provide a way to assure shareholders that a corporate decision is fair and not the result of any undue influence by potentially conflicted directors. Directors may be considered interested to the extent they may have an interest or potential interest on both sides of a transaction, or could otherwise gain an economic benefit above and beyond that of the company generally. Specific examples of transactions that may lead to the formation of a special committee include management buyouts and controlling shareholder transactions, in each case where members of the board represent or are influenced by the conflicted party. If formed, in addition to requiring all members of the special committee to be independent with respect to the potential conflict, the special committee may also engage independent legal and financial advisors. The terms and breadth of the board resolution establishing the special committee are extremely important and may be analyzed by the courts in determining the level of judicial scrutiny warranted in a conflict situation. In many cases, the special committee should be given the power to act on behalf of the company as the independent negotiator for the transaction as necessary, with the full ability to take any requisite actions to come to a fair, independent and informed determination.

A company may also want to form a special committee in the face of shareholder derivative litigation. Special litigation committees may be formed to determine whether certain shareholder derivative claims should be pursued, settled or dismissed, but since a majority of directors will often be interested as defendants in the face of litigation, the standard by which independence is evaluated may be more stringent than in the context of a corporate transaction. As the Delaware Supreme Court stated in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, “[i]ndependence is a fact-specific determination made in the context of a particular case. The court must make that determination by answering the inquiries: independent from whom and independent for what purpose?”<sup>343</sup> In *Beam v. Stewart*, the Delaware Supreme Court determined that a personal friendship or outside business relationship, standing alone, is insufficient to raise a reasonable doubt about a director’s independence in the context of pre-suit demand on the board.<sup>344</sup> However, by contrast, in *In re Oracle Corporation Derivative Litigation*, the Delaware Court of Chancery, in looking at the purpose for which the special committee was formed, found that the members of a special litigation committee formed to investigate alleged insider trading by other directors lacked the requisite level of independence because, like the investigated directors, the special committee members had personal and professional ties to Stanford University.<sup>345</sup>

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<sup>343</sup> *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1049-50 (Del. 2004).

<sup>344</sup> *Beam*, 845 A.2d at 1049-52. However, in 2015, the Delaware Supreme Court clarified that *Beam* was not intended to suggest “that deeper human friendships could not exist that would have the effect of compromising a director’s independence.” *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017, 1022 (Del. Sup. 2015). Drawing on this notion, the Delaware Supreme Court questioned the independence of a director who: (i) had a close friendship of over 50 years with the controlling shareholder and chairman of the company; and (ii) was an executive at an insurance brokerage that is a wholly owned subsidiary of a separate corporation of which the same chairman was the largest stockholder. *Id.* at 1022-23.

<sup>345</sup> *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

## 5. Other Committees

Some companies form other committees to address their specific needs, which may be done on a permanent or ad hoc basis. Companies operating in industries subject to substantial environmental regulation and oversight, for example, may establish committees to address environmental matters. Exxon Mobil Corporation, for instance, has established an ongoing Public Issues and Contributions Committee which “reviews the effectiveness of the Corporation’s policies, programs, and practices with respect to safety, security, health, the environment, and social issues.”<sup>346</sup> BP p.l.c. formed a Gulf of Mexico committee in July 2010 to help the company monitor its response to the Deepwater Horizon accident and “to oversee the management and mitigation of legal and license-to-operate risks arising out of the Deepwater Horizon accident and oil spill.”<sup>347</sup> Companies may also establish ad hoc committees to evaluate strategic initiatives or other tasks for a limited time period and may subsequently dissolve any such committee upon completion of its specific task.

As discussed in Section VI, the chief executive of Vanguard, one of the largest institutional investors, suggested that boards should create “shareholder liaison committees” to foster closer relations with major investors. The idea of such deepened engagement has merit and is consistent with the prevailing shareholder-centric view of corporate governance, but a subcommittee (perhaps of the nominating and governance committee) might be a more appropriate and flexible way to implement this concept.

Committees are also often formed for short-term purposes of convenience, such as to give final approval to the terms of an agreement within parameters identified by the board, or to formally establish a meeting date. Sometimes this committee consists of just one director, often the CEO, when the formal action should be taken by the board rather than by officers.<sup>348</sup>

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<sup>346</sup> Exxon Mobil Corp. Proxy Statement (Schedule 14A), at 14 (Apr. 11, 2014), *available at* [http://cdn.exxonmobil.com/~media/Reports/Other%20Reports/2014/2014\\_Proxy\\_Statement.pdf](http://cdn.exxonmobil.com/~media/Reports/Other%20Reports/2014/2014_Proxy_Statement.pdf).

<sup>347</sup> BP p.l.c., 2014 Annual Report (Form 20-F), at 69 (Mar. 3, 2015), *available at* [http://www.bp.com/content/dam/bp/pdf/investors/BP\\_Annual\\_Report\\_and\\_Form\\_20F\\_2014.pdf](http://www.bp.com/content/dam/bp/pdf/investors/BP_Annual_Report_and_Form_20F_2014.pdf).

<sup>348</sup> However, it should be noted that there has been significant pushback against small (*i.e.*, two-person) board committees when the committee plays a critical function from both governance activists and institutional shareholders. Glass Lewis opposes re-election of directors at companies with fewer than three audit committee members, and Global Head of Corporate Governance at BlackRock Inc. has noted that two-member committees are “out of step with how other boards operate.” Joann S. Lublin, *Two-Person Board Committees Exist at Some Big Firms*, THE WALL ST. J. (Jan. 27, 2016), <http://www.wsj.com/articles/two-person-board-committees-exist-at-some-big-firms-1453942169>.



## XII. Succession Planning

### A. CEO Succession Planning

Arguably the single most important responsibility of the board is selecting the company's CEO and planning for his or her succession. The integrity, dedication and competence of the CEO are critical to the success of the company and the creation of long-term shareholder value. Historically, the nominating and corporate governance committee has led this process and recommended to the board the CEO's successor, and most boards continue to charge it with this responsibility.<sup>349</sup> As executive compensation has become a more central and scrutinized issue, boards have increasingly given their compensation committees a role in succession planning. Some boards involve both the nominating and corporate governance and the compensation committee in succession planning. If a board takes this approach, it is important that the responsibilities of the two committees be clearly delineated to avoid conflict, redundancy or parts of the process slipping through the cracks. Regardless of what committee is charged with leading the effort, a board must remember that it bears the ultimate responsibility for succession planning. Between 2001 and 2013, 442 companies, or 88 percent of the S&P 500, managed at least one transition of the CEO, chairman, or both roles.<sup>350</sup> Management succession planning is, in addition to prudent practice, a requirement for NYSE-listed companies. The NYSE corporate governance guidelines state that succession planning should include formulating policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.<sup>351</sup> Nasdaq does not have such a requirement.

The consequences of failing to effectively plan for the CEO's succession can be dire. If a company is unprepared for when a vacancy occurs—which could happen unexpectedly for a number of reasons—a leadership vacuum can arise that can shake confidence in the company, both internally and externally, make the company more vulnerable to takeover attempts or shareholder activism and render it unable to effectively seize opportunities or respond to challenges in the interim. The absence of a thorough, well-formulated plan will likely force the board to respond reactively and without the opportunity for calm deliberation upon the unexpected departure of the CEO.

Despite the clear importance of succession planning, a number of factors may impede the board from giving this function the attention it warrants.<sup>352</sup> Succession planning can be a sensitive topic. Some boards may be hesitant to consider the replacement of the CEO when the com-

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<sup>349</sup> This is particularly the case for large companies. A 2015 survey found that 28.6 percent of companies with at least \$100 billion in assets formally assign succession planning responsibilities to the nominating and corporate governance committee compared to only 8.3 percent of companies with less than \$5 billion in assets. The Conference Board, *CEO Succession Practices 27* (2015).

<sup>350</sup> Korn-Ferry International and National Association of Corporate Directors, *Annual Survey of Board Leadership 2013*, at 26.

<sup>351</sup> NYSE Listed Company Manual, Rule 303A.09.

<sup>352</sup> A recent survey found that 78 percent of boards formally discuss CEO succession at least once per year and 22 percent of boards discuss succession planning four or more times per year. Spencer Stuart, *Spencer Stuart Board Index 2015* 19 (Nov. 2015), available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

pany is thriving or to compound his or her concerns when the company is facing difficulties. Perhaps an even greater danger to effective succession planning is the natural tendency to focus on the more immediate challenges of running the company at the expense of long-term or contingency planning. This danger is especially acute when the board lacks a formalized structure and process for succession planning.

## **1. Long-Term and Contingency Planning**

The nominating and corporate governance committee should ensure that the company is engaged in both long-term succession planning and contingency or emergency planning. A 2015 survey found that 73 percent of boards have both emergency and long-term succession plans and that 25 percent of boards only have an emergency succession plan in place.<sup>353</sup> Long-term planning should have an eye toward the expected timeline for the incumbent CEO's departure in the normal course and cultivating potential successors with that timeline in mind. To do this effectively, the nominating and corporate governance committee should maintain an ongoing dialogue with the incumbent CEO regarding his or her future plans. The nominating and corporate governance committee should also assess the likelihood and timing of a change of CEO based on his or her performance and the direction of the company. This may be most efficiently done in conjunction with the board's annual review of the CEO. *See* Section XIV.C.

Contingency planning aims to keep the company prepared in the event the company must fill an unexpected vacancy, which may occur due to a scandal or the death or departure of the CEO. The nature of contingency planning requires the nominating and corporate governance committee to adopt an "expect the unexpected" mindset. This has become even more imperative in recent years, as the rate of CEO turnover has increased. According to a 2015 study, 1,341 CEOs left their posts in 2014, the highest figure since 2008.<sup>354</sup> To avoid being caught flat-footed, the nominating and corporate governance committee should ensure that it has considered and developed internal candidates for both the long-term and in the event of an immediate and unexpected vacancy.

## **2. Approach**

There are no prescribed procedures for effective succession planning, and each board and nominating and corporate governance committee should take the time to fashion a process appropriate for its particular company. However, while the process should be tailored to the unique circumstances of each company, there are certain guiding principles that all companies should follow. Most fundamentally, succession planning should be a proactive, comprehensive and ongoing process, rather than an ad hoc or check-the-box activity. This should include, at minimum, an annual comprehensive discussion of internal candidates and emergency plans, which is often combined with the board's annual evaluation of itself and management. *See* Section XIV.A.

Effective succession planning requires the board and the nominating and corporate governance committee to possess an in-depth knowledge of its company and its internal pipeline of

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<sup>353</sup> *Id.*

<sup>354</sup> Press Release, Challenger, Gray & Christmas, Inc., *CEO Turnover Remains Constant: 110 CEO Changes Start 2015; Oil Prices Impact CEOs Too*, Feb. 11, 2015, available at <http://www.challengergray.com/press/press-releases/2015-january-ceo-report-110-ceos-out-some-oil-prices#sthash.wfFjjYPm.dpuf>.

candidates and possibly to monitor outside candidates as well. The board, and the nominating and corporate governance committee if it has been tasked with leading the effort, must take a hands-on approach. It should not unduly defer to the current CEO, rely on résumés, or otherwise outsource the process. The nominating and corporate governance committee should take the lead in ensuring that succession planning is regularly discussed at the board level and that a systematic process for succession planning is in place. As part of this systematic process, the board should regularly review its procedures and may find it helpful to formulate a list of qualities it seeks in a candidate. With the tremendous and ever increasing demands on boards' time, a board that fails to make succession planning an institutionalized priority risks falling into the trap of ignoring the issue until an unforeseen crisis has occurred.

### **3. Creating a Candidate Profile**

The search for a CEO should begin with identifying the challenges and opportunities that the company is expected to encounter in the applicable timeframe. Once this has been done, the board and the nominating and corporate governance committee can identify the traits and qualities in a prospective CEO that would be most useful in leading the company going forward. The board and nominating and corporate governance committee should bear in mind that, as the circumstances and strategic direction of the company change, these traits and qualities may not be the same ones that distinguished the incumbent CEO. These desired traits should be narrowed to a manageable number to facilitate the nominating and corporate governance committee's focus on the most essential areas.

After formulating a desired profile for the next CEO, the board and the nominating and corporate governance committee must establish a well-designed selection process to find candidates who meet these requirements. This will provide a roadmap to keep the search focused and also provide a neutral, pre-agreed-upon path to help avoid or resolve the differences of opinion that often arise during the process.

Once the selection process has winnowed down a short list of the potential candidates possessing the desired qualities, the nominating and corporate governance committee should consider two key corporate-governance-related elements before reaching a final decision. First, the new CEO should be a good fit with the culture of the board and the company. Second, the new CEO's long-term vision for the company must align with the vision of the board. No matter the candidate's other qualifications, if these two elements are absent, the candidate is likely to end up a poor fit for the company. The importance of cultural compatibility and a shared strategic vision underscores the necessity of the board getting to know candidates personally, as these elements cannot be ascertained from reviewing résumés or soliciting recommendations from a search firm. It should be noted that both of these elements depend heavily on the ability of the CEO and the board to communicate and collaborate effectively. This in turn depends on a shared understanding of the respective roles of the CEO and the board. A CEO must understand that the board has the ultimate responsibility for overseeing the management of the company, while the board should appreciate that the day-to-day business of the company is the purview of management, led by the CEO. This understanding will enable the CEO and the board to sustain an ongoing cooperative relationship founded on mutual respect.

#### **4. Internal and External Candidates**

The most promising prospects for the next CEO often reside within the company. Indeed, promotion from within has often proven to be far more successful than hiring a CEO from the outside. CEOs promoted internally benefit from greater familiarity with the company and are typically less expensive (and their compensation less scrutinized) than CEOs recruited from outside. Development of an internal talent pipeline is therefore a strategic imperative for any company, and the board has an important role to play in this process. The search team should actively identify promising leaders to keep a bench of qualified candidates at the ready. One useful step is to create opportunities for promising officers to interact with or appear before the board.<sup>355</sup> This has the benefit of both familiarizing the board with potential candidates and developing the officers' ability to interact with the board. The succession planning team should also consider working with the CEO to establish policies to evaluate internal candidates and to ensure that they are given opportunities to develop the skills and experience needed to possibly head the company in the future; for example, by rotating candidates through the company's key departments. While the CEO should exercise primary responsibility for building the company's management team, the board can also help develop its talent pipeline by seeing that appropriate recruiting and retention policies are in place at all levels of management.

Despite the importance of developing a talent pipeline and the benefits of internal promotion, a CEO succession plan should also include ongoing consideration of external candidates. This will enable the nominating and corporate governance committee to assess all of its options and will take on additional importance if the board determines that a change in strategic direction is in the company's best interest. In all cases, consideration of external candidates will help the board reach a more informed decision by having both a wider pool of candidates and an added ability to benchmark internal candidates. Indeed, a recent survey found that nearly 71 percent of companies have a formal process for reviewing internal succession candidates, and 51 percent benchmark internal candidates against external candidates.<sup>356</sup>

#### **5. Seeking the Input of Others**

Succession planning should be a collaborative process that enables the nominating and corporate governance committee, and ultimately the board, to benefit from a number of perspectives and to utilize all of the company's resources. One such resource is the compensation committee, whose role has become increasingly important due to the centrality of executive compensation in attracting and retaining a qualified CEO, and because of the increased scrutiny generated by the topic in recent years. The nominating and corporate governance committee may also benefit from discussions with senior officers in the company's human resources department, who should have detailed knowledge about pipeline talent as well as a specialized understanding of what skills these promising candidates need to develop.

The nominating and corporate governance committee should consider engaging outside advisors to aid in the canvassing for and assessment of external candidates. While it is by no

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<sup>355</sup> "Nearly all boards (98%) rely on regular interactions during board meetings and presentations to get to know internal succession candidates." Spencer Stuart, *Spencer Stuart Board Index 2015* 19 (Nov. 2015), available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>356</sup> *Id.*

means necessary to engage an outside advisor to lead the CEO search process, the broader reach and perspective they can bring to bear can be invaluable in certain circumstances. It is true that the services of a top-flight recruiting agency can be expensive, but the board must keep in mind that this is one of the most important decisions they will make. A third party should at a minimum be retained to lead a thorough verification and background check so that the board can reasonably rely on this information when selecting a candidate.

## **6. Involvement of the Current CEO**

When a company's CEO enjoys the full confidence of the board, he or she should play a prominent role in the succession planning process. In many circumstances, the board may want the CEO to manage the process, with the board or the nominating and corporate governance committee's oversight. This is because the incumbent CEO is uniquely positioned to understand the needs of the position and determine the successor best prepared to lead the company going forward. A 2014 survey by Spencer Stuart found that 56 percent of CEOs evaluate internal candidates and report back to the board, 29 percent serve as the overall counsel to the committee charged with succession planning, and 31 percent lead the succession process.<sup>357</sup> Absent special circumstances, any process not involving the CEO will be a poor substitute and presents a number of disadvantages. Without the insight of the CEO, the board may struggle to reach consensus on priorities or candidates. This reality has been exacerbated in the past decade by the tremendous emphasis placed on director independence, given the potential challenges in finding candidates with special expertise and experience in the industry who also qualify as independent.

The incumbent CEO should keep the chair or lead director regularly involved and coordinate his or her efforts with those of the nominating and corporate governance committee. The chair or lead director and the nominating and corporate governance committee should in turn update the rest of the board during the board's executive sessions. This will enable the other independent directors to express their views privately, while reinforcing an understanding that choosing the next CEO is ultimately the responsibility of the entire board.

In certain circumstances, such as when the board lacks full confidence in the incumbent CEO or when a crisis prevents use of the normal succession process, the nominating and corporate governance committee may need to take a larger role and minimize the CEO's involvement. Regardless of the circumstances, the committee must take an active role in the process and avoid even the perception that it is merely a rubber stamp for the incumbent CEO. Choosing the company's next CEO is one of the most difficult and consequential decisions a board must make. The nominating and corporate governance committee must work vigilantly to ensure that the board is well prepared to make this decision when the time comes.

## **B. Director Succession Planning**

In addition to CEO succession planning, nominating and corporate governance committees should take many of these same steps with respect to succession planning for the board (of course, the risk of crisis is lower with respect to the board because there are many directors but only one CEO). However, director succession planning was an area of concern for boards in

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<sup>357</sup> Spencer Stuart, *Spencer Stuart Board Index 2014*, at 33, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2014>.

2015: Only 42 percent of boards thought that they were spending sufficient time on director succession planning.<sup>358</sup> The nominating and corporate governance committee should have both long-term and contingency plans in place to prepare for the departure of a director. This planning is particularly important for directors who occupy leadership positions on the board or possess important qualities, such as financial expertise. The nominating and corporate governance committee may find this planning most effectively done in conjunction with the annual evaluation of the board, its committees and directors. *See* Section XIV.A. For an extensive discussion of board composition and qualifications that the nominating committee should consider during board succession planning, *see* Section VII.B.1. The process of identifying and recruiting new directors is discussed in Section VIII.A.

There are various ways to change the board's composition. Many boards have the authority under their company's charter to increase or decrease the size of the board through a resolution. This power can be used to proactively strengthen the board by adding an attractive candidate without waiting for a vacancy or replacing an incumbent director. Alternatively, there may be circumstances where decreasing the board size, at least temporarily, is the best option. Ordinary attrition of directors often provides an opportunity to update the board's skill set to better match the company's changing circumstances. Sometimes a nominating and corporate governance committee may determine that an incumbent director no longer fits the company's needs and recommend against that director's renomination. In a recent survey by PricewaterhouseCoopers, 40 percent of the directors polled suggested that someone on their board should be replaced due to diminished performance because of aging, lack of required expertise, poor preparation for meetings or other factors, an increase from only 31 percent in 2012.<sup>359</sup> If the nominating and corporate governance committee holds this view on a director, it must be prepared to recommend a change. However, it should resist attempts by corporate governance activists to disrupt a well-functioning team in the name of "board refreshment" as an end in itself. This newly popular phrase has been seized upon to promote various agendas, including diversity goals and director independence. However important those criteria may be, they only should be a part of the nominating and corporate governance committee's holistic assessment and not simply an excuse to make changes.

As discussed in Section X.B, there is a growing view among shareholder activist groups and proxy advisory firms that long director tenure can affect a director's independence. As it plans for board succession, the nominating and corporate governance committee must be aware of that view and monitor its prevalence, but always remember the benefits that flow from having experienced and long-term directors on the board in terms of familiarity with the company business, history, values and institutional knowledge.

Sometimes the regular succession planning process of a board is interrupted by an unexpected event. One such event that is occurring with increasing regularity (and may get worse as proxy access becomes more prevalent) is the loss of key directors in a short-slate proxy contest. Such an event will require the nominating and corporate governance committee to reevaluate the resources it has available to it, in terms of qualifications and skill sets, to ensure that the board

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<sup>358</sup> PricewaterhouseCoopers, *2015 Annual Corporate Director Survey* 12 (2015), available at <http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/downloads.html>.

<sup>359</sup> *Id.* at 8.

continues to be able to fulfill its many duties. Although not always the case, it has been our experience that dissident directors who are elected to boards as a result of proxy fights often go on to become valuable and productive members of the board. Understandably, however, nominating and corporate governance committees may be reluctant to assign newly elected dissident directors to particular committees or roles until they appreciate how they will affect the dynamic of the board, and have a sense of their expected longevity on the board.



### **XIII. Director Compensation**

#### **A. Vesting Responsibility for Setting Director Compensation**

While the NYSE and Nasdaq rules do not require a particular process for setting director compensation, this responsibility should be entrusted either to a committee, such as the nominating and corporate governance committee or, in some instances, the compensation committee, or to the full board. When directors who would directly benefit from a plan are charged with approving the plan, courts will review the plan under the entire fairness standard, rather than the more deferential business judgment rule. Thus, it is generally best for the board to charge the nominating and corporate governance committee with setting director compensation, subject to the approval of the full board. Some boards place this responsibility with a company's compensation committee. In either case, the committee's decision with respect to non-employee director compensation should always be subject to full board review and approval. To avoid an inference that the two are connected, boards should strive not to increase the compensation of management at the same time they increase the compensation of non-management directors. Note that officers of the company serving on the board typically receive no compensation for this service.

#### **B. Selecting the Form and Amount of Compensation**

If the nominating and corporate governance committee participates in recommending director compensation, it should carefully consider both the form and the amount of the compensation. As to form, director compensation ordinarily consists of a mix of cash and equity payments in an effort to align directors' incentives with those of the company. A recent survey found that 54 percent of the average director's compensation is paid in grants of the company's stock, 38 percent in cash, and five percent in stock options.<sup>360</sup> While the percent of stock-based compensation has increased in recent years, these programs should be carefully designed to ensure that they do not create the wrong type of incentives. Restricted stock grants, for example, are generally considered to be preferable to option grants because they expose a holder to both upside potential and downside risk, which may better align director and shareholder interests and reduce excessive risk taking.

As the responsibilities, time commitment, public scrutiny and risk of personal liability entailed in board service have increased in recent years, so has the average director's compensation. Indeed, the average director retainer has doubled in the past decade, and the average total director compensation is now roughly \$277,000, a five percent increase from 2014.<sup>361</sup> The nominating and corporate governance committee should consider the time commitment and other responsibilities of the directors as well as "benchmarking" the compensation against that being paid to directors of comparable companies. While directors are not employees and compensation is not their primary motivation for serving, offering appropriate and competitive compensation is an important factor in attracting high quality directors. As part of the board's annual self-evaluation, the nominating and corporate governance committee should therefore consider

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<sup>360</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 30, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015>.

<sup>361</sup> *Id.*

whether director compensation programs need adjustment to reflect the increased responsibilities of director service and director pay at comparable companies.

The nominating and corporate governance committee should carefully consider the mix between individual meeting fees and retainers, particularly in light of the business and regulatory demands that have deepened director involvement and the technological innovations that have changed the way directors meet. Most companies have de-emphasized per-meeting fees and instead increased retainers in light of these developments. In 2015, only 21 percent of S&P 500 companies pay board meeting fees, compared to 62 percent 10 years ago.<sup>362</sup> Increasing retainers in place of meeting fees offers the dual benefits of simplifying director pay and avoiding the issues that arise from electronic forms of communication and frequent, short telephonic meetings.

### **C. Compensation for Additional Director Responsibilities**

As companies transition away from per-meeting fees toward increased retainers, they should consider whether additional retainer pay is appropriate for committee service that entails extra responsibilities and time commitment. Such supplemental pay is legal and appropriate, and indeed, 95 percent of S&P 500 companies provide some retainer to committee chairpersons and 41 percent pay some retainer to committee members.<sup>363</sup> The increase in responsibilities required of directors is especially pronounced for non-executive board chairs, lead directors and committee chairs. Accordingly, particular attention should be paid to whether these individuals are being fairly compensated for their efforts and contribution. Note also that in response to greater shareholder sensitivities, companies may wish to review any director perquisite programs, as well as director legacy and charitable award programs. Survey data will provide a useful starting point in determining appropriate additional director compensation. Nonetheless, the nominating and corporate governance committee should be willing to step outside of common practice if it has a persuasive reason that the best interests of the company are advanced by so doing.

Director compensation is one of the more difficult corporate governance issues, as the need to appropriately compensate directors runs up against the risk that their compensation may result in factionalism on the board, raise an issue as to directors' independence or cause distraction by shareholder activists. The NYSE warns that questions as to a director's independence may be raised if compensation is beyond what is customary, if the company makes substantial charitable contributions to organizations with which a director is affiliated, or if the company enters into consulting contracts with, or provides other indirect compensation to, a director.<sup>364</sup> All of these issues should be tracked and carefully scrutinized by the nominating and corporate governance committee to avoid jeopardizing directors' independence or creating any appearance of impropriety.

### **D. SEC Disclosure**

SEC rules require a Director Compensation Table that discloses director compensation during the prior fiscal year that is comparable to the Summary Compensation Table for named

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<sup>362</sup> *Id.* at 32.

<sup>363</sup> *Id.* at 33-34.

<sup>364</sup> NYSE Listed Company Manual, Rule 303A.09.

executive officers.<sup>365</sup> The Director Compensation Table must disclose, among other things, director perquisites, consulting fees and payments or promises in connection with director legacy and charitable award programs.<sup>366</sup> Additionally, the company must provide narrative disclosure of its processes and procedures for the determination of director compensation.<sup>367</sup>

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<sup>365</sup> Item 402(k) of Regulation S-K. 17 C.F.R. 229.402(k).

<sup>366</sup> Item 402(k)(2)(vii) and Instruction to Item 402(k)(vii) of Regulation S-K. 17 C.F.R. 229.402(k)(2)(vii).

<sup>367</sup> Item 402(k)(3) of Regulation S-K. 17 C.F.R. 229.402(k)(3).



## XIV. Evaluations of the Board, Committees and Management

Boards of NYSE-listed companies are required to conduct annual performance evaluations of the board itself and board committees, and the nominating and corporate governance committee must be tasked with “oversee[ing] the evaluation of the board and management.”<sup>368</sup> While not required by Nasdaq, the annual board evaluation is now a nearly universal practice, with 98 percent of companies engaging in some form of it—up from 94 percent five years ago.<sup>369</sup> The board and the nominating and corporate governance committee are not required by listing standards or other law to adopt any particular approach to conducting this evaluation, leaving the flexibility to proceed in a way tailored to the company’s and board’s particular needs and culture.

### A. The Board’s Annual Governance Review

The board’s annual self-evaluation provides an opportunity and forum for a comprehensive review of the company’s performance, strategy, corporate governance and responses to adversity during the previous year. The board should review its structure, processes and procedures to ensure that they are enabling the board to effectively carry out its responsibilities. This should include a review of the number and mix of directors; the role and functioning of the chairman or lead director and executive board sessions; board agendas; board committee structure and composition; and the quality of information and professional and other resources made available to directors. The board should examine its role in developing and monitoring corporate strategy and evaluate the effectiveness of the board and management in implementing this strategy. As part of this evaluation, directors should consider whether the board’s structure, processes and proceedings afforded them sufficient opportunity to converse with the company’s senior executives regarding the company’s strategy and performance. The board should also review corporate governance matters such as monitoring of corporate controls, management review, succession planning and executive compensation.

The board’s annual evaluation should include a review of the company’s corporate governance guidelines to make certain that they are clear and relevant and that they adequately address key topics such as related-party transactions and conflicts of interest. Corporate governance documents should be updated to reflect any applicable legal or regulatory changes. They should also be company-specific, rather than generic and overbroad. This will serve both to make the documents a more useful guide and also avoid a failure to comply with a policy that may be considered in hindsight as indicative of a lack of due care. Conversely, keeping policies up to date and adhering to these procedures in good faith can be important factors in establishing the applicability of exculpatory charter provisions in any litigation that might arise challenging board actions. It is therefore important that the nominating and corporate governance committee implement and update corporate governance guidelines and measure the board and its committees’ performance against these guidelines.

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<sup>368</sup> NYSE Listed Company Manual, Rule 303A.04(b)(i).

<sup>369</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 29, available at [https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015\\_110215-web.pdf?la=en](https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf?la=en).

If the company faced any crises during the year, the annual evaluation should include a review of how the crises came about and how they were handled. Any review should identify the factors that caused or exacerbated the crises and examine the steps taken to correct any deficiencies. Directors should consider the effectiveness of the board's and management's response to the crises. As part of this inquiry, directors should ask whether they received adequate and timely information from management and whether closer contact with management could help avoid future crises. Directors should also evaluate the contributions of outside advisors, if any were retained, in responding to the crises. Similarly, the evaluation should examine the appropriateness of the board's and management's response to any whistleblower complaints or shareholder proposals made during the year. During the evaluation, the whole board should be briefed on the status and results of any investigations into whistleblower allegations. The board should also review the company's shareholder relations program and ensure that it is maintaining an appropriate level of interaction with key shareholders.

## **1. Methods of Evaluation**

A questionnaire or survey of directors is the most common method of evaluating the full board, with group discussions and interviews of individual directors also widely used.<sup>370</sup> Each of these methods has its advantages. For example, questionnaires and surveys are time-efficient, produce quantifiable results and may encourage directors to speak more freely, whereas interviews and group discussions allow for in-depth and interactive discussion. Additionally, many nominating and corporate governance committees seek management's perspective on the interaction between the board and management as part of the review. However, there is no single, established procedure for a board's annual review of its corporate governance. In order to effectively perform its oversight function, it is important for each nominating and corporate governance committee to develop a customized approach to its annual review using the combination of methods it determines are appropriate for its company's particular circumstances. The board should avoid an overemphasis on check-the-box paperwork and substantively focus on the most critical issues facing its company. More important than the method employed is the result of facilitating an honest assessment of the board's performance and a meaningful discussion of areas for improvement.

It is perfectly acceptable for a board to conduct its annual review during a board meeting without the engagement of third-party advisors.<sup>371</sup> Outside advisors such as accountants, lawyers and consultants offer a plethora of agendas, checklists and forms to assist the board in its review. While these products can in some instances facilitate a productive and transparent review, boards must guard against the danger of sacrificing substance for the sake of form. The nominating and corporate governance committee should bear in mind that if a charter or checklist requires review or other action, the failure to take such action may be argued in hindsight to be evidence of lack of due care. Documents and minutes pertaining to the board's self-evaluation are not privileged; thus, a board should take care to avoid damaging the collegiality of

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<sup>370</sup> Spencer Stuart, *Spencer Stuart Board Index 2013*, at 30, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2013>.

<sup>371</sup> In 2015, only four S&P 500 companies disclosed engagement of an independent third-party to facilitate and conduct all or a portion of the board evaluation process. Spencer Stuart, *Spencer Stuart Board Index 2015*, at 29, available at [https://www.spencerstuart.com/~/\\_media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015\\_110215-web.pdf?la=en](https://www.spencerstuart.com/~/_media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf?la=en).

the board or creating ambiguous records that may be used against the company or the board in litigation. The nominating and corporate governance committee need not create volumes of records to demonstrate that the directors have fulfilled their responsibilities with respect to the board's self-evaluation. As in other matters, a good-faith effort and a reasonable, tailored process will entitle directors to the protection of the business judgment rule.

## 2. Following Through

As important as the annual evaluation is, it should be seen as only one step in a continuous process to enhance corporate governance. First, the nominating and corporate governance committee must ensure that the board proactively addresses corporate governance challenges as they arise, rather than waiting for the next annual review. Second, it should be remembered that assessment is not an end in itself—the findings of the annual review must be translated into a plan of action, and the implementation of this plan should be monitored and reassessed on an ongoing basis. A 2013 survey of directors found that 57 percent of boards act on issues identified in their evaluations, with the most common changes being a change in board committee composition and seeking additional expertise on the board.<sup>372</sup>

### B. Committee Self-Evaluations

The NYSE requires that audit, compensation and nominating and governance committees conduct an annual self-evaluation.<sup>373</sup> Many of the same steps discussed above that should be taken by a board during its self-evaluation are also appropriate during committee self-evaluations. Committees should assess their effectiveness and consider whether they have an adequate structure and procedures to carry out their responsibilities, whether they have sufficient access to the full board and to management, and the usefulness of any outside advisors. Committees should also review their charters for any desirable changes and measure their performance against their charter. Additionally, committees may choose to evaluate the contributions of individual members through group discussion or peer or self-evaluations.

Committees should pay particular attention to their relationships with the board as a whole. Committees are an essential element to an effective board because they allow for specialized and focused attention to important issues. This function is undermined, however, if the work of a committee is either duplicated or ignored by the whole board.<sup>374</sup> An annual evaluation of a committee should therefore ensure that the work of the committee is being efficiently integrated into the overall work of the board. The results of the committees' evaluations should be shared with the full board to further this integration.

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<sup>372</sup> PricewaterhouseCoopers, *Boards Confront an Evolving Landscape: PwC's Annual Corporate Directors Survey*, 14 (2013), available at <http://www.pwc.com/us/en/corporate-governance/publications/boardroom-direct-news-letter/september-2013-issues-in-focus.jhtml>.

<sup>373</sup> NYSE Listed Company Manual, Rules 303A.07(b)(ii); 303A.05(b)(ii); 303A.04(b)(ii).

<sup>374</sup> About half of S&P 500 boards evaluate the full board and its committees annually and one-third evaluate the full board, committees and individual directors. Spencer Stuart, *Spencer Stuart Board Index 2015*, at 29, available at [https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015\\_110215-web.pdf?la=en](https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf?la=en).

## **C. Evaluation of the CEO**

CEOs are currently facing unprecedented levels of scrutiny from investors and the general public, and boards have responded by engaging in more probing review of their CEOs. This increased scrutiny, and say-on-pay legislation in particular, has led to nearly universal annual reviews of CEO performance—98 percent of S&P 500 companies in 2014, up from 94 percent in 2009.<sup>375</sup>

### **1. Tasking the Responsibility**

The NYSE listing standards require that the compensation committee be responsible for reviewing and approving corporate goals and objectives relevant to CEO compensation and for evaluating the CEO's performance in light of those goals.<sup>376</sup> Alternatively, the board may allocate the responsibilities of the compensation committee to another committee composed entirely of independent directors. Given that the NYSE listing standards also require the nominating and corporate governance committee to oversee the evaluation of management,<sup>377</sup> the nominating and corporate governance committee is often involved in CEO evaluation as well.

### **2. Finding the Right Approach**

CEO evaluations present challenges that do not arise in the board's self-evaluation. The board's self-evaluation is typically focused on the board as a group, whereas CEO evaluations necessarily focus on the individual. This difference increases the chance for acrimony or misunderstanding, making it imperative that the evaluation process be thoughtful. Each year, the board should set clear objectives for the CEO and maintain an ongoing dialogue with the CEO regarding progress towards those objectives. An ongoing dialogue will not only benefit the company by addressing problems as they arise, it will also avoid the surprise and confusion of a CEO discovering at an annual evaluation that the board has been dissatisfied with his or her performance.

### **3. Considering Replacing the CEO**

As part of its annual review, a board may well determine that a change in management leadership—either immediately or in the near future—is in the company's best interests. Thus, evaluation of the current CEO and succession planning are closely intertwined. The decision to replace the CEO must be based on the directors' independent judgment of the best interests of the company. While replacing the CEO will sometimes be necessary, boards should carefully weigh the costs of replacement and also consider whether some measure short of removal may be appropriate.

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<sup>375</sup> Spencer Stuart, *Spencer Stuart Board Index 2014*, at 32, available at <https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2014>.

<sup>376</sup> NYSE Listed Company Manual, Rule 303A.05(a)(i)(A).

<sup>377</sup> NYSE Listed Company Manual, Rule 303A.04(b)(i).

## **D. Evaluation of Individual Directors**

One-third of boards evaluate individual directors as part of their annual reviews—up from 17 percent in 2009 years ago.<sup>378</sup> Notably, despite this increase, only a minority of companies evaluate directors individually. This is likely the result of boards' reluctance to single out individual directors and a recognition that the effectiveness of a board or committee cannot be easily disaggregated. It is also likely that, even if there is no official evaluation of directors individually, if there are any significant problems with individual directors, they will come to light as part of an overall board evaluation. While the board is certainly more than the sum of its parts, evaluation of individual directors may identify areas for improvement that an evaluation of the entire board does not. The nominating and corporate governance committee should weigh these considerations and determine whether individual evaluations are in the company's best interest.

### **1. Methods of Evaluation**

If the nominating and corporate governance committee decides to conduct individual director evaluations, it should consider whether to conduct these assessments through self-evaluations or peer evaluations. These evaluations ask directors to rate themselves or their fellow directors in a number of categories, such as meeting attendance and contribution or grasp of the company and its industry. Both peer and self-evaluations can provide an opportunity for constructive assessment of the board, and the nominating and corporate governance committee may decide to use some combination of the two. Peer evaluations may in many cases prove more informative and objective than self-evaluations, but they also risk damaging the collegiality that is vital to a well-functioning board. If peer evaluation is used, the aggregate results should be presented to each director privately. Alternatively, the nominating and corporate governance committee may decide that a group discussion is the most beneficial format. The nominating and corporate governance committee should also consider procedures to engage with directors who receive negative feedback in their evaluations.

### **2. Addressing Underperforming Directors**

Addressing the problem of underperforming directors is one of the most sensitive tasks that a board faces. The ever-increasing responsibilities and time commitments that board service entails have raised the bar for board services. In some cases, additional training or a reduction in the directors' other responsibilities may address the problem. In other cases, personality conflicts may lead to a balkanized board, stifling candid discussion and undermining the board's effectiveness. Although there is generally no easy way to convince an underperforming director to resign, the situation is typically best handled by the chairman of the nominating and corporate governance committee or the lead independent director. Short of seeking a director's resignation, the nominating and corporate governance committee should consider ways to restructure the composition of the board and its committees.

The nominating and corporate governance committee is responsible for deciding whether to recommend incumbent directors for renomination. Whether or not the board engages in a formal review of individual directors, the board's annual review provides an opportunity for the

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<sup>378</sup> Spencer Stuart, *Spencer Stuart Board Index 2015*, at 29, available at [https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015\\_110215-web.pdf?la=en](https://www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf?la=en).

nominating and corporate governance committee to assess whether the company's interests would be best served by the continued service of each director. While the importance of board continuity dictates that a decision to replace an incumbent director not be made lightly, renomination must not be seen as a given. Rather, the nominating and corporate governance committee must carefully assess the contributions and skills of each director and ensure that they continue to fit the company's needs and strategy. If the nominating and corporate governance committee determines not to renominate a director, that director typically should be informed privately to provide him or her with the opportunity to exit gracefully.

#### **E. Director Questionnaires**

Whether or not the nominating and corporate governance committee chooses to engage in individual director evaluations as part of its annual review, it should ensure that directors fill out a questionnaire at least annually. Among the topics typically covered by a director questionnaire are: material relationships with an officer, parent, subsidiary or affiliate of the company; current employment and other directorships; other directorships held in the past five years; relevant experience; certain legal actions in the past 10 years; beneficial ownership and trading of securities; compensation, benefits and other perquisites; and questions tailored to service on particular committees.

These questionnaires serve a number of functions. First, the SEC requires extensive disclosure regarding directors, and thus, gathering information from the directors is necessary to make full and accurate disclosures in the company's filings. Similarly, both the NYSE and Nasdaq require a listed company to make a finding that its independent directors are indeed independent, and the questionnaire will help identify any relationships that may compromise director independence. Director questionnaires also may help the company flag interlocking directorships that may be problematic under antitrust laws or determine that a director may simply have too many other commitments to serve effectively. Lastly, the questionnaires aid in the nominating and corporate governance committee's task of maintaining an up-to-date picture of its board composition, particularly with respect to experience and skills, as part of the process of matching directors' attributes to the company's needs.

An example of a director and officer questionnaire is attached as Annex D.

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**PART THREE:**  
**NOMINATING AND CORPORATE GOVERNANCE COMMITTEE ORGANIZATION  
AND PROCEDURES**

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## **XV. Key Responsibilities of the Nominating and Corporate Governance Committee**

The nominating and corporate governance committee is a standing committee of the board to which the board delegates primary responsibilities for reviewing and recommending to the board director nominees and the formulation, recommendation and implementation, if appropriate, of corporate governance policies and practices.

### **A. Existence and Composition**

#### **1. NYSE Requirements**

The NYSE requires its listed companies to have a nominating and corporate governance committee composed entirely of independent directors.<sup>379</sup> Independence, for purposes of serving on the nominating and corporate governance committee, is determined by the same standards generally applicable to directors. (For a description of the NYSE's independence requirements, see Section VII.C.1.) So long as the committee members ultimately decide any matters within the sole province of the committee, the NYSE's independence requirement does not prohibit officers or non-committee member directors from attending a committee meeting, making a recommendation to the committee or requesting that a matter be addressed by the full board.

#### **2. Nasdaq Requirements**

Companies listed with Nasdaq may perform nominating and corporate governance tasks through a committee of independent directors.<sup>380</sup> Alternatively, Nasdaq allows director nominees to be selected or recommended by a majority of the board's independent directors so long as only independent directors participate in the vote. (For a description of Nasdaq's independence requirements, see Section VII.C.1.) The stated purpose of this rule is to provide companies with the flexibility to choose an appropriate board structure and reduce resource burdens, while ensuring that independent directors approve all nominations.<sup>381</sup>

Additionally, Nasdaq provides a limited exception to the requirement for complete committee-member independence. If the nominating and corporate governance committee is composed of at least three members, a non-independent director who is not currently an executive officer or a family member of an executive officer may serve on the committee if the board determines that it is required by the best interests of the company.<sup>382</sup> This exception is allowed only under limited circumstances, and a member appointed under this exception may serve no longer than two years.<sup>383</sup> As with the NYSE, Nasdaq's rules regarding committee member independence do not prohibit non-committee members or non-committee member directors from attending meetings or otherwise contributing to the work of the committee.

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<sup>379</sup> NYSE Listed Company Manual, Rule 303A.04(a).

<sup>380</sup> Nasdaq Listing Rule 5605(e)(1).

<sup>381</sup> Nasdaq Listing Rule IM-5605-7.

<sup>382</sup> Nasdaq Listing Rule 5605(e)(3).

<sup>383</sup> Note, however, that ISS recommends "against" or "withhold" votes for directors of companies that lack a formal nominating committee or if non-independent directors serve on such committee. ISS, *2016 U.S. Summary Proxy Voting Guidelines* 16 (2015).

### 3. SEC Requirements

The SEC does not establish mandatory standards regarding the existence and composition of the nominating and corporate governance committee but instead specifies certain disclosure obligations. A listed company must state whether or not it has a standing nominating and corporate governance committee (or another committee performing a similar function).<sup>384</sup> A company with a nominating and corporate governance committee must identify each committee member, state the number of meetings held by the committee during the last fiscal year and describe briefly the functions performed by the committee.<sup>385</sup> A company without such a committee must identify each director who participates in the consideration of director nominees and must state the basis for the view of the company's board that it is appropriate not to have such a committee.<sup>386</sup>

The SEC requires a company to identify each member of its nominating and corporate governance committee who is not independent under applicable independence standards.<sup>387</sup> A listed company may use its own definition of independence, provided that the definition complies with the independence standards of the exchange on which the company is listed.<sup>388</sup> In the absence of company-defined independence standards for a committee, the applicable standard is the one used by its exchange.<sup>389</sup> A company that relies on an exemption from the independence requirements of the exchange on which it is listed must identify the exemption and explain its basis for reliance.<sup>390</sup>

#### B. Nominating and Corporate Governance Committee Charter and Responsibilities

A NYSE-listed company must have a written nominating and corporate governance committee charter vesting the committee with certain responsibilities. In contrast, a Nasdaq-listed company need not have a formal nominating and corporate governance committee at all, and therefore need not have a formal committee charter. Nasdaq requires only that each company certify that it has adopted either a written charter or board resolution addressing the process by which directors are selected for nomination. Further, unlike a NYSE-listed company, a Nasdaq-listed company is not required to task a specific committee with formulating its corporate governance standards. Nonetheless, in recent years there has been a notable trend among Nasdaq-listed companies, especially large-cap companies, towards having formal nominating and corporate governance committees and including within their ambit a leading role in forming and implementing corporate governance policy.<sup>391</sup> An example of a nominating and corporate governance committee charter is attached as Annex E.

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<sup>384</sup> Item 407(b)(3) of Regulation S-K. 17 C.F.R. 229.407(b)(3).

<sup>385</sup> *Id.*

<sup>386</sup> Item 407(c)(1) of Regulation S-K. 17 C.F.R. 229.407(c)(1).

<sup>387</sup> Item 407(a) of Regulation S-K. 17 C.F.R. 229.407(a).

<sup>388</sup> Item 407(a)(1)(i) of Regulation S-K. 17 C.F.R. 229.407(a)(1)(i).

<sup>389</sup> *Id.*

<sup>390</sup> Instruction 1 to Item 407(a) of Regulation S-K. 17 C.F.R. 229.407(a).

<sup>391</sup> Ninety-nine percent of S&P 500 companies have a nominating and corporate governance committee. Ernst & Young LLP, *Let's Talk: Governance, Beyond key committees: Boards create committees to support oversight responsibilities* 1 (Apr. 2014).

As a matter of good corporate governance, it is recommended that a company review its nominating and corporate governance charter (or equivalent standards if a company does not have a formal committee) at least annually and more frequently if circumstances warrant. The nominating and corporate governance committee should lead this review, making sure that corporate governance guidelines adequately address key topics such as director elections, related-party transactions and conflicts of interest. As part of any review, a nominating and corporate governance committee should ensure that the company's charter, bylaws, corporate governance guidelines, procedures and committee charters do not set inconsistent standards.

## 1. NYSE Requirements

As noted, the nominating and corporate governance committee of a NYSE-listed company must have a written charter that describes the committee's purpose and its responsibilities. Because the charter is originally adopted by the board and subject to amendment by the board, the authority and procedures of the committee can be altered as long as the committee retains the responsibilities required under the NYSE rules. The responsibilities that the charter must provide for include:

- identification of qualified individuals who meet the criteria for board membership set out by the board;<sup>392</sup>
- selection, or recommendation to the board, of director nominees to be presented at the next annual meeting of shareholders;<sup>393</sup>
- development and recommendation to the board of a set of corporate governance guidelines;<sup>394</sup>
- oversight of the evaluation of the board and management;<sup>395</sup> and
- annual evaluation of the committee's performance.<sup>396</sup>

Commentary to the NYSE rules instructs that the charter should also address a number of topics concerning the committee itself, including:

- committee member qualifications;
- the process for committee member appointment and removal;
- committee structure and operations (including authority to delegate to subcommittees); and
- committee reporting to the board.<sup>397</sup>

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<sup>392</sup> NYSE Listed Company Manual, Rule 303A.04(b)(i).

<sup>393</sup> *Id.*

<sup>394</sup> *Id.*

<sup>395</sup> *Id.*

<sup>396</sup> NYSE Listed Company Manual, Rule 303A.04(b)(ii).

The commentary also states that the charter should give the nominating and corporate governance committee sole authority to retain and terminate a search firm to assist in identifying director candidates.<sup>398</sup> Boards may allocate the responsibilities of the nominating and corporate governance committee to committees of their own denomination, provided that any such committee has a charter and is composed entirely of independent directors.

The NYSE listing standards instruct that the nominating and corporate governance committee is responsible for taking a leadership role in shaping a company's corporate governance.<sup>399</sup> As noted above, the NYSE-listed companies are required to adopt a nominating and corporate governance committee charter giving the committee responsibility for the development and recommendation to the board of a set of corporate governance guidelines applicable to the company. These corporate governance guidelines must address the following subjects:

- director qualification standards;
- director responsibilities;
- director access to management and, as necessary and appropriate, independent advisors;
- director compensation;
- director orientation and continuing education;
- management succession; and
- annual performance evaluation of the board.<sup>400</sup>

This charter must be made available on the company's website.<sup>401</sup>

## **2. Nasdaq Requirements**

Nasdaq is again more flexible in its charter requirements than the NYSE, allowing companies to outline their nominations procedures and such related matters as are required under the federal securities laws in a board resolution rather than a charter.<sup>402</sup> Nasdaq's charter requirements differ from those of the NYSE in two additional respects. First, whereas the NYSE lists a number of responsibilities that must be entrusted to the nominating and corporate governance committee, and also lists with greater specificity the topics that should be addressed in the committee charter, Nasdaq requires only that the charter or board resolution outline a company's director nomination process and any related matters as required by federal securities laws. Second,

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<sup>397</sup> Commentary to NYSE Listed Company Manual, Rule 303A.04.

<sup>398</sup> *Id.*

<sup>399</sup> *Id.*

<sup>400</sup> Commentary to NYSE Listed Company Manual, Rule 303A.09.

<sup>401</sup> Website Posting Requirement to NYSE Listed Company Manual, Rule 303A.04.

<sup>402</sup> Nasdaq Listing Rule 5605(e)(2).

while the NYSE requires a company to make its committee charter available online, Nasdaq requires only that a company certify that it has adopted a committee charter or board resolution.<sup>403</sup>

Although Nasdaq's requirements offer greater flexibility, recent years have seen a notable trend in Nasdaq-listed companies towards expanding the role of the nominating and corporate governance committee to include a leading role in forming and implementing corporate governance policy.

### **3. SEC Requirements**

The SEC requires a company to disclose whether its nominating committee has a charter.<sup>404</sup> If it does, the company must disclose whether a current copy of the charter is available on its website, and if it is, the website address. If a copy is not available on the company's website, one must be included in the company's proxy or information statement once every three fiscal years and every year that the charter has been materially amended. If the company relies on a prior year's filing to fulfill this requirement, the company must identify the prior year.<sup>405</sup>

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<sup>403</sup> *Id.*

<sup>404</sup> Item 407(c)(2)(i) of Regulation S-K. 17 C.F.R. 229.407(c)(2)(i).

<sup>405</sup> Instruction 2 to Item 407 of Regulation S-K. 17 C.F.R. 229.407.



## **XVI. The Membership and Functioning of the Nominating and Corporate Governance Committee**

### **A. Membership**

#### **1. Size and Composition of the Committee**

Neither federal law nor stock exchange listing requirements prescribe a minimum or maximum number of members for a nominating and corporate governance committee.<sup>406</sup> The appropriate number of members will vary depending on such factors as the composition of the board as a whole, the size and complexity of the company and the breadth of responsibilities tasked to the committee. The size of the nominating and corporate governance committee varies, although a committee of three or four members is fairly common. As part of its annual review, the committee and the board should consider the attributes of the committee members to ensure that the committee is appropriately constituted to effectively perform its tasks.

A company must be mindful of the director independence requirements imposed by its stock exchange and other sources when selecting directors to serve on the nominating and corporate governance committee. The NYSE requires a nominating and corporate governance committee to be composed of independent directors and sets standards governing who can qualify as an independent director. While Nasdaq does not require a formal nominating and corporate governance committee, it does require that a company's independent directors perform the nominating function generally assigned to a nominating and corporate governance committee.<sup>407</sup> Unlike members of the audit and compensation committees, who face additional independence requirements, the independence of members of the nominating and corporate governance committee is judged by the same standards the NYSE and Nasdaq employ to determine director independence generally.

#### **2. Chairperson**

While the effectiveness of the nominating and corporate governance committee depends upon the contributions of each of its members, the chairperson has a particularly important role to play. He or she establishes the agenda for committee meetings and leads committee discussions to ensure that meetings are conducted regularly and efficiently and that each item receives appropriate attention. Moreover, the chairperson is typically the voice of the committee in its interactions with outside advisors, senior management and the full board. A 2013 study found that 62 percent of committee chairs rotate every few years, and that rotation can serve to enhance the experience and effectiveness of directors.<sup>408</sup> It is not unusual for the chair of the nominating and corporate governance committee to also serve as lead director when the chief executive of the company also chairs the board. Although this is by no means necessarily the right choice for any given company, the role that the nominating and corporate governance committee plays in

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<sup>406</sup> See NYSE Listed Company Manual, Rule 303A.04. Nasdaq does not require the formation of a nominating and corporate governance committee, and the SEC requires only disclosure of committee-related information.

<sup>407</sup> Nasdaq Listing Rule 5605(e)(1).

<sup>408</sup> Heidrick & Struggles, *2013 Board of Directors Survey: The State of Leadership Succession Planning Today* 7 (2014).

establishing appropriate corporate governance policies and practices for the company positions its chair well to perform the lead director role (which is described in Section III.E).

### **3. Term of Service**

There are no rules that prescribe a particular length or term of service for members of a nominating and corporate governance committee. Consequently, a board is free to fashion policies it determines are appropriate. As a general matter, the board should strike a balance between experience and stability on the one hand, and facilitating the exchange of fresh ideas and perspectives on the other. High turnover on the committee may reduce cohesion, lead to inefficiency and make it harder to develop and implement long-term plans, such as board development plans, corporate governance evolution, and management succession planning. Conversely, having little or no turnover risks depriving the committee of the benefit of fresh ideas and perspectives. In striking this balance, a board should consider periodically rotating its qualified directors onto the committee. Boardroom diversity is an increasingly important consideration (as is described in Section VII.B.3), and this can be thought to be especially true for the nominating and corporate governance committee given its central role in identifying, reviewing and recommending candidates for the board.

## **B. Meetings**

### **1. Regular Meetings**

Apart from the requirement that the nominating and corporate governance committee conduct an annual self-evaluation and oversee the annual self-evaluation of the board, neither the SEC nor the major securities exchanges mandate the frequency of committee meetings. A nominating and corporate governance committee should meet with sufficient regularity to properly carry out its duties. The appropriate frequency will depend on various factors, including the scope of the committee's responsibilities, the size of the company and whether any circumstances, such as an anticipated leadership transition or unusual shareholder activism, require extraordinary committee attention. In addition to other meetings throughout the year, the committee should meet in advance of the board's annual nomination of directors. A 2014 study showed that S&P 100 companies held anywhere between two and 13 committee meetings per year, with a median of five meetings per year, and the frequency of these meetings has remained constant in recent years.<sup>409</sup>

As with a meeting of the board, a meeting of the nominating and corporate governance committee should provide adequate time for the discussion and consideration of each agenda item. To help ensure productive discussion, the committee should devote sufficient attention to planning the timing, agenda and attendees of the meeting.

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<sup>409</sup> David A. Bell, Fenwick & West LLP, *Corporate Governance Survey – 2014 Proxy Season Results* 28 (Dec. 11, 2014), available at [http://www.fenwick.com/FenwickDocuments/2014-Corporate-Governance.pdf?WT.mc\\_id=CG-Survey\\_121114](http://www.fenwick.com/FenwickDocuments/2014-Corporate-Governance.pdf?WT.mc_id=CG-Survey_121114).

## 2. Minutes

Nominating and corporate governance committees ordinarily prepare minutes of their regular meetings but not of their executive sessions. These minutes should identify the topics discussed, but it is neither necessary nor prudent to attempt to create a transcript of meetings. Rather, minutes should be sufficiently detailed to document that the committee requested, received, reviewed and discussed the information it deemed relevant in light of the facts and circumstances as they were known at the time. Courts and regulators reviewing a committee's actions often regard minutes as the most reliable contemporaneous evidence of what transpired at a meeting. In litigation concerning director-level conduct and decision-making, board and committee minutes are regularly used as evidence and can provide a guide to opposing counsel as to which directors to depose and what topics to cover in such depositions. It is therefore of vital importance that minutes are thoughtfully drafted to reflect the topics discussed at meetings and the substance of the committee's discussion in order to avoid creating an ambiguous record that may later be used against the directors in litigation. As part of this effort, and because directors today are often engaged in work with one another for their companies outside of formal meetings, committees should consider including in the minutes reference to any discussion that occurred among the members prior to or after the meeting.

Minutes should also reflect which members of the committee were present and whether any non-committee members attended (and for what portions of the meeting they were in attendance). It is good practice for directors who do not serve on the committee to have the opportunity to ask the committee questions, and the committee should consider providing the full board with a report or copy of the minutes for each committee meeting. Drafts of minutes should be prepared and circulated to each committee member reasonably promptly after each meeting to help ensure accuracy. Where possible, the minutes should also be circulated in advance of a future (ideally, the next) committee meeting in good time to allow each committee member a full opportunity to review them before approval.

## 3. Rights of Inspection

The danger of improvidently drafted minutes is especially acute because state law often provides shareholders a right to inspect the books and records of the company, including committee meeting minutes.<sup>410</sup> For example, any stockholder of a Delaware company may make a written demand to inspect board of director and committee meeting minutes.<sup>411</sup> Although such inspection rights are limited to situations where stockholders have a "proper purpose" for their

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<sup>410</sup> A glaring example of the expansive nature such requests can occasionally take occurred in 2014 when the Delaware courts required Wal-Mart, in response to a shareholder demand to investigate potential wrongdoing associated with illegal payments to Mexican officials, to produce documents from 11 different custodians, including those on disaster recovery tapes, spanning a seven-year time period. The order also required production of documents that were otherwise protected by attorney-client privilege. The stockholder investigation was prompted by an April 2012 New York Times article entitled "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle." *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Trust Fund IBEW*, 95 A.3d 1264 (Del. 2014); cf. *United Technologies Corp. v. Treppel*, 109 A.3d 553, 559 (Del. 2014) (permitting the company to condition use of materials obtained in an inspection of its books and records only to cases filed in Delaware courts and noting that "the stockholder's inspection right is a 'qualified one'" for which the "Court of Chancery has wide discretion to shape the breadth and use of inspections under §220 to protect the legitimate interests of Delaware corporations").

<sup>411</sup> 8 Del. C. § 220.

requested inspections, courts throughout the country have encouraged stockholders seeking to bring derivative litigation to take pre-suit discovery via these statutory inspection rights. Delaware's proper purpose requirement is a "notably low standard,"<sup>412</sup> which requires only that stockholders produce evidence demonstrating a credible basis of actionable corporate wrongdoing.<sup>413</sup>

However, to some extent, recent cases have limited the contours of "proper purpose." In *Southeastern Pennsylvania Transit Authority v. AbbVie, Inc.*, stockholders of AbbVie demanded the company's books and records in order to investigate a potential breach of fiduciary duty after the board abandoned its plans to pursue an inversion transaction and was forced to pay a \$1.635 billion termination fee.<sup>414</sup> The board abandoned its merger with Shire plc in response to changes in Treasury Department inversion regulations, which the news had been speculating might occur for some time prior to AbbVie signing up the deal.<sup>415</sup> On this basis, stockholders alleged that "the risk of loss of the tax advantages inherent in the merger with Shire was so substantial, and so obvious, that the directors must have breached their fiduciary duties to the stockholders by entering the deal."<sup>416</sup> The Chancery Court noted that although the "directors [had taken] a risky decision that failed at substantial cost to the stockholders," this in no way suggested that the directors had breached their duty of loyalty and denied the stockholders request to inspect AbbVie's records.<sup>417</sup>

A second and arguably, more serious consideration for companies is that where stockholders are granted the right to inspect the committee's minutes, they may be able to make them available to the public broadly. While companies have often been able to negotiate confidentiality agreements with shareholders when providing materials in response to books-and-records inspection requests, Delaware courts, at least, have declined to adopt a categorical rule of confidentiality in favor of a balancing test. Specifically, Delaware cases have held that a court must balance a company's interest in privacy against its shareholders' legitimate interest in communicating regarding matters of common interest.<sup>418</sup>

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<sup>412</sup> *Se. Penn. Trans. Auth. v. AbbVie Inc.*, No. 10374-VCG, 2015 WL 1753033 at \*1 (Del. Ch. April 15, 2015), *aff'd* No. 239,2015, 2016 WL 235217 (Del. Jan. 20, 2016).

<sup>413</sup> *See Wal-Mart Stores, Inc.*, 95 A.3d at 1283 (finding a credible basis of actionable corporate wrongdoing and noting "[w]here a Section 220 claim is based on alleged corporate wrongdoing, and assuming the allegation is meritorious, the stockholder should be given enough information to effectively address the problem") (internal quotations omitted).

<sup>414</sup> *Abbvie, Inc.*, No. 10374-VCG, 2015 WL 1753033 at \*1.

<sup>415</sup> *Id.* at \*7-8. The record was mixed as to whether the government was likely to act in the short term, despite "heated anti-inversion" political rhetoric. For example, on the day before AbbVie's board voted to approve the terms of the proposed inversion, the New York Times reported that "Lawmakers say they want to stop United States companies from reincorporating overseas to lower their tax bills, but the Obama administration and Congress appear unlikely to take any action to stem the tide of such deals anytime soon." David Gelles, *Treasury Urges End to Foreign Tax Flights, but Quick Action is Unlikely*, N. Y. TIMES (July 16, 2014), [http://dealbook.nytimes.com/2014/07/16/obama-administration-seeks-end-to-inversion-deals/?\\_r=0](http://dealbook.nytimes.com/2014/07/16/obama-administration-seeks-end-to-inversion-deals/?_r=0).

<sup>416</sup> *Id.* at \*1.

<sup>417</sup> *Id.* at \*1. AbbVie's directors are exculpated from liability for breaches of their duty of care pursuant to Section 102(b)(7) of the Delaware General Corporations Law.

<sup>418</sup> *Disney v. Walt Disney Co.*, No. 380, 2004 (Del. Mar. 31, 2005) (Order).

#### **4. Third-Party Advisors**

The NYSE requires listed companies to grant the nominating and corporate governance committee sole authority to retain and terminate any search firm to assist it in identifying director candidates, including sole authority to approve the search firm's fees and other retention terms.<sup>419</sup> Nasdaq imposes no such requirement, but boards of companies listed on Nasdaq may also want to consider vesting the nominating and corporate governance committee with this power.

If the committee is granted this authority, it should bear in mind that there is no legal obligation to engage third-party advisors to assist in identifying director candidates. Third-party advisors will in some instances bring valuable capabilities that a firm may not possess internally. Directors should have full access to any consultants, and engaging and questioning advisors is often an important part of the process by which the board reaches a judgment after careful and informed deliberation. It is also important for the nominating and corporate governance committee to understand the nature and scope of any other services provided to the company by the third-party advisor in order to detect any actual or perceived conflicts of interest. Of course, a consultant's judgment should not be viewed as a substitute for the independent judgment of the committee and ultimately the board.

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<sup>419</sup> Commentary to NYSE Listed Company Manual, Rule 303A.04.



## **XVII. Fiduciary Duties of Nominating and Corporate Governance Committee Members**

### **A. The Business Judgment Rule**

The decisions of the nominating and corporate governance committee ordinarily will be afforded the protection of the business judgment rule. The business judgment rule is a presumption that in making a business decision independent directors have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.<sup>420</sup> A conscious decision to refrain from acting can also be an exercise of business judgment.<sup>421</sup> Unless a plaintiff can show that directors failed to act with loyalty or due care, the courts will generally defer to the business judgment of the board or committee. If a plaintiff is able to establish that the directors in question were conflicted or did not act with reasonable care, then the burden may shift to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the company and its shareholders.<sup>422</sup>

The business judgment rule focuses on process and is deferential to the substantive decisions reached by informed and disinterested directors. This deference reflects a fundamental principle of Delaware corporate law—that the business and affairs of a company are to be managed under the direction of the board of directors, rather than the courts.<sup>423</sup>

### **B. Fiduciary Duties Generally**

Members of the nominating and corporate governance committee owe the company the same fiduciary duties in the performance of their committee assignments as they do in the performance of their activities as directors: a duty of care and a duty of loyalty.

#### **1. The Duty of Care**

The essence of a director's duty of care is the obligation to exercise informed business judgment. A business judgment is informed if, prior to making a decision, the director apprised himself or herself of all material information reasonably available<sup>424</sup> including potential alternatives.<sup>425</sup> This process would generally include consultation with management and, in many cases, expert advisors, as well as receipt and review of such corporate records and information that the directors consider necessary and appropriate to make the decision in question.<sup>426</sup> A plaintiff alleging a breach of the duty of care must establish that the director's actions were grossly negligent.<sup>427</sup> Delaware Courts define gross negligence in this context as reckless indifference to or a deliberate disregard of the whole body of shareholders, or actions that are outside the bounds of

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<sup>420</sup> *E.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

<sup>421</sup> *Id.* at 813.

<sup>422</sup> *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006).

<sup>423</sup> *See* 8 Del. C. § 141(a).

<sup>424</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

<sup>425</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Sup. 1984); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. 2005).

<sup>426</sup> *See* Section XVII C. for a discussion of reliance on corporate records and experts. *See also*, 8 Del. C. § 141(e).

<sup>427</sup> *Van Gorkom*, 488 A.2d at 873.

reason.<sup>428</sup> Thus, a court will not find a breach of the duty of care simply because the directors' decisions were not flawless. In the landmark *Disney* case, the Delaware courts reaffirmed that informed directors acting in good faith will not be held liable for failure to comply with "the aspirational ideal of best practices" by "a reviewing court using perfect hindsight."<sup>429</sup>

## 2. The Duty of Loyalty

The duty of loyalty requires a director to consider the interests of the company and its shareholders rather than his or her personal interests or the interests of other persons or entities. The Delaware Supreme Court has explained that "[e]ssentially the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the shareholders generally."<sup>430</sup> Subsumed within the duty of loyalty is the duty to act in good faith.<sup>431</sup> A director fails to act in good faith if he or she acts with a purpose other than that of advancing the best interests of the corporation, acts with the intent to violate applicable positive law, or fails to act in the face of a known duty to act, demonstrating a conscious disregard for his or her duties.<sup>432</sup>

## 3. Oversight Duties

Fiduciary duties apply not only to directors' active decisions but also in their capacity as overseers. A breach of the duty to oversee the affairs of the company is categorized as a breach of the duty of loyalty, because establishing such a claim requires a showing of bad faith.<sup>433</sup> These claims can expose directors to personal liability, as under Delaware law directors cannot be exculpated or indemnified for breaches of the duty of loyalty.

The seminal Delaware case drawing the contours of directors' oversight duties is the 1996 case *In re Caremark*.<sup>434</sup> In *Caremark*, the court rejected claims that the company's directors breached their fiduciary duties by failing to sufficiently monitor certain practices that allegedly violated the Anti-Federal Payments Law and resulted in substantial criminal fines. The court held that "only a sustained or systematic failure" of oversight would be sufficient to show the lack of good faith necessary to establish a breach of loyalty claim.<sup>435</sup> A plaintiff alleging a breach of fiduciary duty predicated on directors' oversight function must establish either: (1) that the directors utterly failed to implement any reporting information systems or controls; or (2) that, having implemented such controls, the directors consciously failed to monitor or oversee its operations.<sup>436</sup>

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<sup>428</sup> *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, at 192. (Del. 2005).

<sup>429</sup> *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697-98 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

<sup>430</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

<sup>431</sup> *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006).

<sup>432</sup> *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 67.

<sup>433</sup> *Stone*, 911 A.2d at 370.

<sup>434</sup> *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

<sup>435</sup> *Id.* at 971.

<sup>436</sup> *Stone*, 911 A.2d at 370; *see also*, *Central Laborers v. Dimon*, No. 14-4516 (2d Cir. Jan. 6, 2016) (summary order)

The principles of *Caremark* were reaffirmed in the 2009 case *In re Citigroup*.<sup>437</sup> There, shareholders of Citigroup alleged that the bank’s directors breached their fiduciary duties by ignoring “red flags” and failing to monitor risks from subprime mortgages and securities.<sup>438</sup> The Court dismissed these claims and emphasized the “extremely high burden” faced by claims seeking personal director liability for a failure to monitor business risk, making clear that “[o]versight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.”<sup>439</sup>

### C. Reliance on Experts

Under Delaware law, directors and committee members are protected in relying in good faith upon the company’s records and the information, opinions, reports or statements of the company’s officers, employees or committees, or any other person as to matters the director reasonably believes are within such other person’s professional or expert competence and who has been selected by or on behalf of the company with reasonable care.<sup>440</sup> This protection is available even with respect to matters in which the directors themselves have expertise.<sup>441</sup> Thus, while consultation with experts will not always be necessary or appropriate, it is often an important component of satisfying directors’ duty of care and protecting decisions against judicial second-guessing.

### D. Exculpation and Indemnification

Delaware permits a company’s certificate of incorporation to contain a provision eliminating or limiting the personal liability of a director for monetary damages for breaches of fiduciary duty, except liability for (1) breaches of the duty of loyalty, (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (3) the unlawful payment of a dividend or unlawful stock purchase or redemption by the company and (4) any transaction from which the director derived an improper personal benefit.<sup>442</sup>

Delaware law also permits a company to indemnify a director for expenses incurred in any action by reason of his or her service as a director, so long as the director acted in good faith and had no cause to believe his or her conduct was illegal.<sup>443</sup> A company may also advance expenses incurred in such an action and purchase indemnification insurance for its directors. Unlike an exculpation provision, an indemnification provision may be placed in a company’s by-laws instead of its certificate of incorporation. Indemnification may also be negotiated in a separate agreement between the company and a director. Importantly, because a breach of the duty of loyalty involves an act of bad faith, such breaches are not eligible for exculpation or indemnification.

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<sup>437</sup> *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

<sup>438</sup> *Id.* at 111.

<sup>439</sup> *Id.* at 125, 131 (emphasis in original).

<sup>440</sup> See 8 Del. C. § 141(e).

<sup>441</sup> *In re Citigroup Inc.*, 964 A.2d at 127 n.63.

<sup>442</sup> 8 Del. C. § 102(b)(7).

<sup>443</sup> See 8 Del. C. § 145.



### Comparison of NYSE and Nasdaq Corporate Governance Standards

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
1. Independence	The NYSE standards require that a listed company's board be composed of a majority of independent directors. <sup>444</sup> The NYSE's standard for determining director independence is discussed in Section VII.C.1.	Nasdaq listing requirements likewise provide that a company's board must be composed of a majority of independent directors. <sup>445</sup> Nasdaq's standard for determining director independence is discussed in Section VII.C.1. If a company fails to comply with this requirement due to one vacancy or because one director ceases to be independent because of circumstances beyond the company's control, the company has until the earlier of its next annual shareholder meeting or one year from the event causing noncompliance. However, if the next annual shareholder meeting is no later than 180 days following the first date of noncompliance, the company instead has 180 days to regain compliance. <sup>446</sup> There is no analogous cure period provision in the NYSE corporate governance guidelines.
2. Committees	NYSE-listed companies are required to have a nominating and corporate governance committee, a compensation committee and an audit committee, each of which must be composed entirely of independent directors. <sup>447</sup> Each of these committees must have a charter entrusting the committee with certain responsibilities and providing for an annual evaluation of the committee. <sup>448</sup> Additionally, members of the compensation committee <sup>449</sup> and members of the audit committee <sup>450</sup> must satisfy more stringent independence criteria than other directors.	Nasdaq-listed companies are also required to have an audit committee and a compensation committee composed entirely of independent directors. <sup>451</sup> Both of these committees must have a written charter vesting the committees with certain responsibilities. <sup>452</sup> For a more detailed discussion of these requirements, see Section XI.B. Nasdaq does not require listed companies to have a nominating and corporate governance committee. However, if a Nasdaq-listed company does not have a nominating and corporate governance committee com-

<sup>444</sup> NYSE Listed Company Manual, Rule 303A.01.

<sup>445</sup> Nasdaq Listing Rule 5605(b)(1).

<sup>446</sup> Nasdaq Listing Rule 5605(b)(1)(A).

<sup>447</sup> NYSE Listed Company Manual, Rule 303A.

<sup>448</sup> NYSE Listed Company Manual, Rules 303A.04, 303A.05, 303A.06 and 303A.07.

<sup>449</sup> NYSE listed companies must affirmatively determine that compensation committee members do not have any relationship to the listed company that is material to the director's ability to be independent from management in connection with the duties of compensation committee members by specifically considering (i) the source of compensation of

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
		<p>prised solely of independent directors, director nominees must be selected or recommended to the board by independent directors constituting a majority of the board's independent directors.<sup>453</sup> For listed companies with a nominations committee of at least three directors, Nasdaq permits one non-independent director to be a committee member in exceptional and limited circumstances.<sup>454</sup> Non-independent directors serving under this exception may serve no longer than two years.<sup>455</sup> Additionally, each Nasdaq listed company must have a formal written charter or board resolutions addressing the nominations process.<sup>456</sup></p> <p>The SEC requires that all members of the audit committee be independent.<sup>457</sup> Under SEC rules, an audit committee member may be considered independent only if he or she has not (i) accepted any consulting, advisory or other compensatory fee from the issuer or (ii) been an affiliate of the issuer or any of its subsidiaries.<sup>458</sup> The SEC also provides that national stock exchanges, which must ensure that listed companies have independent compensation committee members, must consider the same factors in assessing the independence of compensa-</p>

such director including any consulting, advisory or other compensatory fee paid by the listed company to such director (excluding standard compensation for board service) and (ii) whether the director is affiliated with the listed company, its subsidiaries, or any affiliates of the listed company. NYSE Listed Company Manual, Rule 303A.02(a)(ii). However, while the NYSE requires companies to analyze any and all potentially relevant circumstances when determining independence, it does not consider ownership of a significant amount of company stock, by itself, as a bar to independence. Commentary to NYSE Listed Company Manual, Rule 303(a)(ii).

<sup>450</sup> In addition to the generally applicable independence requirements for NYSE directors, audit committee members must, in the absence of an applicable exception, satisfy the independence requirements of Exchange Act Rule 10A-3, as discussed in notes 457-459 and accompanying text. NYSE Listed Company Manual, Rule 303A.07(a).

<sup>451</sup> Nasdaq Listing Rules 5605(c)(2)(a) and 5605(d)(2)(A).

<sup>452</sup> Nasdaq Listing Rules 5605(c)(1) and 5605(d).

<sup>453</sup> Nasdaq Listing Rule 5605(e)(1)

<sup>454</sup> Nasdaq Listing Rule 5605(e)(3).

<sup>455</sup> *Id.*

<sup>456</sup> Nasdaq Listing Rule 5605(e)(2).

<sup>457</sup> 17 C.F.R. § 240.10A-3(b)(i).

<sup>458</sup> 17 C.F.R. § 240.10A-3(b)(ii)

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
		tion committee members as the SEC uses to assess audit committee member independence. <sup>459</sup>
3. Corporate Governance Guidelines and Code of Conduct	As discussed in Section XV.B.1, NYSE-listed companies are required to adopt, post to their website and disclose in SEC filings corporate governance guidelines that must address director qualification standards, director responsibilities, director access to management and, as appropriate, independent advisors, director compensation, director orientation and continuing education, management succession and an annual performance evaluation of the board. <sup>460</sup>	In contrast to the NYSE listing standards, Nasdaq listing standards do not address corporate governance guidelines.
	NYSE-listed companies are also required to adopt, post to their website and disclose in SEC filings a code of business conduct and ethics for directors, officers and employees. This code of conduct must address conflicts of interest, corporate opportunities, confidentiality, fair dealing, the protection and proper use of the company's assets, compliance with laws, rules and regulations (including insider trading laws) and encouraging the reporting of any illegal or unethical behavior. A code of conduct must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee, and listed companies must promptly disclose any waivers of the code for directors or executive officers. Each code of business conduct must also contain compliance standards and procedures that will facilitate the effective operation of the code. <sup>461</sup>	Nasdaq-listed companies are also required to adopt and make public a code of conduct applicable to all directors, officers and employees. <sup>462</sup> The code of conduct must include standards that promote: (i) honest and ethical conduct (including the ethical handling of conflicts of interest); (ii) full, fair, accurate, timely and understandable disclosure; (iii) compliance with applicable governmental laws, rules and regulations; and (iv) prompt internal reporting of violations of the code. <sup>463</sup> The code of conduct must also include an enforcement mechanism. Any waivers of the code for directors or executive officers must be approved by the board and disclosed to the public within four business days.

<sup>459</sup> 17 C.F.R. §§ 240.10C-1(a)-(b).

<sup>460</sup> NYSE Listed Company Manual, Rule 303A.09

<sup>461</sup> NYSE Listed Company Manual, Rule 303A.10.

<sup>462</sup> Nasdaq Listing Rule 5610.

<sup>463</sup> The requirements for a Nasdaq-listed company's Code of Ethics are derived from Section 406(c) of the Sarbanes-Oxley Act of 2002 and Item 406 of Regulation S-K promulgated thereunder. *Id. See also*, 17 C.F.R. § 228.406; 17 C.F.R. § 229.406.

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
4. Executive Sessions	<p>The NYSE requires that non-management directors meet at regularly scheduled executive sessions without management.<sup>464</sup> “Non-management” directors include those directors who do not qualify as independent for reasons other than their position as an executive officer of the company. A company may instead choose to hold regular executive sessions of independent directors only. If a company chooses to include all non-management directors in its regular executive sessions, it should hold an executive session including only independent directors at least once a year. An independent director must preside over each executive session of independent directors, although it need not be the same director at each session.<sup>465</sup></p>	<p>Nasdaq requires that a company hold regularly scheduled executive sessions at which only independent directors are present.<sup>466</sup> This is a more stringent requirement than the NYSE requirement, which allows regularly scheduled executive sessions to include all non-management directors (including non-independent directors). Commentary to this rule instructs that executive sessions should occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.<sup>467</sup> Unlike the NYSE guidelines, Nasdaq does not address who must lead executive sessions.</p>
5. Shareholder Approval of Certain Matters	<p><u>Acquisitions</u>: The NYSE requires shareholder approval prior to the issuance of securities in connection with any transaction or series of related transactions if the common stock to be issued is or will be equal to or greater than 20 percent of the voting power or number of shares of common stock outstanding before the issuance (subject to certain exceptions).<sup>468</sup></p> <p><u>Changes in Control</u>: Shareholder approval is required prior to an issuance that will result in a change of control of the company.<sup>469</sup></p> <p><u>Insider Transactions</u>: Shareholder approval is required prior to the issuance of common stock to a director, officer or substantial security holder, or any of their affiliates, if the issuance</p>	<p><u>Acquisitions</u>: Nasdaq requires shareholder approval prior to the issuance of securities in connection with the acquisition of the stock or assets of another company if the common stock to be issued is or will be equal to or greater than 20 percent of the voting power or number of shares of common stock outstanding before the issuance.<sup>472</sup></p> <p><u>Changes in Control</u>: Shareholder approval is required prior to the issuance of securities if such issuance or potential issuance will result in a change of control of the company.<sup>473</sup></p> <p><u>Insider Transactions</u>: Shareholder approval is required prior to the issuance of securities in connection with the acquisition of the stock or assets of another company if (A) any director, of-</p>

<sup>464</sup> NYSE Listed Company Manual, Rule 303A.03.

<sup>465</sup> Additionally, if one director is chosen to preside at all executive sessions, his or her name must be publicly disclosed. If the same director does not preside over every executive session, the company must publicly disclose the procedure by which a presiding director is chosen. Commentary to NYSE Listed Company Manual, Rule 303A.03.

<sup>466</sup> Nasdaq Listing Rule 5605(b)(2).

<sup>467</sup> Nasdaq Listing Rule IM-5605-2.

<sup>468</sup> NYSE Listed Company Manual, Rule 312.03(c).

<sup>469</sup> NYSE Listed Company Manual, Rule 312.03(d).

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
	<p>exceeds one percent of the voting power or shares of common stock of the company.<sup>470</sup></p> <p><u>Equity Compensation:</u> Subject to certain exceptions, shareholders must be given the opportunity to vote on the establishment or material amendment of equity-compensation plans.<sup>471</sup></p>	<p>ficer or substantial shareholder of the company has a five percent or greater interest (or if such persons have a 10 percent or greater interest, collectively) in the company or assets to be acquired or in the consideration to be paid in the transaction, and (B) the consideration paid in the transaction could result in an increase in the company's voting power or outstanding common shares of five percent or more.<sup>474</sup></p> <p><u>Equity Compensation:</u> Subject to certain exceptions, shareholder approval is required prior to the issuance of securities when a stock option or purchase plan or other equity compensation arrangement is made or materially amended.<sup>475</sup></p>
6. Exemptions	<p><u>Limited Partnerships, Companies in Bankruptcy and Controlled Companies:</u> Limited partnerships, companies in bankruptcy, and controlled companies (defined as a company in which more than 50 percent of the voting power for director elections is held by an individual, group or another company) are not required to have a majority-independent boards, compensation committee or nominating and corporate governance committee.<sup>476</sup> These companies are, however, subject to the remaining NYSE corporate governance standards.</p> <p><u>Foreign Private Issuers:</u> Foreign private issuers listed on the NYSE are permitted to follow home country practice in lieu of the NYSE corporate governance standards, with the exception of the NYSE governance standards regarding audit committees and certification of compliance.<sup>477</sup> Foreign private issuers</p>	<p><u>Controlled Companies:</u> Controlled companies (defined as a company in which more than 50 percent of the voting power for director elections is held by an individual, group or another company) are not required to have majority-independent boards or compensation committees, or to meet Nasdaq's requirements regarding nominations by independent directors.<sup>479</sup> Controlled companies are, however, subject to the remaining Nasdaq corporate governance standards.<sup>480</sup></p> <p><u>Limited Partnerships:</u> Limited partnerships are not generally subject to Nasdaq corporate governance requirements. Limited partnerships must, however, maintain a general partner responsible for the day-to-day affairs of the company with a sufficient number of directors to satisfy Nasdaq's audit committee requirements.<sup>481</sup> Limited partnerships must also be audited by an</p>

<sup>472</sup> Nasdaq Listing Rule 5635(a)(1).

<sup>473</sup> Nasdaq Listing Rule 5635(b).

<sup>470</sup> NYSE Listed Company Manual, Rule 312.03(b).

<sup>471</sup> NYSE Listed Company Manual, Rule 303A.08.

<sup>474</sup> Nasdaq Listing Rule 5635(a)(2).

<sup>475</sup> Nasdaq Listing Rule 5635(c).

<sup>476</sup> NYSE Listed Company Manual, Rule 303A.00.

<sup>477</sup> *Id.*

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
	<p>must disclose any significant ways in which their corporate governance practices differ from the NYSE listing standards. Commentary to the NYSE guidelines clarify that “what is required is a brief, general summary of the significant differences, not a cumbersome analysis.”<sup>478</sup></p>	<p>independent public accounting firm, review related-party transactions and abide by Nasdaq’s notification of non-compliance requirements. Limited partnerships are also subject to the shareholder approval requirements with respect to establishing or amending equity compensation arrangements. While Nasdaq does not require limited partnerships to hold annual meetings, if annual meetings are held Nasdaq imposes requirements regarding quorums and solicitation of proxies.<sup>482</sup></p> <p><u>Foreign Private Issuers:</u> Foreign private issuers listed on Nasdaq may follow the practices of their home countries in lieu of Nasdaq corporate governance requirements, except that they must comply with Nasdaq requirements concerning audit committees, the prohibition on certain alterations to common stock voting rights and notification of noncompliance.<sup>483</sup> A foreign private issuer electing to follow home country practices in lieu of Nasdaq governance requirements must disclose in its annual SEC reports each requirement that it does not follow and describe the home country practice it follows in lieu of that requirement. Such issuer must also submit to Nasdaq a written statement from an independent counsel from the company’s home country certifying that the company’s practices are not prohibited by the home country’s laws.<sup>484</sup></p>

<sup>479</sup> Nasdaq Listing Rule 5615(c)(2).

<sup>480</sup> *Id.*

<sup>481</sup> Nasdaq Listing Rule 5615(a)(4)(B)-(C).

<sup>478</sup> Commentary to NYSE Listed Company Manual, Rule 303A.11.

<sup>482</sup> Nasdaq Listing Rule 5615(a)(4)(D)-(J).

<sup>483</sup> Nasdaq Listing Rule 5615(a)(3).

<sup>484</sup> *Id.*

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
7. Phase-In Exceptions	<p><u>Companies Listing in Conjunction with an Initial Public Offering:</u> A company listing on the NYSE in conjunction with an initial public offering (“IPO”) must have a majority-independent board within one year of its listing date.<sup>485</sup> The company must have at least one independent member of its compensation and nominating and corporate governance committees by the earlier of the date its IPO closes or five business days from its listing date (typically, the date on which “when-issued” trading begins), a majority of independent members of these committees within 90 days of its listing date, and fully independent committees within one year of listing. The company must have at least one independent member of its audit committee by its listing date, a majority of independent members within 90 days of the effective date of its registration statement and a fully independent audit committee within one year of the effective date of its registration statement.</p> <p><u>Companies Listing in Conjunction with a Carve-Out or Spin-Off Transaction:</u> A company listing on the NYSE in conjunction with a carve-out or spin-off transaction must have at least one independent member on its audit committee by the listing date, a majority independent audit committee within 90 days of the effective date of its registration statement and a fully independent audit committee within one year of the effective date of its registration statement. Further, the audit committee must have at least two members within 90 days of the listing date and at least three members within one year of the listing date. Additionally, carved-out and spun-off companies must have at least one independent member on each of its compensation and nominating and corporate governance committees by the date the transaction closes, a majority of independent members on each committee within 90 days thereafter and fully independ-</p>	<p><u>Companies Ceasing to Qualify as Controlled Companies and Companies Listing in Conjunction with an IPO or Upon Emergence from Bankruptcy:</u> A company that ceases to qualify as a controlled company or a company listing on Nasdaq in conjunction with an IPO or upon emergence from bankruptcy must have a majority-independent board within one year of its listing date.<sup>487</sup> For each committee, the company must have one independent director as of its listing date, a majority of independent committee members within 90 days of listing and solely independent committee members within one year of listing.<sup>488</sup></p> <p><u>Companies Transferring from Other Markets:</u> Companies transferring to Nasdaq from other markets with a substantially similar requirement are afforded the balance of any grace period afforded by the other market. Companies transferring to Nasdaq from other listed markets that do not have a substantially similar requirement are afforded one year from the date of listing on Nasdaq.<sup>489</sup></p>

<sup>485</sup> NYSE Listed Company Manual, Rule 303A.00.

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
	<p>ent committees within one year.<sup>486</sup> The company must have a majority independent board within one year of its listing date.</p> <p><u>Companies Listing Upon Emergence from Bankruptcy:</u> A company listing on the NYSE upon emergence from bankruptcy must have a majority independent board within one year of the listing date. The company also must have at least one independent member on both its compensation and nominating and corporate governance committees by its listing date, a majority of independent members within 90 days after such date and fully independent committees within one year. The company must comply with the NYSE requirements regarding audit committees as of its listing date.<sup>490</sup></p> <p><u>Companies Ceasing to Qualify as a Controlled Company:</u> An NYSE company that ceases to qualify as a controlled company must have a majority-independent board and fully independent compensation and nominating and corporate governance committees within one year from its status change.<sup>491</sup> The company must also have at least one independent member on each of its compensation and nominating and corporate governance committees as of the date of its status change, and a majority of independent committee members within 90 days.</p> <p><u>Companies Ceasing to Qualify as a Foreign Private Issuer:</u> An NYSE company that ceases to qualify as a foreign private issuer must have a majority independent board and fully independent audit, compensation and nominating and corporate governance committees within six months of the date it ceases to so</p>	

<sup>487</sup> Nasdaq Listing Rules 5615(b)(1)-(2) and 5615(c)(3).

<sup>488</sup> *Id.*

<sup>489</sup> Nasdaq Listing Rule 5615(b)(3).

<sup>486</sup> *Id.*

<sup>490</sup> *Id.*

<sup>491</sup> *Id.*

<u>Standard</u>	<u>Category</u>	<u>Comment</u>
	<p>qualify.<sup>492</sup> Additionally, such companies must comply with the shareholder approval of equity compensation plans requirement by the later of six months after losing foreign private issuer status or its first annual meeting after losing foreign private issuer status, but, in any event, within one year after loss of status.<sup>493</sup></p> <p><u>Companies Transferring from another National Securities Exchange:</u> With regards to particular requirements of the NYSE's Corporate Governance Standards, companies transferring to the NYSE from another national securities exchange that has a substantially similar governance requirement are afforded the balance of any transition period afforded by the other exchange. Companies transferring to the NYSE from other national securities exchanges that do not have a substantially similar requirement are afforded one year from the date of listing on the NYSE.<sup>494</sup></p>	
8. Noncompliance	<p>The CEO of a NYSE-listed company must certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE corporate governance standards, qualifying the certification to the extent necessary.<sup>495</sup></p> <p>The CEO must promptly notify the NYSE in writing after any executive officer of the company becomes aware of any non-compliance with the NYSE corporate governance standards.</p>	A company must provide Nasdaq with prompt notification after an executive officer of the company becomes aware of any noncompliance with Nasdaq's corporate governance rules. <sup>496</sup>

<sup>492</sup> *Id.*

<sup>493</sup> NYSE Listed Company Manual, Rule 303A.08.

<sup>494</sup> *Id.*

<sup>495</sup> NYSE Listed Company Manual, Rule 303A.12(a).

<sup>496</sup> Nasdaq Listing Rule 5625.



**Example of  
Director Resignation Policy**

This Director Resignation Policy (“Policy”) of [COMPANY] (the “Company”) applies to annual elections of directors in which the number of director nominees equals or is less than the number of board seats being filled, hereinafter referred to as uncontested elections of directors. All other elections of directors shall be governed by the Company’s Certificate of Incorporation and Bylaws without giving effect to this Policy.

In an uncontested election of directors, any incumbent nominee who receives a greater number of votes “withheld” from his or her election than votes “for” his or her election will, [promptly] [within [five] days] following the certification of the stockholder vote, tender his or her resignation in writing to the Chairman of the Board for consideration by the Nominating and Governance Committee (the “Committee”).

The Committee will consider any such tendered resignation and, within [90] days following the date of the stockholders’ meeting at which the election occurred, will make a recommendation to the Board of Directors concerning the acceptance or rejection of such resignation. In determining its recommendation to the Board of Directors, the Committee will consider all factors deemed relevant by the members of the Committee including, without limitation, the reasons why stockholders who cast “withhold” votes for such director did so, if known, the qualifications of the director (including, for example, the impact the director’s resignation would have on the Company’s compliance with the requirements of the Securities and Exchange Commission and the [NASDAQ][NYSE]), and whether the director’s resignation from the Board of Directors would be in the best interests of the Company and its stockholders.

The Committee may also consider a range of possible alternatives concerning the director’s tendered resignation as the members of the Committee deem appropriate, which may include, without limitation, acceptance of the resignation, rejection of the resignation or rejection of the resignation coupled with a commitment to seek to address and cure the underlying reasons reasonably believed by the Committee to have substantially resulted in the “withhold” votes.

The Board of Directors will take formal action on the Committee’s recommendation within a reasonable period of time following the date of the stockholders’ meeting at which the election occurred. In considering the

Committee's recommendation, the Board of Directors will consider the information, factors and alternatives considered by the Committee and such additional information, factors and alternatives as the Board of Directors deems relevant.

The Company, within four business days after such decision is made, will publicly disclose, in a Form 8-K filed with the Securities and Exchange Commission, the Board of Director's decision to accept or reject the resignation, together with [a full explanation of the process by which the decision was made and], if applicable, the reasons for rejecting the tendered resignation.

No director who, in accordance with this policy, is required to tender his or her resignation, shall participate in the Committee's deliberations or recommendation, or in the Board of Director's deliberations or determination, with respect to accepting or rejecting his/her resignation as a director. Any such director shall, however, otherwise continue to serve as a director during this period.

This Policy is effective commencing with the Company's [next] annual stockholders' meeting.

## ANNEX C

### SECTION 1.1. Advance Notice of Stockholder Business and Nominations.

(A) Annual Meeting of Stockholders. Without qualification or limitation, subject to Section [●] [reference the right of stockholders to include proposals in the proxy statement under Rule 14a-8 not being affected by this provision] of these Bylaws, for any nominations or any other business to be properly brought before an annual meeting by a stockholder pursuant to Section [●] [reference the corporation's annual meeting of stockholders bylaw] of these Bylaws, the stockholder must have given timely notice thereof (including, in the case of nominations, the completed and signed questionnaire, representation and agreement required by Section [●] [reference the director qualification bylaw if applicable] of these Bylaws), and timely updates and supplements thereof, in each case in proper form, in writing to the Secretary, and such other business must otherwise be a proper matter for stockholder action.

To be timely, a stockholder's notice shall be delivered to the Secretary at the principal executive offices of the Corporation not earlier than the close of business on the one hundred and twentieth (120<sup>th</sup>) day and not later than the close of business on the ninetieth (90<sup>th</sup>) day prior to the first anniversary of the preceding year's annual meeting; provided, however, that in the event that the date of the annual meeting is more than thirty (30) days before or more than sixty (60) days after such anniversary date, notice by the stockholder must be so delivered not earlier than the close of business on the one hundred and twentieth (120<sup>th</sup>) day prior to the date of such annual meeting and not later than the close of business on the later of the ninetieth (90<sup>th</sup>) day prior to the date of such annual meeting or, if the first public announcement of the date of such annual meeting is less than one hundred (100) days prior to the date of such annual meeting, the tenth (10<sup>th</sup>) day following the day on which public announcement of the date of such meeting is first made by the Corporation. In no event shall any adjournment or postponement of an annual meeting, or the public announcement thereof, commence a new time period for the giving of a stockholder's notice as described above.

Notwithstanding anything in the immediately preceding paragraph to the contrary, in the event that the number of directors to be elected to the Board of Directors is increased by the Board of Directors, and there is no public announcement by the Corporation naming all of the nominees for director or specifying the size of the increased Board of Directors at least one hundred (100) days prior to the first anniversary of the preceding year's annual meeting, a stockholder's notice required by this Section [1.1(A)] shall also be considered timely, but only with respect to

nominees for any new positions created by such increase, if it shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business on the tenth (10<sup>th</sup>) day following the day on which such public announcement is first made by the Corporation.

In addition, to be considered timely, a stockholder's notice shall further be updated and supplemented, if necessary, so that the information provided or required to be provided in such notice shall be true and correct as of the record date for the meeting and as of the date that is ten (10) business days prior to the meeting or any adjournment or postponement thereof, and such update and supplement shall be delivered to the Secretary at the principal executive offices of the Corporation not later than five (5) business days after the record date for the meeting in the case of the update and supplement required to be made as of the record date, and not later than eight (8) business days prior to the date for the meeting or any adjournment or postponement thereof in the case of the update and supplement required to be made as of ten (10) business days prior to the meeting or any adjournment or postponement thereof. For the avoidance of doubt, the obligation to update and supplement as set forth in this paragraph or any other Section of these Bylaws shall not limit the Company's rights with respect to any deficiencies in any notice provided by a stockholder, extend any applicable deadlines hereunder [*or under any other provision of the bylaws*]<sup>497</sup> or enable or be deemed to permit a stockholder who has previously submitted notice hereunder [*or under any other provision of the bylaws*] to amend or update any proposal or to submit any new proposal, including by changing or adding nominees, matters, business and/or resolutions proposed to be brought before a meeting of the stockholders.

(B) Special Meetings of Stockholders. [Without qualification or limitation, subject to Section [1.1(C)(4)] of these Bylaws, for any business to be properly requested to be brought before a special meeting by a stockholder pursuant to Section [●] [*reference special meeting of stockholders bylaw*] of these Bylaws, the stockholder must have given timely notice thereof and timely updates and supplements thereof in each case in proper form, in writing to the Secretary and such business must otherwise be a proper matter for stockholder action.]<sup>498</sup>

Subject to Section [1.1(C)(4)] of these Bylaws, in the event the Corporation calls a special meeting of stockholders for the purpose of electing one or more directors to the Board of Directors, any stockholder may nominate an individual or individuals (as the case may be) for election to such position(s) as specified in the Corporation's notice of meeting,

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<sup>497</sup> To be included only if stockholders have the ability to call a special meeting.

<sup>498</sup> To be included only if stockholders have the ability to call a special meeting.

provided that the stockholder gives timely notice thereof (including the completed and signed questionnaire, representation and agreement required by Section [●] [*reference director qualification bylaw, if applicable*] of these Bylaws), and timely updates and supplements thereof, in each case in proper form, in writing, to the Secretary.

To be timely, a stockholder's notice shall be delivered to the Secretary at the principal executive offices of the Corporation not earlier than the close of business on the one hundred and twentieth (120<sup>th</sup>) day prior to the date of such special meeting and not later than the close of business on the later of the ninetieth (90<sup>th</sup>) day prior to the date of such special meeting or, if the first public announcement of the date of such special meeting is less than one hundred (100) days prior to the date of such special meeting, the tenth (10<sup>th</sup>) day following the day on which public announcement is first made of the date of the special meeting and [, *if applicable,*]<sup>499</sup> of the nominees proposed by the Board of Directors to be elected at such meeting. In no event shall any adjournment or postponement of a special meeting of stockholders, or the public announcement thereof, commence a new time period for the giving of a stockholder's notice as described above.

In addition, to be considered timely, a stockholder's notice shall further be updated and supplemented, if necessary, so that the information provided or required to be provided in such notice shall be true and correct as of the record date for the meeting and as of the date that is ten (10) business days prior to the meeting or any adjournment or postponement thereof, and such update and supplement shall be delivered to the Secretary at the principal executive offices of the Corporation not later than five (5) business days after the record date for the meeting in the case of the update and supplement required to be made as of the record date, and not later than eight (8) business days prior to the date for the meeting, any adjournment or postponement thereof in the case of the update and supplement required to be made as of ten (10) business days prior to the meeting or any adjournment or postponement thereof.

(C) Disclosure Requirements.

(1) A stockholder's notice pursuant to Section [●] [*reference stockholder ability to call a special meeting bylaw, if applicable*], Section [●] [*reference the corporation's annual meeting bylaw*], this Section [1.1] or Section [*reference director qualification bylaws, if applicable*] must include the following, as applicable.

(a) As to the stockholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or

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<sup>499</sup> To be included only if stockholders have the ability to call a special meeting

proposal, as applicable, is made, a stockholder's notice must set forth: (i) the name and address of such stockholder, as they appear on the Corporation's books, of such beneficial owner, if any, and of their respective affiliates or associates or others acting in concert therewith, (ii) (A) the class or series and number of shares of the Corporation which are, directly or indirectly, owned beneficially and of record by such stockholder, such beneficial owner and their respective affiliates or associates or others acting in concert therewith, (B) any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege or a settlement payment or mechanism at a price related to any class or series of shares of the Corporation or with a value derived in whole or in part from the value of any class or series of shares of the Corporation, or any derivative or synthetic arrangement having the characteristics of a long position in any class or series of shares of the Corporation, or any contract, derivative, swap or other transaction or series of transactions designed to produce economic benefits and risks that correspond substantially to the ownership of any class or series of shares of the Corporation, including due to the fact that the value of such contract, derivative, swap or other transaction or series of transactions is determined by reference to the price, value or volatility of any class or series of shares of the Corporation, whether or not such instrument, contract or right shall be subject to settlement in the underlying class or series of shares of the Corporation, through the delivery of cash or other property, or otherwise, and without regard to whether the stockholder of record, the beneficial owner, if any, or any affiliates or associates or others acting in concert therewith, may have entered into transactions that hedge or mitigate the economic effect of such instrument, contract or right, or any other direct or indirect opportunity to profit or share in any profit derived from any increase or decrease in the value of shares of the Corporation (any of the foregoing, a "Derivative Instrument") directly or indirectly owned beneficially by such stockholder, the beneficial owner, if any, or any affiliates or associates or others acting in concert therewith, (C) any proxy, contract, arrangement, understanding, or relationship pursuant to which such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith has any right to vote any class or series of shares of the Corporation, (D) any agreement, arrangement, understanding, relationship or otherwise, including any repurchase or similar so-called "stock borrowing" agreement or arrangement, involving such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith, directly or indirectly, the purpose or effect of which is to mitigate loss to, reduce the economic risk (of ownership or otherwise) of any class or series of the shares of the Corporation by, manage the risk of share price changes for, or increase or decrease the voting power of, such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith with respect to any class or series of the shares of the Corporation, or

which provides, directly or indirectly, the opportunity to profit or share in any profit derived from any decrease in the price or value of any class or series of the shares of the Corporation (any of the foregoing, a “Short Interest”), (E) any rights to dividends on the shares of the Corporation owned beneficially by such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith that are separated or separable from the underlying shares of the Corporation, (F) any proportionate interest in shares of the Corporation or Derivative Instruments held, directly or indirectly, by a general or limited partnership in which such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith is a general partner or, directly or indirectly, beneficially owns an interest in a general partner of such general or limited partnership, (G) any performance-related fees (other than an asset-based fee) that such stockholder, such beneficial owner of any of their respective affiliates or associates or others acting in concert therewith is entitled to based on any increase or decrease in the value of shares of the Corporation or Derivative Instruments, if any, including without limitation any such interests held by members of the immediate family sharing the same household of such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith, (H) any significant equity interests or any Derivative Instruments or Short Interests in any principal competitor of the Corporation held by such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith and (I) any direct or indirect interest of such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith in any contract with the Corporation, any affiliate of the Corporation or any principal competitor of the Corporation (including, in any such case, any employment agreement, collective bargaining agreement or consulting agreement), (iii) all information that would be required to be set forth in a Schedule 13D filed pursuant to Rule 13d-1(a) or an amendment pursuant to Rule 13d-2(a) if such a statement were required to be filed under the Exchange Act and the rules and regulations promulgated thereunder by such stockholder, such beneficial owner or any of their respective affiliates or associates or others acting in concert therewith, if any, and (iv) any other information relating to such stockholder, such beneficial owner of any of their respective affiliates or associates or others acting in concert therewith, if any, that would be required to be disclosed in a proxy statement and form or proxy or other filings required to be made in connection with solicitations of proxies for, as applicable, the proposal and/or for the election of directors in a contested election pursuant to Section 14 of the Exchange Act and the rules and regulations promulgated thereunder;

(b) If the notice relates to any business other than a nomination of a director or directors that the stockholder proposes to bring before the meeting, a stockholder’s notice must, in addition

to the matters set forth in paragraph (a) above, also set forth: (i) a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest of such stockholder, such beneficial owner and each of their respective affiliates or associates or others acting in concert therewith, if any, in such business, (ii) the text of the proposal or business (including the text of any resolutions proposed for consideration and, in the event that such proposal or business includes a proposal to amend the Bylaws of the Corporation, the text of the proposed amendment), and (iii) a description of all agreements, arrangements and understandings between such stockholder, such beneficial owner and each of their respective affiliates or associates or others acting in concert therewith, if any, and any other person or persons (including their names) in connection with the proposal of such business by such stockholder;

(c) As to each individual, if any, whom the stockholder proposes to nominate for election or reelection to the Board of Directors, a stockholder's notice must, in addition to the matters set forth in paragraph (a) above, also set forth: (i) all information relating to such individual that would be required to be disclosed in a proxy statement or other filings required to be made in connection with solicitations of proxies for election of directors in a contested election pursuant to Section 14 of the Exchange Act and the rules and regulations promulgated thereunder (including such individual's written consent to being named in the proxy statement as a nominee and to serving as a director if elected) and (ii) a description of all direct and indirect compensation and other material monetary agreements, arrangements and understandings during the past three years, and any other material relationships, between or among such stockholder and beneficial owner, if any, and their respective affiliates and associates, or others acting in concert therewith, on the one hand, and each proposed nominee, and his or her respective affiliates and associates, or others acting in concert therewith, on the other hand, including, without limitation all information that would be required to be disclosed pursuant to Rule 404 promulgated under Regulation S-K if the stockholder making the nomination and any beneficial owner on whose behalf the nomination is made, if any, or any affiliate or associate thereof or person acting in concert therewith, were the "registrant" for purposes of such rule and the nominee were a director or executive officer of such registrant; and

(d) With respect to each individual, if any, whom the stockholder proposes to nominate for election or reelection to the Board of Directors, a stockholder's notice must, in addition to the matters set forth in paragraphs (a) and (c) above, also include a completed and signed questionnaire, representation and agreement required by Section [●] [*reference director qualification bylaw, if applicable*] of these Bylaws. The Corporation may require any proposed nominee to furnish such

other information as may reasonably be required by the Corporation to determine the eligibility of such proposed nominee to serve as an independent director of the Corporation or that could be material to a reasonable stockholder's understanding of the independence, or lack thereof, of such nominee. Notwithstanding anything to the contrary, only persons who are nominated in accordance with the procedures set forth in these Bylaws, including without limitation Sections [●] [*reference annual meeting, advanced notice and director qualification bylaws, as applicable*] hereof, shall be eligible for election as directors.

(2) For purposes of these Bylaws, "public announcement" shall mean disclosure in a press release reported by a national news service or in a document publicly filed by the Corporation with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Exchange Act and the rules and regulations promulgated thereunder.

(3) Notwithstanding the provisions of these Bylaws, a stockholder shall also comply with all applicable requirements of the Exchange Act and the rules and regulations thereunder with respect to the matters set forth in this Bylaw; provided, however, that any references in these Bylaws to the Exchange Act or the rules promulgated thereunder are not intended to and shall not limit the separate and additional requirements set forth in these Bylaws with respect to nominations or proposals as to any other business to be considered.

(4) Nothing in these Bylaws shall be deemed to affect any rights (i) of stockholders to request inclusion of proposals in the Corporation's proxy statement pursuant to Rule 14a-8 under the Exchange Act or (ii) of the holders of any series of Preferred Stock if and to the extent provided for under law, the Certificate of Incorporation or these Bylaws. Subject to Rule 14a-8 under the Exchange Act, nothing in these Bylaws shall be construed to permit any stockholder, or give any stockholder the right, to include or have disseminated or described in the Corporation's proxy statement any nomination of director or directors or any other business proposal.



Name: \_\_\_\_\_

[COMPANY]

### DIRECTORS' AND OFFICERS' QUESTIONNAIRE

[COMPANY], a [STATE] corporation (the "Company"), is preparing its annual report on Form 10-K ("Form 10-K"), its annual report to stockholders and its proxy statement for its upcoming annual stockholders' meeting. Certain information about the Company's Directors, Executive Officers and key employees is needed to complete the Form 10-K, the annual report and the proxy statement. The purpose of this Questionnaire is to obtain that information so that the Company and its counsel can provide accurate and complete information, and verify the disclosures to be contained, in those documents.

Capitalized terms used in this Questionnaire are defined in the Glossary attached at the end of this Questionnaire.

Please complete, sign, date and return this Questionnaire to [NAME OF CONTACT PERSON AT THE COMPANY AND COMPANY ADDRESS] on or before [DATE]. This Questionnaire may also be returned by facsimile to [FAX NUMBER] or e-mailed to [E-MAIL ADDRESS].

If you have any questions regarding this Questionnaire, please contact [NAME OF CONTACT PERSON] at [TELEPHONE NUMBER], and [s]he will assist you.

*[Note: Generally the contact person is someone in the legal department, such as the Corporate Secretary or a Deputy or Associate General Counsel. If the Company has asked its outside counsel to assist with the preparation, distribution and collection of the Questionnaires, an additional contact person at the outside law firm could be added.]*

#### General Instructions

1. Part I of this Questionnaire should be answered by all Executive Officers, Directors and Director nominees. Part II should only be answered by non-executive Directors and Director nominees. Part III should only be answered by those Directors and Director nominees who are members of or nominees for the Audit Committee.

2. If the answer to any question is “No,” “None” or “Not Applicable,” please indicate that as your response, but do not leave any answers blank.

3. If additional space is required to answer any question, please use the “Additional Information” page at the end of this Questionnaire. Please identify all questions answered there by their respective question numbers.

4. Information requested in this Questionnaire is to be provided as of the date you complete this Questionnaire, unless otherwise indicated. If, after submitting this Questionnaire, any events occur or information comes to your attention that would affect the accuracy of any of your responses herein, please notify [NAME OF CONTACT PERSON] at [TELEPHONE NUMBER] as soon as possible.

**PART I – TO BE ANSWERED BY ALL EXECUTIVE OFFICERS, DIRECTORS AND DIRECTOR NOMINEES**

1. Background Information. Please provide the following information:

[*Note: This information is required by Item 7 of Schedule 14A, Item 401 of Regulation S-K.*]

(a) Name: \_\_\_\_\_

(b) Business address and telephone number:  
\_\_\_\_\_  
\_\_\_\_\_

Residential address and telephone number:  
\_\_\_\_\_  
\_\_\_\_\_

(c) Date of birth: \_\_\_\_\_

(d) Citizenship: \_\_\_\_\_

(e) Are you related by blood, marriage or adoption to any Executive Officer, Director or any nominee to become an Executive Officer or Director of the Company?

Yes  No

If yes, please name the Executive Officer, Director or the nominee and state the nature of the relationship:

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(f) Were you appointed to serve as an Executive Officer or Director of the Company as a result of any arrangement or understanding between you and any other Person (except the Directors or Executive Officers of the Company acting solely in their capacity as such)? [*Note: This information is required by Item 7 of Schedule 14A, Items 401(a) and (b) of Regulation S-K.*]

Yes  No

If yes, please explain the arrangement or understanding below and name the other Party(ies) and attach a copy of any written arrangement or understanding to this questionnaire:

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(g) Please review and update, if necessary, your personal information, which is attached as Appendix A. This information includes a description of your business experience for at least the past [five **OR** [NUMBER]] fiscal years, including:

- Principal occupations and employment;
- The name and principal business of any company or other organization in which these occupations and employment were carried on; and
- Whether such company or organization is a parent, subsidiary or other Affiliate of the Company.

This information should include all positions and offices, if any, that you currently hold with the Company or any of its subsidiaries, the period of time for which you have held each position or office and all positions and offices held with the Company or any of its subsidiaries at any time during the past [five **OR** [NUMBER]] fiscal years.

*[Note: Item 401(e) of Regulation S-K requires disclosure of only a five-year business experience biography of each officer, director and director nominee. However, a company must also describe the specific qualifications, skills and experiences of each director or director nominee that*

*qualify him or her to serve as a director. Obtaining this additional information is primarily addressed in Question 1(h) below. However, it is possible that many directors and director nominees may be too busy or reluctant to complete this type of question, yet the company would still be obligated to provide this information. In that event, the company's legal department or outside counsel should be prepared to draft this discussion on their behalf, subject to review by the specific director(s) or director nominee(s). Obtaining a longer business experience biography, such as for at least 10 years instead of only five years, from each person can provide a good background for this drafting. It is a good idea to use a 10-year period, but a longer period may be more appropriate for more senior directors or director nominees. Some companies may find that five years is sufficient.]*

If you are an Executive Officer and have been employed by the Company or one of its subsidiaries for less than five years, please ensure that this information includes a brief description of the nature of your responsibilities in prior positions.

If you are a Director or nominee for Director, this information should also list all other Directorships (and committee memberships) of public companies or investment companies registered under the Investment Company Act of 1940 that you currently hold or have held at any time during the past five fiscal years.

*[Note: This information is required by Item 7 of Schedule 14A, Items 401(a), (b) and (e) of Regulation S-K.]*

Is the information in Appendix A complete and correct?

Yes  No

If no, please correct the information in Appendix A.

(h) If you are a Director or nominee for Director, please describe any specific qualifications or skills that you possess and/or any specific experience that you have had that you believe best address your qualifications to serve as a Director of the Company. Please note that this information can extend beyond the past five years and can include any specific past experience that could be useful to the Company, such as previous directorships or employment with other companies in the same industry as the Company or specific areas of expertise, such as accounting, finance, risk assessment skills or experience with compensation. Please feel free to use the "Additional Information" page at the end of this Questionnaire for additional space to answer this question if necessary.

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*[Note: This Question 1(h) addresses the requirement in Item 401(e) of Regulation S-K, in which a company must describe the specific qualifications, skills and experiences of each director or director nominee that qualify him or her to serve as a director.]*

- (i) During the past 10 years:

*[Note: This information is required by Item 7 of Schedule 14A, Item 401(f) of Regulation S-K.]*

(To determine the 10-year period for Questions 1(i) and 1(j), the date of a reportable event is considered to be the date on which the final order, judgment or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments or decrees have lapsed. For bankruptcy petitions, this date is the date of filing for uncontested petitions or the date on which approval of a contested petition became final.)

- (i) Has a petition under the federal bankruptcy laws or any state insolvency law been filed by or against you, or has a receiver, fiscal agent or similar officer been appointed by a court for the business or property of (A) you, (B) any partnership in which you were a general partner at, or within two years before, the time of such filing or (C) any company or business association of which you were an Executive Officer at, or within two years before, the time of such filing?

Yes  No

- (ii) Have you been convicted of fraud in a civil or criminal proceeding (that was not overturned or expunged)?

Yes  No

(j) During the past 10 years:

*[Note: This information is required by Item 7 of Schedule 14A, Item 401(f) of Regulation S-K.]*

(i) Have you been convicted in a criminal proceeding or named the subject of a pending criminal proceeding, excluding traffic violations and other minor offenses?

Yes  No

(ii) Have you been the subject of any order, judgment or decree, not subsequently reversed, suspended or vacated, of any court, permanently or temporarily enjoining or limiting you from any of the following:

(A) acting as futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, floor broker, leverage transaction merchant, any other Person regulated by the Commodity Futures Trading Commission, or an associated Person of any of the foregoing, or as an investment advisor, underwriter, broker or dealer in securities, or as an affiliated Person, Director or employee of any investment company, bank, savings and loan association or insurance company, or engaging in or continuing any conduct or practice in connection with such activity;

(B) any type of business practice; or

(C) any activity in connection with the purchase or sale of any security or commodity or in connection with any violation of federal or state securities laws or federal commodities laws?

Yes  No

(iii) Have you been the subject of any order, judgment or decree, not subsequently reversed, suspended or vacated, of any federal or state authority barring, suspending or otherwise limiting for more than 60 days your right to engage in any activity described in subsection (ii)(A) above or to be associated with Persons engaged in any such activity?

Yes  No

(iv) Have you been found by a court in a civil action or by the Securities and Exchange Commission (the “SEC”) to have violated any federal or state securities law, and the judgment in such civil action or finding by the SEC has not been subsequently reversed, suspended or vacated?

Yes  No

(v) Have you been found by a court in a civil action or by the Commodity Futures Trading Commission to have violated any federal commodities law, and the judgment in such civil action or finding by the Commodity Futures Trading Commission has not been subsequently reversed, suspended or vacated?

Yes  No

(vi) Have you been the subject of any order, judgment, decree or finding, not subsequently reversed, suspended or vacated, of any federal or state court or administrative agency relating to an alleged violation of any of the following:

(A) any federal or state securities or commodities law or regulation;

(B) any law or regulation relating to financial institutions or insurance companies (including any temporary or permanent injunctions, orders of disgorgement or restitution, civil money penalties, temporary or permanent cease-and-desist orders or removal or prohibition orders); or

(C) any law or regulation prohibiting mail or wire fraud or fraud relating to any business entity?

Yes  No

(vii) Have you been the subject of any sanction or order, not subsequently reversed, suspended or vacated, of any national securities exchange, registered securities association, registered clearing agency, registered commodities or derivatives exchange, registered derivatives transaction execution facility or registered derivatives clearing organization or any similar exchange, association, entity or organization with disciplinary authority over its members?

Yes  No

If you answered yes to any of the foregoing questions in (i) and (j), please describe each such event on the “Additional Information” page at the end of this Questionnaire.

(k) Relationships with Government Officials.

(i) Do you currently hold a position as a Government Official or have you been a Government Official within the past three years?

Yes  No

(ii) Do you have a familial relationship with a Government Official?

Yes  No

If you answered yes to either (k)(i) or (k)(ii), please provide details regarding your position as a Government Official or your familial relationship with a Government Official, as applicable:

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[2. Stock Ownership.

[**Note:** Use this version of Question 2 if the Company has the information necessary to complete the security ownership table in Appendix B for each director, officer and director nominee. Complete an Appendix B on behalf of each person who is sent a Questionnaire before distributing the Questionnaires.]

(a) Do you know of any Person(s) or group(s) that Beneficially Own(s) more than five percent of any class of the Company’s voting securities (other than [NAMES OF KNOWN five percent OR MORE STOCKHOLDERS])? [**Note:** This information is required by Item 6(d) of Schedule 14A, Item 403(a) of Regulation S-K.]

Yes  No

If yes, please provide the names and addresses of the Person(s) or group(s) below:

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(b) Please review and update, if necessary, the table in Appendix B, which provides information regarding your security ownership, including the number of shares of each class of equity securities of the Company (or any of its parents or subsidiaries) that you “Beneficially Owned” on [DATE]. [*Note: Insert the most recent date possible, which should be after the end of the company’s fiscal year.*] Appendix B also describes the nature and terms of any of your rights to acquire Beneficial Ownership, whether you share voting or investment power over any shares you own with any other Person and whether you disclaim Beneficial Ownership of any of the shares. [*Note: This information is required by Item 6(d) of Schedule 14A, Item 403(b) of Regulation S-K.*] Is the information in Appendix B accurate and complete?

Yes  No

If no, please correct the information in Appendix B.

(c) Have you pledged as security any shares of any class of equity securities that you beneficially own as set forth in Appendix B, including any securities held in margin accounts?

Yes  No

If yes, please list the number and class of equity securities below:

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(d) Have you or any of your Immediate Family Members or anyone else on your behalf, currently or since [DATE AT LEAST 12 MONTHS PRIOR TO QUESTIONNAIRE DISTRIBUTION], purchased or sold any financial instruments (*e.g.*, prepaid variable forward contracts, equity swaps and cash-settled total return swaps, collars or exchange-traded puts or calls) that are designed to hedge or offset any decrease in the market value of Company Securities (i) granted to you by

[COMPANY] as part of you compensation as a director or officer of [COMPANY] or (ii) otherwise beneficially owned by you?

Yes  No

If yes, please provide details, including the number and type(s) of securities and the date(s) on which the underlying transaction occurred:

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[2. Stock Ownership.

*[Note: Use this version of Question 2 if the Company does not have all of the information necessary to complete the security ownership table in Appendix B for each director, officer and director nominee. This version of Question 2 eliminates the use of a completed Appendix B and requires each person completing this Questionnaire to provide the information on his or her own behalf in this Questionnaire.]*

(a) Do you know of any Person(s) or group(s) that Beneficially Own(s) more than five percent of any class of the Company's voting securities (other than [NAMES OF KNOWN five percent OR MORE STOCKHOLDERS])? *[Note: This information is required by Item 6(d) of Schedule 14A, Item 403(a) of Regulation S-K.]*

Yes  No

If yes, please provide the names and addresses of the Person(s) or group(s) below:

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(b) Please complete the information below regarding the equity securities of the Company (or any of its parents or subsidiaries) that you "Beneficially Owned" on [DATE]. *[Note: Insert the most recent date possible.] [Note: This information is required by Item 6(d) of Schedule 14A, Item 403(b) of Regulation S-K.]*

Please be sure that the table includes all of the following:

- (i) Company securities owned solely by you through one or more brokerage accounts (*i.e.*, shares held in street name for your account);
- (ii) Company securities owned jointly with your spouse or others;
- (iii) Company securities owned by you as trustee of a trust;
- (iv) Company securities owned by you as executor or administrator of an estate;
- (v) Company securities owned by you as custodian for a minor or as a legal guardian for a minor; and
- (vi) Company securities owned directly by others (such as a corporation or foundation) over which you share voting power and/or investment power.

<i>Number of shares of common stock owned (includes vested restricted stock awards)</i>	
<i>Number of vested options owned</i>	
<i>Number of unvested options owned (please include vesting schedule)</i>	
<i>Number of shares of unvested restricted stock (please include vesting schedule)</i>	
<i>Any other equity securities owned (please describe and include any applicable vesting schedule)</i>	

<i>Any equity securities in which ownership, voting power or investment power is shared (please describe and include any applicable vesting schedule)</i>	
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If you need additional space to complete this table, please include the information on the “Additional Information” page at the end of this Questionnaire.

(c) If you share the voting or investment power over any security, please identify the Persons with whom you share such power and the relationship that gives rise to sharing such power:

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(d) Describe the nature and terms of any rights to acquire Beneficial Ownership identified in Question 2(b):

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(e) If you disclaim Beneficial Ownership of any shares listed in Question 2(b), please describe the shares and why you disclaim Beneficial Ownership:

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(f) Have you pledged as security any shares of any class of equity securities that you beneficially own as set forth in the table above, including any securities held in margin accounts?

Yes  No

If yes, please list the number and class of equity securities below:

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(g) Have you or any of your Immediate Family Members or anyone else on your behalf, currently or since [DATE AT LEAST 12 MONTHS PRIOR TO QUESTIONNAIRE DISTRIBUTION], purchased or sold any financial instruments (e.g., prepaid variable forward contracts, equity swaps and cash-settled total return swaps, collars or exchange-traded puts or calls) that are designed to hedge or offset any decrease in the market value of Company Securities (i) granted to you by [COMPANY] as part of your compensation as a director or officer of [COMPANY] or (ii) otherwise beneficially owned by you?

Yes  No

If yes, please provide details, including the number and type(s) of securities and the date(s) on which the underlying transaction occurred.

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[3. Section 16 Reporting Compliance. Attached as Appendix C are copies of the Section 16 filings that the Company made on your behalf during the Company's last fiscal year. Based on a review of these filings and all your transactions in the Company's securities, please answer the following questions:

*[Note: Use this version of Question 3 if the Company filed the Section 16 reports on behalf of the directors and officers and if copies of these filings on behalf of each director and officer will be attached to his or her respective Questionnaire. If this is done for each officer and director, make sure that copies of every filing made on behalf of the respective officer or director have been attached and that no filings have been omitted. Attaching the filings will increase the size of this Questionnaire, which may make distribution more difficult or costly.]*

(a) Were any of your Section 16 filings (Forms 3, 4 and/or 5) filed after the date on which they were due to be filed, or did you engage in any transaction in the Company's securities for which you failed to file

a required form? For reference, the due dates for Section 16 filings are as follows: A Form 3 must be filed within 10 days after the event by which you became a reporting person; a Form 4 must be filed by the end of the second business day following the reportable transaction; and a Form 5 must be filed within 45 days after the end of the Company's fiscal year.

Yes  No

If yes, please indicate the number of late filings, the number of transactions that were not reported on a timely basis and any known failure to file a required form:

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(b) Have you engaged in any transactions in the Company's securities that have not yet been reported in the most recently filed Form 4 or Form 5?

Yes  No

If yes, please briefly describe the transaction(s):

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(c) Is the information contained in Appendix C otherwise accurate and complete?

Yes  No

If no, please explain below:

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(d) Are you required to file a Form 5 with the SEC for the past fiscal year? (A Form 5 is required to be filed with the SEC within 45 days after the end of the Company's fiscal year that reflects (a) any transaction in the Company's securities that you completed during the past fiscal year that was not required to be reported on Form 4 and that you did not so report; (b) any transaction in the Company's securities that you should have reported during the past fiscal year but did not; and (c) your aggregate ownership of the Company's securities as of the date that you file the

Form 5. However, you do not need to file a Form 5 if (i) you have not engaged in any transaction in the Company's securities during the past fiscal year that is required to be reported on Form 5 or (ii) (x) each such transaction was previously reported during the past fiscal year on a Form 4 and (y) you do not have any other holding or transaction which otherwise was required to be reported during the past fiscal year and which was not so reported to the SEC.) By answering "No," you are representing to the Company that no Form 5 filing is required.

*[Note: Include this clause (d) and the following clause (e) only if the company has not made a Form 5 filing on behalf of the individual director or officer and the Form 5 is not attached to Appendix C.]*

Yes  No

(e) If you answered "Yes" to question 3(d) above, have you filed a Form 5 or was one filed on your behalf, or will you be able to file a Form 5 (or have the form filed on your behalf) by [DATE]? *[Note: Insert the date that is 45 days after the end of the Company's fiscal year.]*

Yes  No

If no, please explain why below:

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*[Note: The Form 5 is due within 45 days after the end of the fiscal year, but, depending on the size of the company, the Form 10-K is due within 60 to 90 days after the end of the fiscal year. If the director or officer answers "Yes" to subparagraph (e) of this version of Question 3, confirm with the director or officer that his or her Form 5 was, in fact, filed on time. If "Yes" was answered, but the Form 5 is not filed on time, this version of Question 3 must be updated.]*

[3. Section 16 Reporting Compliance. Based on a review of all your transactions in the Company's securities and all filings you made with the SEC during the last fiscal year, please answer the following questions:

*[Note: Use this version of Question 3 if copies of the filings of each director and officer will not be attached to his or her respective Questionnaire.]*

(a) Were any of your Section 16 filings (Forms 3, 4 and/or 5) filed after the date on which they were due to be filed, or did you engage

in any transaction in the Company's securities for which you failed to file a required form? For reference, the due dates for Section 16 filings are as follows: A Form 3 must be filed within 10 days after the event by which you became a reporting person; a Form 4 must be filed by the end of the second business day following the reportable transaction; and a Form 5 must be filed within 45 days after the end of the Company's fiscal year.

Yes  No

If yes, please indicate the number of late filings, the number of transactions that were not reported on a timely basis and any known failure to file a required form:

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(b) Have you engaged in any transactions in the Company's securities that have not yet been reported in the most recently filed Form 4 or Form 5?

Yes  No

If yes, please briefly describe the transaction(s):

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(c) Are you required to file a Form 5 with the SEC for the past fiscal year? (A Form 5 is required to be filed with the SEC within 45 days after the end of the Company's fiscal year that reflects (a) any transaction in the Company's securities that you completed during the past fiscal year that was not required to be reported on Form 4 and that you did not so report; (b) any transaction in the Company's securities that you should have reported during the past fiscal year but did not; and (c) your aggregate ownership of the Company's securities as of the date that you file the Form 5. However, you do not need to file a Form 5 if (i) you have not engaged in any transaction in the Company's securities during the past fiscal year that is required to be reported on Form 5 or (ii) (x) each such transaction was previously reported during the past fiscal year on a Form 4 and (y) you do not have any other holding or transaction which otherwise was required to be reported during the past fiscal year and which was not so reported to the SEC.) By answering "No," you are representing to the Company that no Form 5 filing is required.

Yes  No

(d) If you answered “Yes” to 3(c) above, have you filed a Form 5 or was one filed on your behalf, or will you be able to file a Form 5 (or have the form filed on your behalf) by [DATE]? [*Note: Insert the date that is 45 days after the end of the Company’s fiscal year.*]

Yes  No

If no, please explain why below:

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*[Note: The Form 5 is due within 45 days after the end of the fiscal year, but, depending on the size of the company, the Form 10-K is due within 60 to 90 days after the end of the fiscal year. If the director or officer answers “Yes” to subparagraph (d) of this version of Question 3, follow up with the director or officer to confirm that his or her Form 5 was, in fact, filed on time. If “Yes” was answered, but the Form 5 is not filed on time, this version of Question 3 must be updated.]*

4. Payments for Personal Benefit. During the last fiscal year, did you or any Immediate Family Member receive, or are you or any Immediate Family Member to receive, directly or indirectly, any perquisite or other benefit which was not (or will not be) directly related to the performance of your job or the satisfaction of your obligations to the Company, from (a) the Company or any of its parents or subsidiaries (examples would be the payment of personal expenses, personal use of the Company’s property, such as automobiles, and use of the corporate staff for personal purposes) or (b) third parties as a result of or in connection with your employment by or relationship or association with the Company or any of its parents or subsidiaries? [*Note: This information is required by Item 8 of Schedule 14A, Item 402 of Regulation S-K.*]

Yes  No

If yes, please describe the benefit and list its dollar value (or any other value ascribed to it).

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5. Transactions with Related Persons. Since the beginning of the Company's last fiscal year, have you or any Immediate Family Member engaged in any transaction in which the Company or any of its subsidiaries was or is to be a participant and which the dollar amount involved exceeds \$120,000? Does any proposed transaction exist in which the Company or any of its subsidiaries was or is to be a participant and in which the dollar amount involved exceeds \$120,000 and in which you or your Immediate Family Member will have a direct or indirect interest? For the purposes of these questions, a "transaction" includes, but is not limited to, any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. [*Note: This information is required by Item 7 of Schedule 14A, Item 404(a) of Regulation S-K.*]

Yes  No

If yes, please briefly describe the transaction or series of similar transactions, including: (a) the name of such Person and the Person's relationship to the Company and/or the Company's subsidiaries; (b) the nature of such Person's interest in the transaction (including the Person's position or relationship with, or ownership in, a firm, corporation or other entity that is a party to, or has an interest in, the transaction); (c) the approximate dollar value of such transaction; (d) the approximate dollar value of such Person's interest in the transaction; and (e) any other information regarding the transaction or the Person in the context of the transaction that could be considered Material.

In the case of indebtedness, disclosure of the amount involved in the transaction must include (a) the largest aggregate amount of principal outstanding during the period for which disclosure is provided, (b) the amount outstanding as of the most recent date, (c) the amount of principal paid during the period for which disclosure is provided, (d) the amount of interest paid during the period for which disclosure is provided and (e) the interest rate or amount payable on the indebtedness.

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6. Financial or Economic Interests in Certain Entities with Relationships with [COMPANY]. Do you or any of your Immediate Family Members or any other person living in your home, have a direct or indirect financial or economic interest in or relationship with another business entity, vendor, sponsor or contractor with which [COMPANY] (or any of its

subsidiaries) has done business since [DATE AT LEAST THREE YEARS PRIOR TO QUESTIONNAIRE DISTRIBUTION] or which is a competitor of [COMPANY] (or any of its subsidiaries)?

Yes  No

If yes, please provide the information requested below.

(i) Name of the person having the interest or relationship and such person's relationship to [COMPANY] or any of its subsidiaries.

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(ii) Name and nature of business entity, vendor, sponsor, contractor or competitor.

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(iii) Description of the financial or economic interest in the business entity, vendor, sponsor, contractor or competitor.

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(iv) Brief description of any transactions or series of similar transactions between [COMPANY] (or any of its subsidiaries) and the other business entity, vendor, sponsor, or contractor, including the dollar amount involved.

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7. Five Percent or Greater Ownership in Any Entities. Do you or any of your Immediate Family Members, either alone or in the aggregate, have a direct or indirect ownership interest of five percent or more of the equity of any entity?

Yes  No

If yes, please provide the information requested below.

(i) Name of the person having the interest or relationship and such person's relationship to [COMPANY] or its subsidiaries.

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(ii) Name and nature of the business entity.

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(iii) Description of the financial or economic interest in the business entity.

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8. Change in Control. Do you know of any arrangement, including any pledge of securities of the Company, which resulted in a change in control of the Company in the last fiscal year, or may result in the future in a change in control of the Company? [*Note: This information is required by Item 6 of Schedule 14A, Item 403(c) of Regulation S-K.*]

Yes  No

If yes, please briefly describe any such arrangement:

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9. Adverse Interest in Legal Proceedings. Do you know of any pending legal proceedings in which either you or any Director, Officer or Affiliate of the Company or any owner of more than five percent of any class of voting securities of the Company, or any Associate of any such Director, Officer, Affiliate or security holder, is a party adverse to the Company or any of its subsidiaries, or has a material interest adverse to the Company or any of its subsidiaries? [*Note: This information is required by Item 7 of Schedule 14A, Item 103 (inst. 4) of Regulation S-K.*]

Yes  No

If yes, please briefly describe any such proceedings:

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10. Compensation Committee or Similar Committee.

(a) During the last fiscal year, have you been a member of the compensation committee or similar committee of a company other than the Company or, in the absence of such a committee, a member of the board of directors of a company other than the Company that was involved in making decisions regarding compensation policy? [*Note: This information is required by Item 8 of Schedule 14A, Item 407(e)(4) of Regulation S-K.*]

Yes  No

If yes, please indicate which company(ies) below:

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(b) As a director or director nominee of the Company, during the last three fiscal years, were you, or was an Immediate Family Member, an Executive Officer or employee of any partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit, of which any executive of the Company was a director?

Yes  No

If yes, please describe such relationship, stating particularly the name of the Company executive who is or was a director, whether such person is or was on the compensation committee (or other committee performing equivalent functions) of such partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit (please note if such partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit did not have a compensation or equivalent committee), or otherwise participates or participated in any deliberation of Executive Officer or other employee compensation:

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(c) As a current or former officer of the Company or any of its Subsidiaries or other Affiliates, did you also serve, at any time during the last three fiscal years, as a member of the compensation committee (or other committee performing equivalent functions), or as a director, of another partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit, where an Executive Officer or employee of such other partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit, has served or currently serves on the Company's Board of Directors?

Yes  No

If the answer to question 10(c) is "Yes," did any other Executive Officers of the Company or any of its Subsidiaries or other Affiliates serve at the same time on the compensation committee (or other committee performing equivalent functions) of that partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit?

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*[Note: Item 8 of Schedule 14A (Item 402 of Regulation S-K) requires detailed information on the compensation of executive officers and directors. However, this Questionnaire does not include any questions requesting an itemized response of the elements of executive compensation or director compensation because it is typically easier and more efficient to obtain executive compensation information from the Company's compensation or human resources department and director compensation information from the Company's Corporate Secretary. As a result, some directors and officers may not complete such a question.]*

**PART II – TO BE ANSWERED BY NON-EXECUTIVE DIRECTORS AND DIRECTOR NOMINEES ONLY**

*[Note: For companies that use the Wachtell, Lipton, Rosen & Katz form model bylaws (or a similar form), the representations and agreement attached as Appendix D should be completed along with this Questionnaire for all nominees for election or reelection as directors.]*

[11. Independence.

*[Note: Under Item 407(a) of Regulation S-K, a company must identify its independent directors in its proxy statement. This version of Question 11 incorporates the NYSE's independence standards and is applicable only to reporting companies listed on the NYSE. If the company is listed on NASDAQ, delete this version of Question 11 and use the following version. In addition, this Question 11 should be modified to include any additional independence standards adopted by the company.]*

(a) Are you currently, or at any time during the last three years were you, an employee of the Company or of any parent or subsidiary of the Company, or is any Immediate Family Member currently, or at any time during the last three years was an Immediate Family Member, an Executive Officer of the Company or of any parent or subsidiary of the Company? *[Note: This question is based on Section 303A.02(b)(i) of the NYSE Listed Company Manual.]*

Yes  No

If yes, please briefly describe:

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(b) Did you or any of your Immediate Family Members receive, during any 12-month period within the last three years, more than \$120,000 in direct compensation from the Company or from any parent or subsidiary of the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), or do you or any of your Immediate Family Members plan to accept such payments in the current fiscal year? *[Note: This question is based on Section 303A.02(b)(ii) of the NYSE Listed Company Manual.]*

Yes  No

If yes, please briefly describe:

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(c) Are you, or is any Immediate Family Member, a current partner of [NAME OF THE COMPANY'S AUDITORS]; are you a current employee of [NAME OF AUDITORS]; is any Immediate Family Member a current employee of [NAME OF AUDITORS] who personally works on the audit of the Company; or were you, or was any Immediate Family Member, a partner or employee of [NAME OF AUDITORS] who personally worked on the audit of the Company or any parent or subsidiary of the Company within the last three years (but not currently)? [*Note: This question is based on Section 303A.02(b)(iii) of the NYSE Listed Company Manual.*]

Yes  No

If yes, please indicate the entity and describe your or your Immediate Family Member(s)' role with the entity:

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(d) Are you or are any of your Immediate Family Members currently employed, or have you or any of your Immediate Family Members been employed within the last three years, as an executive officer of another entity where any of the Executive Officers of the Company or any parent or subsidiary of the Company at the same time serves or served on that entity's compensation committee? [*Note: This question is based on Section 303A.02(b)(iv) of the NYSE Listed Company Manual.*]

Yes  No

If yes, please indicate the entity and describe your or your Immediate Family Member(s)' role with the entity:

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(e) Are you a current employee, or is an Immediate Family Member a current executive officer, of a company that has made payments to, or received payments from, the Company or any parent or subsidiary of the Company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or two percent of such other company's consolidated gross revenues during any of the last three fiscal years? [*Note: This question is based on Section 303A.02(b)(v) of the NYSE Listed Company Manual.*]

Yes  No

If yes, please indicate the organization and describe the payments and your role with the organization:

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(f) Are you an executive officer of a charitable or other tax-exempt organization which received contributions from the Company or from any parent or subsidiary of the Company in any of the three preceding years in an amount which exceeds the greater of \$1 million, or two percent of the organization's consolidated gross revenues? [*Note: This question is based on Section 303A.02(b)(v) of the NYSE Listed Company Manual.*]

Yes  No

If yes, please indicate the organization and describe the payments and your role with the organization:

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(g) Do you have any other relationship with the Company or any parent or subsidiary of the Company, either directly or as a partner, stockholder or officer of an organization that has a relationship with the Company or any parent or subsidiary of the Company? [*Note: This question is based on Section 303A.02(a) of the NYSE Listed Company Manual.*]

Yes  No

If yes, please describe the relationship:

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[11. Independence.

[*Note: Under Item 407(a) of Regulation S-K, a company must identify its independent directors in its proxy statement. This version of Question 11 incorporates NASDAQ's independence standards and is applicable only to reporting companies listed on NASDAQ. If the company is listed on the NYSE, delete this version of Question 11 and use the preceding version. In addition, this Question 11 should be modified to include any additional independence standards adopted by the company.*]

(a) Are you currently, or were you at any time during the past three years, an employee of the Company or of any parent or subsidiary of the Company? [*Note: This question is based on Rule 5605(a)(2)(A) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please briefly describe:

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(b) During any 12 consecutive months within the last three years, did you, or did any of your Family Members, accept any compensation from the Company or from any parent or subsidiary of the Company in excess of \$120,000 (other than: (i) compensation for board or board committee service, (ii) compensation paid to a Family Member who is a

non-executive employee of the Company or any parent or subsidiary of the Company, or (iii) benefits under a tax-qualified retirement plan or non-discretionary compensation)? For purposes of this Question 11, the term “Family Member” means a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in the person’s home. Additionally, “compensation” refers to both direct and indirect compensation including, among other things, consulting or personal service contracts between the Company and a director or Family Member of the director and political contributions to the campaign of a director or a Family Member of the director.

*[Note: This question is based on Rule 5605(a)(2)(B) of the NASDAQ Listing Rules. Under NASDAQ Marketplace Rule IM-5605, a director can be deemed to be independent regardless of:*

- non-preferential payments made in the ordinary course of providing business services (such as payments of interest or proceeds related to banking services or loans by an issuer that is a financial institution or payment of claims on a policy by an issuer that is an insurance company);*
- payments arising solely from investments in the company’s securities; or*
- loans permitted under Section 13(k) of the Exchange Act,*

*as long as the payments are not considered compensation. However, depending on the circumstances, a loan or payment could be compensatory if, for example, it is not on terms generally available to the public.]*

Yes  No

If yes, please briefly describe:

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(c) Are any of your Family Members currently serving as an executive officer of the Company or any parent or subsidiary of the Company, or were any of your Family Members serving in such capacity at any time during the past three years? *[Note: This question is based on Rule 5605(a)(2)(C) of the NASDAQ Listing Rules.]*

Yes  No

If yes, please briefly describe:

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(d) Are you, or are any of your Family Members, a partner in, or a controlling stockholder or an executive officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceeded five percent of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more (other than: (i) payments arising solely from investments in the Company's securities or (ii) payments under non-discretionary charitable contribution matching programs)? [*Note: This question is based on Rule 5605(a)(2)(D) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please briefly describe:

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(e) Are you, or are any of your Family Members, employed as an executive officer of another entity where at any time during the past three years any of the Company's executive officers served on the compensation committee of the other entity? [*Note: This question is based on Rule 5605(a)(2)(E) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please briefly describe:

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(f) Are you, or are any of your Family Members, a partner of [NAME OF THE COMPANY'S AUDITORS], or have you or any of your

Family Members been a partner or employee of [NAME OF AUDITORS] who worked on the Company's audit at any time during any of the past three years? [*Note: This question is based on Rule 5605(a)(2)(F) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please briefly describe:

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(g) Do you have any other relationships (*i.e.*, being a partner, stockholder or officer of an organization that has any commercial, industrial, banking, consulting, legal, accounting, charitable, familial or any other relationships with the Company or any of its subsidiaries) that could interfere with your exercise of independent judgment in carrying out the responsibilities as a director of the Company? [*Note: This question is based on Rule 5605(a)(2) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please briefly describe:

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**PART III – TO BE ANSWERED ONLY BY DIRECTORS WHO ARE MEMBERS OF OR NOMINEES FOR THE AUDIT COMMITTEE**

12. Audit Committee Independence. As a member of or nominee for the Company's audit committee:

(a) Do you currently or do you plan to, in the current fiscal year, accept directly or indirectly any consulting, advisory, or other compensatory fee from the Company or from any of its subsidiaries, other than in your capacity as a member of the audit committee, the board of directors or any other board committee or the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the Company or its subsidiaries, provided that such compensation is not contingent in any way on continued service? For purposes of this Question 12(a), "indirect" includes acceptance of such a fee

by a spouse, a minor child or stepchild or a child or stepchild sharing a home with you or by an entity in which you are a partner, member, an officer such as a managing director occupying a comparable position or Executive Officer, or occupying a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and who provides accounting, consulting, legal, investment banking or financial advisory services to the Company or any of its subsidiaries. [*Note: This question is based on Rule 10A-3(b)(1)(ii)(A) under the Exchange Act.*]

Yes  No

If yes, please describe the nature of the services that are to be provided and the fee that is to be obtained:

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(b) Other than in your capacity as a member of the audit committee, the board of directors or any other committee of the board of directors, are you an “affiliated person” of the Company or of any of the Company’s subsidiaries? For purposes of this Question 12(b), an “affiliated person” is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the Company or a subsidiary of the Company. You are not deemed to control the Company or any of the Company’s subsidiaries if you are not the beneficial owner, directly or indirectly, of more than 10 percent of any class of voting equity securities of the Company or its subsidiaries and you are not an executive officer of the Company or any of its subsidiaries. [*Note: This question is based on Rule 10A-3(b)(1)(ii)(B) under the Exchange Act.*]

Yes  No

If yes, please describe your affiliation:

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(c) Do you believe that you qualify as an “audit committee financial expert”? For purposes of this Question 12(c), an “audit committee

financial expert” means a person who has the following attributes: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal control over financial reporting; and (v) an understanding of audit committee functions. Such attributes must be acquired through the following: (1) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions; (2) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; (3) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or (4) other relevant experience. [*Note: This information is required by Item 7 of Schedule 14A, Item 407(d)(5) of Regulation S-K.*]

Yes  No

If yes, please describe your relevant education and experience:

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[13. Other Audit Committee Criteria.

[*Note: This version of Question 13 is applicable only to reporting companies listed on the NYSE. If the company is listed on NASDAQ, delete this version of Question 13 and use the following version.*]

(a) Do you believe that you are “financially literate” (as it would be interpreted by the Company’s board of directors in its business judgment) or, if not, can become so within a reasonable period of time of your appointment to the Audit Committee? [*Note: This question is based on Section 303A.07(a) of the NYSE Listed Company Manual.*]

Yes  No

(b) Do you have accounting or related financial management expertise (as it would be interpreted by the Company's board of directors in its business judgment)? [*Note: This question is based on Section 303A.07(a) of the NYSE Listed Company Manual.*]

Yes  No

(c) On how many other audit committees of public companies do you serve? [*Note: This question is based on Section 303A.07(a) of the NYSE Listed Company Manual.*]

0  1  2  3  4  5  ]

[13. Other Audit Committee Criteria.

[*Note: This version of Question 13 is applicable only to reporting companies listed on NASDAQ. If the company is listed on the NYSE, delete this version of Question 13 and use the preceding version.*]

(a) Have you participated in the preparation of the financial statements of the Company or any of its current subsidiaries at any time during the past three years? [*Note: This question is based on Rule 5605(c)(2)(A)(iii) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please describe the extent of your participation:

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(b) Are you able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement? [*Note: This question is based on Rule 5605(c)(2)(A)(iv) of the NASDAQ Listing Rules.*]

Yes  No

(c) Do you have past employment experience in finance or accounting, requisite professional certification in accounting or any other comparable experience or background which results in your financial sophistication? [*Note: This question is based on Rule 5605(c)(2)(A) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please describe your relevant education and experience:

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(d) Are you or have you been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities? [*Note: This question is based on Rule 5605(c)(2)(A) of the NASDAQ Listing Rules.*]

Yes  No

If yes, please describe your relevant experience:

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**PART IV – TO BE ANSWERED ONLY BY DIRECTORS WHO ARE MEMBERS OF OR NOMINEES FOR THE COMPENSATION COMMITTEE OR DIRECTORS OR EXECUTIVE OFFICERS OTHERWISE RESPONSIBLE FOR ADMINISTERING EXECUTIVE COMPENSATION**

14. Independence Under Certain Federal Tax Laws. [*Note: This question is based on Treasury Regulation § 1.162-27(e)(3) of the Internal Revenue Code.*]

(a) Are you currently, or have you ever been, an officer of the Company or of any of the Company’s subsidiaries or Affiliates?

Yes  No

(b) Are you currently, or have you ever been, an employee of the Company or of any of the Company's subsidiaries or Affiliates?

Yes  No

If yes, please briefly describe any compensation you received from the Company or such subsidiary or Affiliate in respect of your services as an employee (other than benefits under a tax-qualified retirement plan) in the last year or expect to receive in the future:

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(c) Do you or any associated entity, directly or indirectly, currently receive or expect to receive, or during the last year have you or any associated entity received, any payments (or been party to a contract in respect of any payments) in exchange for goods or services from the Company or any of the Company's subsidiaries or Affiliates (other than for services as a director of the Company)? For purposes of this Question 14(c), the term "associated entity" means an organization that is a sole proprietorship, trust, estate, partnership or corporation (and any affiliate thereof) of which you have a beneficial ownership of at least five percent or by which you are employed.

Yes  No

If yes, please briefly describe such payments, including their amount, and, if applicable, your relationship to the entity receiving such payments:

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15. Compensation Committee Independence. As a member of or nominee for the Company's compensation committee:

(a) Do you have any business or personal relationship with any compensation consultant, legal counsel or other advisor that is currently retained by the Compensation Committee or that you expect to be retained by the Compensation Committee? [*Note: This question is based on Item 407(e)(3) of Regulation S-K.*]

Yes  No

If yes, please describe such relationship:

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(b) Do you serve on the board of directors of any Company (other than the Company) that retains [the same compensation consultant as the Company] an advisor on executive compensation or other matters? [*Note: This question is based on Reg. S-K 407(e)(3).*]

Yes  No

If yes, please name the company(ies) and briefly describe the services that [the same compensation consultant as the Company] provides and lists who at [the consultant] advises the company (as applicable):

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I hereby acknowledge that the answers to the foregoing questions are correct and complete to the best of my knowledge. If any changes in the information provided occur prior to the date of the proxy statement for the annual stockholders' meeting, I will notify the Company and its counsel of such changes. I hereby consent to being named as a Director or Executive Officer of the Company in the Form 10-K, annual report and the proxy statement, including any supplements or amendments to such documents.

Date: [DATE]

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Signature

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Please type or print your name

**ADDITIONAL INFORMATION**

(Attach additional sheets as necessary.)

Question

Answer

## GLOSSARY

### DEFINITION OF CERTAIN TERMS

The terms below that are used in this Questionnaire have the following meanings:

**Affiliate:** An “Affiliate” of the Company or a Person “affiliated” with the Company refers to any Person that directly or indirectly Controls, or is Controlled by, or is under common Control with, the Company, and includes any of the following Persons:

- Any Director or Officer of the Company.
- Any Person performing general management or advisory services for the Company.
- Any “Associate” of the foregoing Persons.

**Associate:** An “Associate” of, or a Person “associated” with, a Person means: (i) any relative or spouse of such Person or any relative of such spouse, (ii) any corporation or organization (other than the Company or its subsidiaries) of which such Person is an Officer or partner or directly or indirectly the beneficial owner of 10 percent or more of any class of equity securities and (iii) any trust or estate in which such Person has a substantial beneficial interest or as to which such Person serves as a trustee, executor or in a similar fiduciary capacity.

**Beneficially Owned:** A “Beneficial Owner” of a security includes any Person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares (i) voting power, including the power to vote or to direct the voting of such security, or (ii) investment power, including the power to dispose of, or direct the disposition of, such security. In addition, a Person is deemed to have “Beneficial Ownership” of a security if such Person has the right to acquire beneficial ownership of that security at any time within 60 days, including, but not limited to: (i) through the exercise of any option, warrant or right, (ii) through the conversion of any security, or (iii) pursuant to the power to revoke, or the automatic termination of, a trust, discretionary account or similar arrangement.

It is possible that a security may have more than one “Beneficial Owner,” such as a trust, with two co-trustees sharing voting power, and the settlor or another third party having investment power, in which case each of the three would be the “Beneficial Owner” of the securities in the trust. The power to vote or direct the voting, or to invest or dispose of, or direct the investment or disposition of, a security may be indirect and arise from le-

gal, economic, contractual or other rights, and the determination of beneficial ownership depends upon who ultimately possesses or shares the power to direct the voting or the disposition of the security.

The final determination of beneficial ownership depends upon the facts of each case. You may, if you believe it is appropriate, disclaim beneficial ownership of securities that might otherwise be considered “Beneficially Owned” by you.

**Control:** “Control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a Person, whether through the ownership of voting securities, by contract or otherwise.

**Director:** A “Director” means any Director of a corporation, trustee of a trust, general partner of a partnership, or any Person who performs for an organization functions similar to those performed by the foregoing Persons.

**Executive Officer:** An “Executive Officer” means a president, a principal financial officer, a principal accounting officer (or, if there is no such accounting officer, the controller), any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function and any other Person performing similar policy-making functions. Executive officers of the Company’s subsidiaries may be deemed executive officers of the Company if they perform such policy-making functions for the Company.

**Government Official:** A “Government Official” includes: any elected or appointed government officials; any employee or person acting for or on behalf of a government official, agency, or enterprise performing a governmental function; any political party officer, employee or person acting for or on behalf of a political party or candidate for public office; or an employee or person acting for or on behalf of a public international organization.

**Immediate Family Member:** An “Immediate Family Member” of a person means the person’s spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than a tenant or domestic employee) who shares such person’s home.

**Material:** “Material,” when used to qualify a requirement for providing information on any subject, unless otherwise indicated, limits the infor-

mation required to those matters as to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the Company's securities.

**Officer:** An "Officer" refers to a president, vice president, secretary, treasurer or principal financial officer, controller or principal accounting officer, and any person that performs similar functions for any organization whether incorporated or unincorporated.

**Person:** A "Person" means an individual, corporation, partnership, limited liability company, association, joint stock company, trust, unincorporated organization or other entity, or a government or political subdivision thereof.

## APPENDIX A

*[Note: Appendix A should contain biographic information for the relevant director or executive officer from the prior year's Form 10-K or proxy statement, as applicable, including the following items:*

- The person's name and age, any positions and offices with the Company held by such person, the term of office as director or officer and the period during which he or she has served as such. [Note: This information is required by Item 7(b) of Schedule 14A, Items 401(a)-(c) of Regulation S-K.]*
- Business experience of the person during the past five years, including: (1) the person's principal occupations and employment during the past five years, (2) the name and principal business of any corporation or other organization in which such occupations and employment were carried on and (3) whether such corporation or organization is a parent, subsidiary or other affiliate of the Company. [Note: This information is required by Item 7(b) of Schedule 14A, Item 401(e) of Regulation S-K.]*
- All positions and offices currently held by the person with the Company or any of its subsidiaries and the period of time during which such person has held each such position or office. If the person is not currently employed by the Company or any of its subsidiaries, Appendix A should include information as to whether such person has been employed by the Company at any time during the past five fiscal years. [Note: This information is required by Item 7 of Schedule 14A, Items 401(a) and (b) of Regulation S-K.]*

*When an executive officer or other person has been employed by the Company or a subsidiary of the Company for less than five years, Appendix A should include a brief description of the nature of the responsibility undertaken by the individual in prior positions to provide adequate disclosure of his or her prior business experience.*

*For directors, this information should also include all directorships held by the person in public companies and U.S.-registered investment companies, including any board committees on which such individual serves. [Note: This information is required by Item 7(b) of Schedule 14A, Item 401(e) of Regulation S-K.]*

*For director nominees, Appendix A should contain a draft biography regarding each nominee, including the following items:*

- The person's name and age. [Note: This information is required by Item 7(b) of Schedule 14A, Item 401(a) of Regulation S-K.]*

- *Business experience of the person during the past five years, including: (1) the person's principal occupations and employment during the past five years, (2) the name and principal business of any corporation or other organization in which such occupations and employment were carried on and (3) whether such corporation or organization is a parent, subsidiary or other affiliate of the Company. [Note: This information is required by Item 7(b) of Schedule 14A, Item 401(e) of Regulation S-K.]*
- *All positions and offices currently held by the person with the Company or any of its subsidiaries and the period of time during which such person has held each such position or office. If the person is not currently employed by the Company or any of its subsidiaries, Appendix A should include information as to whether such person has been employed by the Company at any time during the past five fiscal years. [Note: This information is required by Item 7 of Schedule 14A, Items 401(a) and (b) of Regulation S-K.]*

**APPENDIX B**

*[Note: If the version of Question 2 that requires completion of an Appendix B for each person who will be sent a Questionnaire is being used, Appendix B should contain security ownership information as of the most recent date possible for the relevant director or executive officer, as required by Item 6(d) of Schedule 14A and Item 403(b) of Regulation S-K. The following is an example of a table that should be included in Appendix B, to be verified by the individual.]*

<i>Number of shares of common stock owned (Includes vested restricted stock awards)</i>	
<i>Number of vested options owned</i>	
<i>Number of unvested options owned (Please include vesting schedule)</i>	
<i>Number of shares of unvested restricted stock (Please include vesting schedule)</i>	
<i>Any other equity securities owned (Please describe and include any applicable vesting schedule)</i>	
<i>Any equity securities in which ownership, voting power or investment power is shared (Please describe and include any applicable vesting schedule)</i>	

*In addition to confirming security ownership, Appendix B should also describe the nature and terms of any of the individual's rights to acquire beneficial ownership and whether the individual disclaims beneficial ownership of any of the securities listed.*

*If the information to complete this table cannot be obtained (for a director nominee or because the company does not have sufficient records), use the version of Question 2 that requires each person completing this Questionnaire to complete the table.]*



## APPENDIX C

*[Note: Appendix C, if it is being included, should include all Form 3, Form 4 and Form 5 filings made by the Company on behalf of the Director or Executive Officer during the last fiscal year.]*



## APPENDIX D

*[Note: For companies that use the Wachtell, Lipton, Rosen & Katz model bylaws (or a similar form specifying director qualification), the following Director Nominee Representation and Agreement can be used to fulfill the requirement in Section 2.10 of the model bylaws. This form should be completed by all nominees for election and reelection as directors of the Company.]*

[COMPANY]

### DIRECTOR NOMINEE REPRESENTATION AND AGREEMENT

THIS DIRECTOR NOMINEE REPRESENTATION AND AGREEMENT (this “Representation and Agreement”) is delivered as of \_\_\_\_\_, to [COMPANY], a [STATE] corporation (the “Company”), by the undersigned nominee for election as a director of the Company (the “Nominee”).

WHEREAS, the Nominee has been nominated for election as a director of the Company (the “Nomination”) by [a shareholder of] the Company pursuant to [Article II] of the Bylaws of the Company (the “Bylaws”); and

WHEREAS, [Section 2.9] of the Bylaws provides that, in order to be eligible to be a nominee for election as a director of the Company, the Nominee must complete and deliver to the Secretary of the Company at the principal offices of the Company a written representation and agreement as to certain specified matters.

NOW, THEREFORE, the Nominee hereby represents and warrants to the Company and agrees as follows:

1. The Nominee:
  - (a) is not and will not become a party to:
    - (i) any agreement, arrangement or understanding with, and has not given any commitment or assurance to, any person or entity as to how the Nominee, if elected as a director of the Company, will act or vote on any issue or question (a “Voting Commitment”) that has not been disclosed to the Company; or
    - (ii) any Voting Commitment that could limit or interfere with the Nominee’s ability to comply, if elected as a director of the Company, with his or her fiduciary duties under applicable law;

(b) is not and will not become a party to any agreement, arrangement or understanding with any person or entity other than the Company with respect to any direct or indirect compensation, reimbursement, or indemnification in connection with service or action as a director that has not been disclosed to the Company; [and]

(c) both in his or her individual capacity and on behalf of any person or entity on whose behalf the Nomination is being made, would be in compliance, if elected as a director of the Company, and will comply with all applicable publicly disclosed corporate governance, conflict of interest, confidentiality, and stock ownership and trading policies and guidelines of the Company; [and]

[(d) *[for companies that have share ownership requirements for directors]* beneficially owns, or agrees to purchase within 90 days if elected as a director of the Company, not less than [ ] common shares of the Company (“Qualifying Shares”) (subject to adjustment for any stock splits or stock dividends occurring after the date of such representation or agreement), will not dispose of such minimum number of shares so long as the Nominee is a director, and has disclosed to the Company whether all or any portion of the Qualifying Shares were purchased with any financial assistance provided by any other person and whether any other person has any interest in the Qualifying Shares;] [and]

[(e) *[for companies with majority voting]* will abide by the requirements of [Section 2.10] of the Bylaws.]

2. The Nominee acknowledges and agrees that:

(a) the representations, warranties and agreements of the Nominee in this Representation and Agreement will be relied upon by the Company and that the Nominee will provide prompt written notice to the Company upon any change, event, transaction or condition affecting the accuracy or continued validity of the representations and warranties of the Nominee or of any breach by the Nominee of any agreement made herein; and

(b) in the event (i) any representation or warranty of the Nominee in this Representation and Agreement is inaccurate in any material respect or (ii) the Nominee is in breach of any agreement of the Nominee in this Representation and Agreement, such representation, warranty or agreement shall be deemed not to have been provided in accordance with [Section 2.9] of the Bylaws and the Nomination shall be deemed invalid.

3. Any notice required or permitted by this Representation and Agreement shall be in writing and shall be delivered as follows with

notice deemed given as indicated: (i) by personal delivery upon delivery; (ii) by overnight courier upon written verification of receipt; (iii) by facsimile transmission upon acknowledgment of receipt of electronic transmission; or (iv) by certified or registered mail, return receipt requested, upon verification of receipt. Any notice to be made to the Company hereunder shall be sent to the following:

[COMPANY]  
Attn: Corporate Secretary  
[ADDRESS 1]  
[ADDRESS 2]  
[FACSIMILE]

4. This Representation and Agreement shall be governed in all respects by the laws of [STATE], without regard to the conflicts of laws provisions therein, and it shall be enforced or challenged only in federal or state courts located in [STATE].

5. Should any provisions of this Representation and Agreement be held by a court of law to be illegal, invalid or unenforceable, the legality, validity and enforceability of the remaining provisions of this Representation and Agreement shall not be affected or impaired thereby.

*[Remainder of Page Intentionally Left Blank]*

**IN WITNESS WHEREOF**, the Nominee has delivered this Representation and Agreement as of the date first written above.

NOMINEE

\_\_\_\_\_  
Signature

Name: \_\_\_\_\_

Address: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Facsimile: \_\_\_\_\_

**EXAMPLE OF  
NOMINATING & CORPORATE GOVERNANCE  
COMMITTEE CHARTER**

**Purpose**

The Nominating & Corporate Governance Committee (the “Committee”) is appointed by the Board of Directors (the “Board”) of [COMPANY] (the “Company”) (1) to assist the Board by identifying individuals qualified to become Board members, consistent with criteria approved by the Board, and to recommend to the Board the director nominees for the next annual meeting of shareholders and the individuals to fill vacancies occurring between annual meetings of stockholders; (2) to recommend to the Board the Corporate Governance Guidelines applicable to the Company; (3) to lead the Board in its annual review of the Board and management’s performance; and (4) to recommend to the Board director nominees for each committee.

**Committee Membership**

The size of the Committee shall be determined by the Board in its sole discretion, provided that, in no event, shall it consist of fewer than [●]<sup>500</sup> member(s).

The members of the Committee shall be appointed annually by the Board and will serve at the Board’s discretion. Committee members may be removed from the Committee by the Board at any time, with or without cause and any vacancies will be filled through appointment by the Board.

The Board shall appoint one member of the Committee as its Chairperson.

All members of the Committee shall meet the independence requirements of the New York Stock Exchange and any other applicable laws or regulations.

**Meetings**

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the Committee

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<sup>500</sup> Minimum number to be set in a manner consistent with governing state law and the Company’s charter and bylaws.

members present at that meeting shall designate one of its members as the acting chair of such meeting.

### **Committee Authority and Responsibilities**

1. The Committee shall have the resources and authority to discharge its responsibilities, including the sole authority (i) to retain and terminate any search firm to be used to identify director candidates and (ii) to approve the search firm's fees and other retention terms. The Committee shall also have authority to obtain advice and assistance from internal or external legal, accounting or other advisors.
2. The Committee shall actively seek individuals qualified to become directors for recommendation to the Board, consistent with criteria identified by the Board.
3. The Committee shall seek to complete customary vetting procedures and background checks with respect to individuals suggested for potential Board membership by stockholders of the Company or other sources.
4. The Committee shall annually review and make recommendations to the Board with respect to the compensation and benefits of directors, including under any incentive compensation plans and equity-based compensation plans.
5. The Committee shall receive comments from all directors and report annually to the Board with an assessment of the Board's performance, to be discussed with the full Board following the end of each fiscal year.
6. The Committee shall annually, or more frequently as it deems appropriate, review and reassess the adequacy of the Corporate Governance Guidelines of the Company and recommend any proposed changes to the Board for approval.
7. The Committee shall annually, or more frequently as it deems appropriate, review the succession planning for the Company's senior executive officers, including but not limited to the Chief Executive Officer and [may][will] do so in concert with the Compensation Committee.
8. The Committee shall make regular reports to the Board.
9. The Committee shall review and reassess the adequacy of this Charter annually and recommend any proposed changes to the Board for approval.

10. The Committee shall annually review its own performance.
11. The Committee may form and delegate authority to subcommittees when appropriate.