Draft policy: Universal Proxy

Approved by the Policies Committee July 23, 2013

The committee moves to add language to Section 2.2 of CII's Corporate Governance Policies to support a universal proxy for contested elections.

<u>Currently</u>, Section 2.2 reads as follows:

> 2.2 Director Elections: Directors in uncontested elections should be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats.
>
> Directors who fail to receive the support of a majority of votes cast should step down from the board and not be reappointed. A modest transition period may be appropriate under certain circumstances, such as for directors keeping the company in compliance with legal or listing standards. But any director who does not receive the majority of votes cast should leave the board as soon as practicable.

<u>As amended</u>, the section would read as follows. New language is italicized and underlined. There are no proposed deletions to the existing language.

> 2.2 Director Elections: Directors in uncontested elections should be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. <u>*To facilitate the shareholder voting franchise, the opposing sides engaged in a contested election should utilize a proxy card naming all management-nominees and all shareholder-proponent nominees, providing every nominee equal prominence on the proxy card.*</u>
>
> Directors who fail to receive the support of a majority of votes cast <u>*in an uncontested election*</u> should step down from the board and not be reappointed. A modest transition period may be appropriate under certain circumstances, such as for directors keeping the company in compliance with legal or listing standards. But any director who does not receive the majority of votes cast should leave the board as soon as practicable.

Background and Intent

Proxy contests are pivotal events for both companies and their owners. It is critically important that shareholders are able to cast votes in accordance with their actual preferences when board seats, and in some cases, board control, are at stake.

Shareholders currently have limited flexibility when casting votes in proxy contests. Their choices are generally restricted to either supporting management's nominees using management's proxy card or a shareholder-proponent's specified combination of nominees using the shareholder's proxy card. If they wish to support a different combination, shareholders must obtain a legal proxy, attend the shareholder meeting in person, and 'split' the vote at the meeting; or alternatively, they must make special voting arrangements through a vote processor available exclusively to institutional investors. The language equips CII to support regulatory reform allowing either side in a proxy contest to circulate a proxy card naming all candidates, ensuring a less confusing, less cumbersome voting process.

Allowing for a "universal proxy" would require the SEC to amend its "bona fide nominee" rule, which since 1966 has required the opposing sides in a proxy contest to obtain consent before listing opposing candidates. The 1992 "short slate" rule provided, in essence, a carve-out from the consent requirement in cases where the shareholder puts forward a number of candidates representing a minority of the board. In those instances, shareholders have the ability to support the shareholder-specified combination of shareholder and management nominees. However, the short slate rule does not allow for full "mix and match" capability. Moreover, if the shareholder-proponent puts forward a "control slate" (i.e. a set of candidates that would constitute a majority of the board), the 1992 rule is inapplicable and shareholders have no ability to vote for their preferred mix of nominees using the shareholder-proponent proxy card.

The language supports the perspective that the shareholder voting franchise will be enhanced only if proxy contest participants are allowed to circulate a proxy card with all candidates with equal prominence on a single card. Solely supporting an end to the consent requirement may ultimately work against the voting franchise, as that more narrow approach could empower proxy contest participants to circulate "semi-universal" proxy cards featuring more—but not all—candidates or all candidates with unequal prominence. These tactics, designed to enhance the likelihood of success, would rob shareholders of the flexibility to easily choose any mixture of candidates using one proxy card.

The effective circulation and execution of a universal proxy in a 2012 proxy contest involving Canadian Pacific suggests that reform in this area may be easier to implement than previously understood.

The clarification to the second paragraph is consistent with long-held Council position that the majority-support expectation for director elections applies only to uncontested elections. This clarification becomes particularly justified given the additional focus on contested elections in the amended first paragraph.

Draft policy: Board Refreshment

Approved by the Policies Committee July 23, 2013

The committee moves to amend the introduction of Section 7 of CII's Corporate Governance Policies to affirm that board tenure may impact independence and warrants the board's consideration as it determines whether a director is independent.

Currently, Section 7.1 reads as follows:

> 7.1 Introduction: A narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and shareowners' financial interest because:
>
> - Independence is critical to a properly functioning board;
> - Certain clearly definable relationships pose a threat to a director's unqualified independence;
> - The effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members; and
> - While an across-the-board application of any definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small and is far outweighed by the significant benefits.
>
> Independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors that may compromise the director's objectivity and loyalty to shareowners. Directors have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent.

As amended, the section would read as follows. Deleted language is shown by strike-through, while new language is italicized and underlined.

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should meet this standard) is in the corporation's and shareowners' financial interest because:

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[Paragraph break]

~~Directors~~ *Boards* have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent. *These considerations include the director's years of service on the board. Extended periods of service may adversely impact a director's ability to bring an objective perspective to the boardroom.*

Background and Intent

Investors expect independent directors to monitor managers with unbiased judgment. This task may become increasingly difficult to achieve when a director's tenure extends into its second, third or even fourth decade. At some point during an extended period of service, the phenomenon of "board capture" can transition from risk to reality.

The amended policy is intended to prompt boards to thoughtfully examine whether the service of a seasoned director has reached a point where it is no longer appropriate to consider the director independent. In doing so, the amended policy facilitates the emerging priority of board refreshment. According to one recent study, S&P 500 boards acquired fewer new directors in 2012 in any year since 2001.[1] Lack of turnover also arose as an issue in a recent corporate director survey in which 57 percent of respondents reported that their board did not replace a single director in the last year.[2]

Recent empirical research covering a broad index and 13 years of data suggests that firm value is enhanced at companies where the average director tenure is moderate.[3] It is notable that 26 percent of all Russell 3,000 directorships have more than 10 years of service and 14 percent have more than 15 years.[4]

Given the appeal of a corporate directorship, it may not be reasonable to expect the tenure issue to "manage itself" via voluntary resignations. S&P 500 companies now pay an average of more than $250,000 per year for these part-time jobs, whose duties typically involve less than six hours per week to fulfill.[5] Directorships provide coveted opportunities professional development, and despite the demands in recent years for more active oversight and responsiveness to shareholders, more than 92 percent of surveyed directors indicate that they enjoy being a director.[6]

The amended policy does not endorse a tenure limit, which facilitates board refreshment but brings the potential consequence of preventing directors with critical expertise from continuing to serve on the board. We note that other markets employ non-binding approaches to board tenure. The European Commission advises that non-executive directors serve no more than 12 years. In the United Kingdom directors with more than 9 years of service are deemed non-independent unless the company can explain otherwise.[7]

The paragraph break recognizes a distinction between independence considerations related to relationships and those pertaining to other relevant

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[1] See Spencer Stuart study at http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf

[2] See http://www.directorship.com/how-to-get-a-seat-on-a-public-company-board/

[3] Board Tenure and Firm Performance, by Sterling Huang, measures firm value based on Tobin's Q, a ratio that measures the degree to which equity market value exceeds equity book value. http://efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2013-Reading/phd/Board%20Tenure%20and%20Firm%20Performance.pdf.

[4] Percentages derived from GMI report on board tenure and diversity available at http://www3.gmiratings.com/wp-content/uploads/2013/06/GMIRatings_WOB_TenureGender_062013.pdf.

[5] See http://www.bloomberg.com/news/2013-05-30/board-director-pay-hits-record-251-000-for-250-hours.html

[6] See http://www.heidrick.com/PublicationsReports/Documents/WCD_2012BoardSurvey.pdf

[7] The European Commission's recommendation is available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF. The U.K.'s position is found in the FRC's Corporate Governance Code, available at http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx.

factors. Establishing a separate paragraph that leads with the principle that *all* relevant facts and circumstances warrant consideration complements the proposed language regarding length of service. Tenure is a factor that extends beyond the scope of a formal “relationship” such as former employment, a business relationship, a consulting arrangement or a family connection.

The replacement of the term “Directors” with “Boards” in the beginning of the final paragraph leaves no uncertainty that the policy supports the board’s consideration of relevant factors and not a self-assessment by individual directors of their own independence.