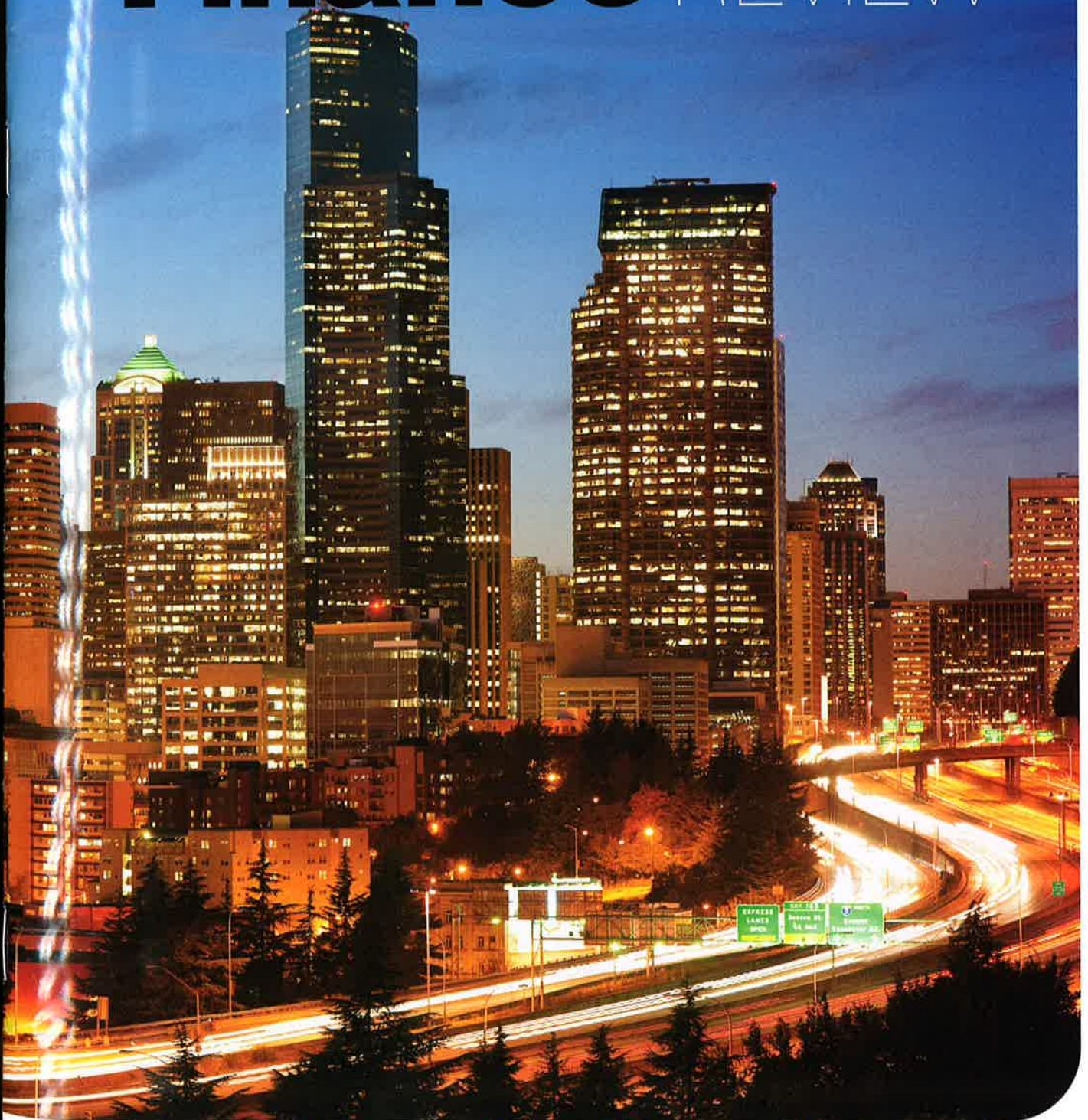


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CORPORATE Finance REVIEW



Organizational Trust
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CORPORATE Finance REVIEW

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CORPORATE PROXIES— THE TRADITIONAL “SEASON” HAS BECOME A YEAR-ROUND PROCESS FOR INVESTORS

For many board members, chief executive officers, chief financial officers, and other C-Suite executives, the annual “proxy season” has long been characterized by intense preparation of the proxy documents for shareholder voting and busy staff preparing for the Annual Meeting. This once-a-year meeting is often the only opportunity for shareowners to voice their opinions directly to management and the board (if members are in attendance) in the presence of other shareholders.

The majority of Annual Meetings and proxy voting takes place in the spring months for companies with a fiscal year-end that is also the calendar year-end. Proxy voting, while much reduced after the April-May-June “season,” continues to the year-end.

For managements, the Annual Meeting, proxy voting, and board elections used to be once a year, and the hope was that everything would go smoothly. And then the season would be over. But for some investors, the proxy resolution business is a continuous, year-round activity that includes engagement and dialogue with companies in their portfolio (if activist investors can get a meeting). Proxy activism has been steadily rising over the last 25 years.

And over the past two decades, on a steadily increasing basis, some firms are having to deal with “pesky” interference

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in the company's ordinary business, as shareholders presented their own resolutions for inclusion in the proxy materials. Many managements' view: annoyance and interference with company business.

The shareholder-sponsored proxy resolution has to survive a company challenge if

management does not agree with the spirit or content of the resolution. The typical course of action: Corporate managements ask the Securities & Exchange Commission (SEC) for (in effect) permission to exclude the resolution from the proxy package.

These challenges are usually posed because management believes that the intent of the resolution, if passed, would intrude on management's ability to operate the business. (They might disagree with the intention of the proposal if passed by shareholders, because management might dismiss, for example, rising interest in climate change.)

Besides disagreement with the intent of the resolution, a challenge could be posed for a resolution submitted by a shareholder who did not meet the ownership standards for presenting the proxy draft. (The “threshold” for qualification is a hot topic among investors. SEC has considered changes for the past two years.)

SEC staff recommendations to commissioners

After the corporation submits its request or explanation of why the company believes the resolution should be excluded from the proxy, if the proposal deals with “ordinary business operations,” the SEC staff will usually recommend that no action be taken by the Commission (Rule 14a-8(i)(7)).¹

So, for the corporation, there is some element of “cover” with the no-action letter; it means the Corporate Finance Divi-

sion staff will recommend to the commissioners (the chair plus four) that there be no action if the company is further challenged or protested by the investor. There have been many no-action letters to companies based on the premise that the investor's resolution, if passed (usually a remote possibility), would interfere with management's operations of the company.

If the resolution does make it past the company challenge and request to the SEC, the shareholder-sponsored item could be on the ballot for voting. Many companies (in analyzing the past two years of proxy materials distribution) will then advise shareholders to vote "no" on these resolutions. The prevailing view of managers—and courts where challenges are dealt with—is that some (only a few?) shareholders want to interfere in "their company."

But the nature of the typical proxy resolution exclusion that management counts on may be changing, it would appear. Important societal issues may be part of the consideration in SEC staff review. (That will trigger a debate, no doubt, on what is "important" and a "societal issue.")

Sea change at SEC? Investors hope so—time will tell

In 2011, at the start of the proxy voting season, the SEC's Division of Corporate Finance staff issued some explanation on its decision-making for no-action responses. Ford Motor Company and several other corporate managers requested an exclusion for proposals submitted to their companies. They received considerably more information on the staff's no-action decision-making regarding their challenge of the shareholder resolutions.

In a January 31, 2011 letter to the corporate secretary, the Office of Chief Counsel considered the resolution submitted to Ford by a shareholder (Robert Granzow), whose resolution would provide (if on the ballot and approved) that shareholders who purchased a new vehicle and "had no spare tire and hardware for mounting same will be able to pur-

chase same from Ford at the manufacturing cost of same."²

That does sound like ordinary business to many managements. Charles Kwon, SEC special counsel, explained the Commission's reasoning to the company. The proposal related to the company's discount pricing policies; discount pricing is generally excludable under the rule—the actions are fundamental to management's ability to run the company day-to-day. So, there would be no enforcement action if Ford omitted the proposal in the proxy materials.

The SEC's informal procedure regarding shareholder proposals is "to aid those who must comply with the rule by offering informal advice and suggestions and to determine, initially, whether or not it may be appropriate ... to recommend enforcement to the Commission. [The Corporate Finance] staff considers the information furnished to it by the Company in support of its intention to exclude the proposals from the Company's proxy materials, as well as any information furnished by the proponent or the proponent's representative." The determinations reached in no-action letters do not "adjudicate the merits of a company's position with respect to the proposal"—only a U.S. District Court can do that.

As explained, the corporation appeals to the SEC under the *Securities Exchange Act of 1934* for "concurrence of the staff [of the Division] that it will not recommend any enforcement action to the Commission if the shareholder proposal ... is omitted ..."³

In the letter to Ford Motor Company, key phrases signaled what may be important changes taking place in proxy matters.⁴

From the SEC:

Rule 14a-8(i)(7) permits a company to omit a proposal if it deals with a matter relating to the company's ordinary business operations. In Exchange Act Release No. 34-40017 (May 21, 1998), the Commission stated: The policy underlying the ordinary business exclusion rests on two central considerations. The first relates to the subject matter of the proposal. Certain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight.



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And here is the language that may indicate a change in the SEC staff view of shareholder proposals that are deemed to be beyond ordinary business:

However, proposals relating to such matters but focusing on *sufficiently significant social policy* issues (emphasis added) . . . generally would *not* be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.

Ordinary business versus significant social policy—the considerations may become a big deal for companies and certainly for some of their investors.

And director elections are changing

Also on the proxy ballot are elections for directors. The corporate board of directors has the important responsibility of representing the owners' interests (and oversight of management). In the majority of elections, election or re-election to the board is a *pro forma* exercise. Few directors or nominations are challenged when considering the number of corporate elections and nominations of new directors. (For years, it was up to the CEO to decide who gets on and stays on the board. In recent years, activist investors are challenging some directors—being nominated or standing for re-election.)

In large-cap companies, the shareholder base is so diffused and broad-based (shares held in mutual funds, in pools, 401(k) accounts) that the shareholder may have significant difficulty in trying to marshal support for his or her own resolution. (Plus, individual shareholders who may agree with the sense of the proposal may not bother to vote at all.)

Elections are changing, too, as activist investors—the sustainable and responsible investor (SRI) community, hedge funds, private equity players, and large shareholders—mount challenges to individual board members or nominees. And large investors (such as the well-known Carl Icahn) may try to place their own directors on the board. For less powerful investors (without large holdings) a challenge could be posed through a “no

vote” or “withhold vote” campaign to send a signal to the board of their displeasure with the nominee—and at times, with the whole board.

For a growing number of stockholders—and numerous stakeholders—the season is a year-round, intensive exercise, characterized by the expectation (or demand) that management and board will listen carefully to the concerns of the owners. Engagement is sought; often the resolution drafted and submitted is a sign of failure to engage, discuss, and resolve outstanding issues. Some of these issues may be about a “sufficiently significant social policy”—certainly many SRI investors believe that many of their issues fit the description.

So the discussions about normal business operations are now mattering more than in past years. Shareholder advocates and their allies and supporters may (and often do) have very different views of what is ordinary business and strategic business. Public policy issues are at the heart of the SRI's activism.

Looking back at 2011 and the actions of SEC staff, activist and involved shareholders are hoping that the SEC decisions on corporate challenges to shareholder-sponsored proxy resolutions are changing—and will be more likely to give careful consideration to their proposed resolution.

As the SEC staff explained, when the resolution is focused on sufficiently significant social policy, the proposal “generally would *not* be considered to be excludable.” The spirit and content of the proposal “would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.” Encouraging language for shareholders. Challenging for management and boards.

This could open the door, for example, for shareholders to propose changes or oversight or more reporting on the company's supply chain policies and practices and what happens on the ground in other countries (with supplier company employees). This is an issue for many activist investors, given the reliance (for example) of technology companies on suppliers based in China or East Asian

nations such as Indonesia or Vietnam. The policies and practices of the corporation viewed as ordinary business contrasts with the views of the activists, who see serious workforce or human relations issues. That's one example. Other issues for investors are and will be about the corporation's policies and disclosure on climate change matters, practices in sourcing raw materials (such as minerals in Africa or New Guinea), and seafood sustainability.

Constructive engagement and dialogue—for company and investor

Seafood sustainability is an issue raised in 2011 with Costco (NASDAQ:COST), the larger retailer by Trillium Asset Management LLC, a Boston-based pioneer in the field of environmental, social, and governance investing. Trillium engaged with the company in constructive dialogue. Costco released to Trillium and Green Century Funds an improved seafood sustainability policy. Costco will discontinue sales of 12 wild species identified by the Marine Stewardship Council. The company is also partnering with non-governmental organizations to help compliance with best practices standards for shrimp and salmon agriculture, says Trillium.

In 2011, Trillium engaged with about two dozen companies. Matthew Patsky, CEO, commented: "A good portion of dialogues and [submitted] resolutions resulted in agreements with companies to improve policies and provide more transparency. Both [approaches] are helpful in assessing the environmental, social and governance risks and their financial impact on shareholders."⁵

Watching the 2012 proxy resolutions presented by SRI investors such as Trillium and other shareholders, managements and investors will also be watching the SEC staff decisions on no-action requests. The definition of sufficiently significant social policy by the staff of the Division of Corporate Finance in 2011 may encourage more managements to engage and address issues before they reach the stage where the investor drafts a resolution.

Engagements are year-round processes ... the proxy season has therefore become year-round.⁶ ■

NOTES

¹Rule 14a-8: Governs Shareholder Proposals, including eligibility of shareholder.

²Division of Finance, SEC letter to Peter J. Sherry, Jr., Office of the Secretary of Ford Motor Company.

³Division of Corporate Finance, "Informal Procedures Regarding Shareholder Proposals."

⁴Other firms receiving 2011 no-action letters included Duke Energy Corporation, allowing the company to omit a proposal relating to supplier relationships, which are generally excludable under the Rule. Stockholder Douglas S. Doremus proposed that Duke "strive to purchase a very high percentage [75 percent] of 'Made in USA' goods and services." The company argued that the proposal intruded on management's ability to control day-to-day operations in the best interests of shareholders. Verizon Communications could exclude a proposal to form a [board level] "'Corporate Responsibility Committee' to monitor the extent to which Verizon lives up to its claims pertaining to integrity, trustworthiness, and reliability and the extent to which Verizon lives up to its Code of Business Conduct."

⁵Trillium Asset Management, Boston, Massachusetts. "Seasonal Wrap-up: Trillium's 2011 Engagement Highlights," September 14, 2011. Included are its proposals, which addressed climate change and fossil fuels, reliance on coal, environmental justice, human rights, political contributions, and water risk, among other issues.

⁶Special recognition to The Corporate Counsel.net, Broc Romanek, principal. This is an excellent source of information related to the corporate proxy process. Information was provided to subscribers on February 17, 2011. www.corporatecounsel.net