

the Corporate Governance I a d v i s o r

ASPEN PUBLISHERS

March/April 2009 • Volume 17, Number 2

RISK MANAGEMENT

The Risk-Adjusted Board: How Should the Board Manage Risk?

By Cynthia M. Krus and Hannah L. Orowitz

Over the past year, the media's,¹ legislators'² and regulators'³ discussions of risk assessment and management seem to have steadily increased in inverse proportion to the stock markets' decline. Then on October 14, 2008, when the US Treasury announced executive compensation rules under the Emergency Economic Stabilization Act (the EESA), that required, among other things, "ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution," the issue shot to the forefront of legislators' and regulators' agendas. As a result, companies are now asking their boards of directors to turn more of their attention to the various risks their respective companies may face as a result of slowed or declining economic growth.

In recent weeks, calls for legislative and regulatory action regarding risk assessment and risk management have been made with increased frequency and conviction. New legislation incorporating risk management requirements has been recently introduced into and passed by the House of Representatives, and we can

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expect that additional legislation and/or regulation will continue to be introduced in the weeks and months to come. In short, it appears that many believe that the effects of undue risk-taking are the central catalyst behind the collapse of the economy.

The question that the board of directors must now answer—and the focus of this article—is how to best carry out its risk oversight role within the company’s risk management program. The first section of this article briefly discusses the sources of a board of director’s risk oversight obligations. The second section recommends practices that a company may want to consider in order to better implement and structure risk oversight by its board of directors, and to prepare for possible regulatory responses related to risk management that are expected in the near future.

The Board’s Oversight Obligation

Risk management should not be viewed as “risk avoidance” or “risk elimination.” Instead, it should be seen as the process of ensuring that a company takes risks responsibly by balancing the cost and benefit associated with each risk that exists. The board of directors should not be involved in day-to-day risk management. Rather, the role of boards of directors in this process is to oversee risk management to ensure that their companies have effective risk management programs in place that bring material risks to management and the board’s attention in a timely manner. A board of director’s oversight obligations arise from state law fiduciary duties, federal laws and regulations, and, if public, exchange listing requirements. Compliance with applicable laws and exchange listing standards should be part of any effective risk management program. In addition, industry-specific best practices often exist, which may influence the structure of a company’s risk management program.

State law. State law imposes the duties of care, loyalty, and good faith upon directors. A board of directors’ failure to exercise oversight may be seen as a breach of its fiduciary duties. *In re Caremark International Inc. Derivative Litigation*,⁴ and more recently *Stone ex rel. AmSouth Bancorporation v. Ritter*,⁵ confirm that Delaware courts view failure to exercise oversight as a breach of the duty of loyalty (and the duty of good faith implicit therein).

In *Caremark*, the Delaware Chancery Court held that a board of directors’ fiduciary duty of loyalty requires it to adopt and oversee a compliance program, even in the absence of any known illegal behavior. However, in an effort to protect the business judgment of directors from court scrutiny, the Court found that directors would not be liable for failure to exercise board oversight unless either a “sustained or systematic failure for the board to exercise oversight” or “an utter failure to attempt to ensure a reporting and information system” exists.

More recently in *Stone v. Ritter*, the Delaware Supreme Court affirmed directors’ *Caremark* duties, and located directors’ duty of good faith within the duty of loyalty, noting that bad faith requires a conscious or knowing failure to exercise oversight. Specifically, the Court held that bad faith exists where “having implemented such a system of controls, [the board of directors] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of *risks or problems* requiring their attention.” [emphasis added]

Caremark and *Stone v. Ritter* illustrate that, although it is difficult to show a breach of directors’ duty of loyalty for failure to exercise oversight, it is possible in situations where a board fails to implement any monitoring system or consciously fails to inform itself of risks or problems facing a company. Given the current economic climate, risks and problems facing a company may emerge and evolve rapidly, and shareholders may be increasingly likely to institute derivative litigation regarding boards’ failure to exercise oversight. Therefore, boards will want to diligently oversee risk management at their companies to avoid any risk of *Caremark* liability.

Exchange listing standards. The listing standards of national securities exchanges also regulate corporate governance by requiring companies to adopt certain governance standards. For example, these standards mandate that boards of directors be composed primarily of independent directors and have specified committees composed entirely of independent directors. In addition, the listing standards of the New York Stock Exchange explicitly impose the duty of risk oversight on the audit committee—or a separate committee or sub-committee of the board of directors charged with overseeing risk – by requiring that it “discuss guidelines and policies to govern the process by which risk assessment and management is undertaken.”

Federal laws and regulation. Depending upon the industry in which a company operates, it may have to incorporate numerous federal laws and regulations into its risk management program.⁶ However, regardless of industry, all public companies have been impacted by the Sarbanes-Oxley Act of 2002. Although not directly tied to risk management, Sarbanes-Oxley drastically changed the corporate governance landscape in the United States by imposing on companies and boards of directors numerous specified requirements that incorporate financial risk management, such as requiring companies to implement and annually report on internal controls over financial reporting.

The recently enacted EESA legislation also focuses on risk management, imposing upon the compensation committees of boards whose companies accepted money under the Treasury Department's TARP Capital Purchase Program the duty to ensure that executive compensation at their companies was not designed to encourage "unnecessary and excessive risks." In carrying out this duty, the compensation committee must meet with the company's senior risk officer(s) shortly after accepting TARP funds, and annually thereafter, to review each of the company's senior officers' incentive compensation arrangements to ensure that the arrangements do not encourage excessive risk taking and comply with the company's risk management policies and procedures. In conducting these reviews, the committee and the company's senior risk officer(s) take steps to limit any features of senior executives' incentive compensation arrangements that have been identified as potentially encouraging unnecessary risk.

In addition, the compensation committee must annually certify either in the company's Compensation Discussion and Analysis (CD&A) (if public) or to its primary regulator that it has completed such reviews and made reasonable efforts to ensure that senior executives' incentive compensation arrangements do not encourage unnecessary risk-taking. Despite requiring this risk assessment, the legislation offers few, if any, parameters as to how a company should conduct the assessment. Although only companies accepting TARP funds are required to perform such an executive compensation risk analysis, many corporate governance experts, including members of the SEC Staff, are encouraging all companies to conduct such an analysis.⁷

Recently proposed legislation and regulation. Following the passage of the EESA, the regulatory landscape regarding executive compensation risk management has continued to evolve. Recently, Rep. Barney Frank (D-MA), the Chairman of the House Financial Services Committee, introduced the "TARP Reform and Accountability Act of 2009" in the house.⁸ This bill, which attempts to harmonize and broaden the executive compensation standards applicable to current and future companies accepting government financial assistance, passed a House vote on January 21, 2009.⁹ In addition, on January 29, 2009, the Congressional Oversight Panel released its report urging broad regulatory reform of financial regulation, including executive compensation reform to discourage excessive risk taking and the designation of a regulatory body to monitor systemic risk, among other recommendations. These recent events illustrate the extent to which executive pay reform has and likely will continue to be in the public consciousness.

As a result of the current environment, many diverse voices in the corporate governance world are joining together in advocating for increased regulatory oversight of risk management. Given this concurrence, the current topic of debate seems to be not whether there should be new regulation governing risk oversight, but rather how and by whom such regulation should be carried out. At Mary Schapiro's confirmation hearing to serve as chair of the SEC, Schapiro expressed her desire to reconstitute the SEC's Office of Risk Assessment (which recently was comprised of only one staff member) and stated that risk assessment should permeate the SEC's operations.¹⁰ Others have suggested that the national exchanges may become more involved in risk management by requiring listed companies to appoint a senior risk officer and/or make certain certifications regarding risk management practices.

Boards of directors may want to review their company's current risk management policies or adopt new practices to prepare for this expected new regulatory environment. Although the specific mode of regulation is not yet clear, new regulation regarding risk management and risk assessment nonetheless seems likely. Regulation of risk assessment and risk management may prove difficult to implement, in part because the regulatory answer to this question is extremely difficult to construct. One source that may prove helpful, which serves

as the basis for some of the recommendations of this article, is the Turnbull Report. The Turnbull Report serves as a complimentary report to the UK's Combined Code on Corporate Governance and sets forth detailed guidelines regarding the implementation and operation of risk management programs. In addition, to assist with this process, set forth below are several recommendations to boards of directors to improve their risk oversight function.

Recommendations to Improve Risk Oversight

According to existing case law, to effectively carry out its risk oversight duties, a board must ensure (1) that the company has a risk management program in place tailored to its individual industry and needs; (2) that it periodically reviews this program with the company's senior risk officers, general counsel and outside consultants as necessary to assess the effectiveness of the program; and (3) that it addresses any issues that arise from its monitoring and/or investigation accordingly.

US companies may find that the Turnbull Report offers helpful guidance in establishing an assessment framework¹¹ to assess the effectiveness of a risk management program. In addition, set forth below are several recommendations to assist boards in successfully carrying out their risk oversight duties, several of which are based on the guidance set forth in the Turnbull Report.

Determine the adequacy of the company's risk management program. It is important for the board of directors to be familiar with the company's risk management program in order to determine that it operates adequately to identify and evaluate risks that may need to be brought to the board's attention. In doing this, it may be helpful for the board to invite company management to review the program at a board meeting in light of the following:

- What are the nature and extent of the risks that the company faces;
 - How do the program's processes and controls adjust to reflect new or evolving risks;
 - What extent and categories of risk does the company consider acceptable to bear;
 - What is the likelihood that the risks identified materialize;
 - What ability does the company have to reduce the incidence and impact of risks that do materialize;
 - Who is tasked with the authority and/or responsibility to make decisions and take actions necessary to address risks that materialize, and if these decisions and actions may be taken by various individuals, are they appropriately coordinated;
 - Do those tasked with authority and responsibility (and any outside consultants) have the knowledge, skills, and tools necessary to effectively manage risks to achieve the company's objectives; and
 - What are the costs of operating individual controls relative to the benefit obtained in managing (rather than avoiding) the related risks?¹²
- These questions should help a board to review the adequacy of the company's risk management program and identify any adjustments that may need to be made. In particular, the board will want to be satisfied that any program includes a clear policy and strategy for managing any such risks that are identified.
- Regularly assess the effectiveness of the program.* On an annual basis, the board may undertake a review of the company's risk management program. In completing this review, it is helpful to consider:
- Whether the program incorporates adequate training and informational materials;
 - How risks have been identified, evaluated and managed;
 - If the system has been effective in managing risk, paying particular attention to any failures or weaknesses in the system have been identified;
 - To the extent significant failings or weaknesses occurred, what steps have been or are being promptly taken to remedy such occurrences;
 - Whether any changes or additions to the system are needed.¹³

By annually completing this review, the board can satisfy itself that the company's program continues to be effective and consistently enforced. The board may also want to consider including a discussion of this assessment in the CD&A section of the company's annual proxy statement.

*Consider creating a risk oversight committee or sub-committee.*¹⁴ A company's full board must remain informed regarding its risk management activities. A company, however, may find it more effective to charge a single committee with responsibility for oversight of risk management, with that committee providing the full board with committee reports regarding its activities and findings. Many companies currently task their audit committees with responsibility for monitoring financial risks. Given the importance of risk oversight, and the variety of risks that exist, companies may want to consider delegating this function to a separate risk committee or sub-committee that is not already focused on compliance with accounting standards.¹⁵ By housing risk oversight at the audit committee level, it is possible that non-financial risks may be minimized or overlooked to the detriment of the company and its shareholders.

The risk committee's mission would be to remain fully informed regarding the company's business, industry, and financial market conditions in order to anticipate future potential risks and encourage management to plan accordingly. To do this, just as the audit committee meets regularly with a company's internal and external auditors, the risk committee would meet regularly with the company's internal risk officers, as well as any outside consultants it deems necessary or beneficial. The risk committee will also want to keep minutes of any meetings it holds that contain detail sufficient to document its discussions and deliberations.

Executive compensation risk assessment. In addition to the board's overall risk oversight role, compensation committees may also want to—and those of companies participating in the TARP Capital Purchase Program are required to—conduct an executive compensation risk assessment. The purpose of such an assessment is to identify and mitigate any features in a company's compensation program that encourage a company's senior executive officers to take “unnecessary and excessive risks that could threaten the value of the financial institution.” See Frederic W. Cook's

article in the January/February 2009 issue of the *Corporate Governance Advisor* for a suggested framework for conducting an executive compensation risk assessment.¹⁶

Maintain a strong tone at the top. A company's board of directors and senior management are responsible for establishing the culture of the company and communicating that the company views good governance and risk management as essential to its operations. In order to do this, the board of directors and company management, particularly a company's senior risk officer(s), will need to maintain open lines of communication with one another. In addition, incorporating the company's risk management program into its operations, rather than treating it as an isolated function, may help to communicate this point.

Be cognizant of the board's composition. In filling board vacancies, the board, or, to the extent applicable, its nominating and corporate governance committee, may want to seek director candidates with experience relevant or complimentary to the company's industry. Including board members with experience that is relevant to a company will assist the entire board in understanding the risks facing the company. Increased understanding, in turn, will help the board to more effectively carry out its oversight role.

Incorporate risk management into board training programs. The topic of risk management could be incorporated into board orientation and training materials. While most companies will find it helpful to include an overview of the risk management program in board orientation materials, how a company incorporates risk management into board training will likely vary depending on the industry in which a company operates. For example, companies engaged in manufacturing may find that a site visit is an effective risk training tool.

Financial companies, on the other hand, may find that tutorials regarding accounting concepts that are material to the company are more useful. For companies that are highly regulated, keeping directors apprised of potential new legislation or regulatory changes, and the effects thereof, is an important component of its board training programs. Regardless of industry, the goal of such training programs is to maintain a clear understanding between management and the board

as to what risks exist and what level of risk is acceptable.

Conclusion

As a result of the ongoing economic crisis, companies have begun asking their boards of directors to turn increased attention to the various risks their respective companies may face. In addition, in recent weeks and months legislators and regulators, among others, have begun to advocate for risk assessment regulatory reform with increased conviction. And it seems likely that courts soon will begin looking at the topic of risk assessment with increased scrutiny as well.

Given the recent attention paid to the topic of risk management and assessment, new regulation in some form seems likely. If the EESA legislation is an indication of regulation to come, it appears likely that boards of directors may be required to certify their risk assessment processes in the future. Furthermore, any certification requirement may impose liability upon the board of directors if it does not adequately assess its company's risk management program prior to certification. As difficult as it may be to identify the risks to which a company is exposed, validating that the board of directors appropriately considered such risks will likely prove to be only more difficult.¹⁷ Hopefully boards of directors will find the recommendations set forth in this article helpful in overseeing their companies' current risk management programs and in positioning themselves to be well prepared for any new regulation regarding risk management and oversight.

Notes

1. Arthur J. Levitt, Jr., *How the SEC Can Prevent More Madoffs*, Wall Street Journal, Jan. 5, 2009.
2. H.R. 384, 111th Cong. (1st Sess. 2009).
3. Jacquelyn Lumb, *Schapiro Responds to Wide-Ranging Questions at Confirmation Hearing*, SEC Today, Jan. 26, 2009.

4. 698 A.2d 959 (Del. Ch. 1996).
5. 911 A.2d 362 (Del. 2006) (en banc).
6. Additionally, it is interesting to note that the federal sentencing guidelines encourage companies to adopt effective compliance programs by reducing the criminal fines imposed on convicted corporations that maintain such programs.
7. John W. White, Director, Div'n of Corp. Fin., Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009 (Oct. 21, 2008).
8. HR 384, 111th Cong. (1st Sess. 2009).
9. The bill received 260 "for" votes and 166 "against" votes (with 7 abstentions).
10. Schapiro seems to be in agreement with Arthur Levitt, Jr. regarding the importance of this office. Levitt, Jr., *supra* note 1.
11. The Committee of Sponsoring Organization's Enterprise Risk Management-Integrated Framework may also offer some helpful guidance in establishing a framework.
12. These factors have been adapted from those set forth in the Internal Control: Revised Guidance for Directors on the Combined Code, commonly referred to as the "Turnbull Report." The Turnbull report elaborates that an effective system of internal control will include control activities, information and communication processes, and "processes for monitoring the continuing effectiveness of the system of internal control." See Financial Reporting Council, *Revised Guidance for Directors on the Combined Code* (Oct. 2005) (hereinafter the "Turnbull Report"), available at <http://www.frc.org.uk/documents/pagemanager/frcl/Revised%20Turnbull%20Guidance%20October%202005.pdf> (last visited Feb. 5, 2009).
13. These factors have been adapted from those set forth in the Turnbull Report. See *supra* note 12.
14. NYSE-listed companies that choose to delegate risk oversight to a separate committee must ensure compliance with the NYSE's listing standards.
15. Only five of the 100 largest US Corporations currently have a separate risk committee. See Martin Lipton, *et al.*, *Risk Management and the Board of Directors* (Nov. 2008).
16. Frederic W. Cook, *A Compensation Committee Framework for Conducting Executive Compensation Risk Assessments*, Corp. Gov. Advisor, Jan.-Feb. 2009, at 1.
17. Determining the internal controls process required by Section 404 of Sarbanes Oxley required a Herculean effort and related only to financial reporting, making the process of validating risk assessment on a broad basis seem even more daunting.

Overcoming the Obstacles to CEO Succession Planning

By Mark Nadler, Steve Krupp and Richard Hossack

When it comes to the crucial process of CEO succession planning, there is a wide and troubling gap between aspiration and reality. Our latest research, in collaboration with the National Association of Corporate Directors, shows that nearly 8 in 10 directors view the identification and preparation of capable CEOs as one of their most important responsibilities, yet less than 25 percent rate their boards as “excellent” in that area.

Much of the research in recent years has focused on establishing “best practices” in succession planning, and it is evident that there are, in fact, certain common approaches employed by those companies that have been most successful in managing CEO succession. But in our experience, the fundamental problem is that the majority of companies perceive the obstacles to formal succession planning to be so formidable that they never even get started.

Some companies and their boards do a good job of CEO succession. These organizations employ many of the “10 Best Practices” published in the research conducted by Oliver Wyman with the NACD (*see* Rational, Political and Emotional Issues in CEO Succession box). But for most CEOs and boards, the more essential issues to be grappled with—before they even get to best practices—concern if, when, and how to begin planning for the transition at the top.

The good news is that we are seeing an increasing number of directors and boards take a more activist approach, seeking education and information about best practices. For many, the impetus for overcoming their unwillingness to take on CEO succession flows directly from the experience of trying to replace a CEO and suddenly realizing there were no suitable internal candidates. As one director told us, “We don’t ever want to find ourselves in that position.”

Avoiding such a scenario—and to surmount the roadblocks to a robust succession process—the first step is to truly understand the complex dynamics

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involved. With that in mind, here are the objections to succession planning that we encounter most often:

(1) Reluctance to Launch a “Horse Race”

There’s no doubt about it, setting in motion an explicit process in which a small number of senior executives are under constant scrutiny as potential successors to the CEO will almost certainly unleash some complicated and often dysfunctional dynamics, both inside and outside the organization. Colleagues begin to view each other as competitors. People begin to choose sides. What should be routine business decisions take on political overtones. Inside politics becomes a major spectator sport, diverting focus from markets and customers. In more specific terms, there is a heightened risk of losing those executives who handicap the race and decide their chances are slim or are offended at not being involved in the race at all, and who, in either case, decide to head for greener pastures rather than wait for the race to run its course.

There is also a significant danger that launching the “horse race”—either formally or informally—will send signals that are easily misinterpreted. Some CEOs worry that the moment the succession process is perceived as beginning in earnest, they will assume lame duck status. CEOs and boards are also concerned about sending the wrong signals to customers, competitors, and the financial community; there is always the risk that talk of CEO succession implies unsatisfactory performance, a loss of confidence by the board, and the potential for instability.

(2) Resistance from the CEO to “Letting Go”

Apart from the organizational dynamics of a “horse race,” succession planning is an intensely personal experience for CEOs, particularly for company founders or for older CEOs who are unlikely to go on to another CEO position somewhere else.

For any of us, the inevitability of retirement can be traumatic, with its sobering implication of mortality. For CEOs in particular—many of whom have made a lifetime of choices in which career goals took precedence over family or personal interests—the prospect of retirement can be particularly unsettling. At a certain point, they find that their personal identity has become inseparable from their professional role; if the role disappears, there’s a gaping void that must suddenly be filled. So, it is not at all surprising that a number of CEOs engage in their own form of executive denial and find endless excuses to delay the succession process until a more propitious time.

The truth is that far too many boards find it all too easy to become “enablers” of their CEO’s dysfunctional approach to retirement. We should not be surprised; at most companies where the CEO has been in place for years, there are strong personal relationships between the chief executive and at least some of the board members. If the CEO is actively resisting any discussion of retirement or succession, there is no simple way for the board to raise the question. Almost certainly, the mere mention of the issue will provoke embarrassment or anger or the very real prospect of direct conflict, none of which are welcome in most boardrooms. So everyone tiptoes around the issue, hoping the situation will somehow be resolved amicably before a crisis ensues.

(3) Uncertainty Over What Robust Succession Process Entails (And How Much Work It Might Require)

We often encounter CEOs and boards who have never engaged in a fully organized succession process. As a result, they are unclear about what work would be required, what the timeline would be, what internal and external resources might be needed, who would be involved, and what roles they would play. Faced with those uncertainties and fearful of how much time, effort, and expense the process might entail, they decide to keep things simple—either by hiring a search firm to line up some outside candidates or by merely selecting whoever seems to be the best available contender at the time the job must be filled.

More specifically, we hear CEOs and boards say things like, “We’re not GE; things just aren’t that

complicated here. Forget about managing a horse race; we’ll be lucky if we have one solid candidate when the time comes. If we don’t, we’ll go outside and hire someone.” In many companies, it is a matter of priorities and focus, and in particular, companies with a new and relatively young CEO tend to view succession planning as a far-off task that falls well toward the bottom of the priority list.

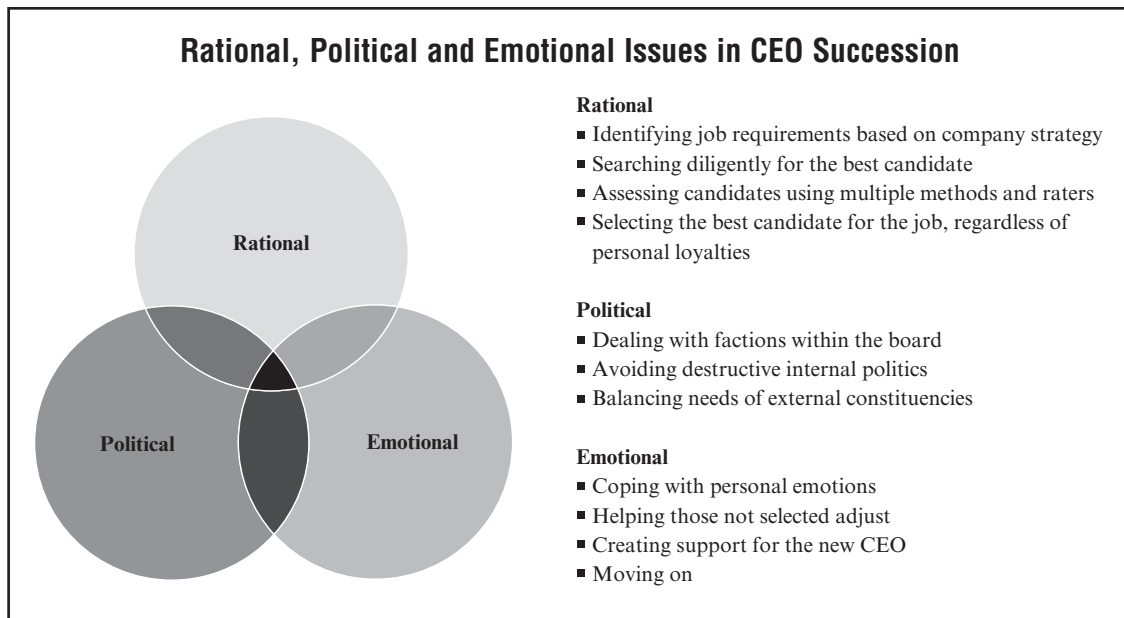
Understanding Succession Dynamics

All three of those obstacles to planned CEO succession—reluctance to launch a horse race, a CEO’s resistance to “letting go,” and the board’s uncertainty about embarking on an unfamiliar and potentially complicated process—underscore quite legitimate and understandable concerns. That does not mean they should be accepted as valid reasons for delaying or even totally ignoring one of the most profound responsibilities faced by every CEO and board—the responsibility to take prudent yet proactive steps to identify and develop viable candidates to fill the organization’s most senior jobs, including that of CEO. On the contrary, these obstacles should be examined closely, because they illustrate the underlying components—political, emotional and rational/analytical—of practically every succession process. And to be effective, a succession process must recognize and address each of these components.

The following graphic elaborates on what we mean when we talk about the three components, and is followed by examples of companies where the components were identified and successfully managed.

Best Practices for Boards in CEO Succession Planning

1. Board/CEO discussions on long-term succession planning should begin 3-5 years prior to the time a CEO transition is expected.
2. The full board should be involved in CEO succession planning.
3. Open and ongoing dialogue should occur between the CEO and the board on the topic of succession planning, including a formal annual discussion of at least half a day.



4. Criteria for the new CEO should be developed consistent with the company’s future strategic needs; ensure that the board and the CEO are aligned on these criteria.
5. Formal assessment processes should be used to give board members a better quality of information to assess candidates.
6. Board members should be given ongoing opportunities to interact with internal candidates in various settings.
7. The succession should be staged, but horse races should be avoided.
8. Developing internal candidates is typically preferable to external recruitment.
9. The outgoing CEO should either leave the board immediately or stay on as Chairman for a transitional period of 6-18 months maximum.
10. A comprehensive emergency CEO succession plan should be in place at all times and reviewed at least annually.

The Political Component

The concerns surrounding any potential succession “horse race” illustrate one aspect—but only

one—of the political component of the succession process. There are a number of other aspects that are a function of the range of individuals and groups, both internal and external, who care far more about the CEO selection than any other appointment the company makes. These stakeholders fall into four major categories:

- The board of directors, whose responsibility to shareholders transcends the tenure of any CEO;
- Outside stakeholders: activist shareholders, financial analysts, the business press, unions, major customers, suppliers, regulators, communities where the company operates, and various political and social interest groups;
- Internal candidates for the CEO position: some adhere to the rule that the best way to win the new job is to steer clear of politics and let performance speak for itself; others will take matters into their own hands by actively lobbying for their candidacy or trying to sabotage others; and
- Internal constituencies: some will search for ways to either support their favorite candidate or undercut the competition—office politics at its most destructive and dysfunctional.

In a realistic succession process, it is acknowledged that political dynamics are at play and understood

that the process must be implemented and communicated—to the interested parties in all four of the above categories—in ways that will manage expectations and mitigate, to the extent possible, the steady stream of rumors, gossip, and uninformed analysis that inevitably accompanies the lead-in to a CEO transition.

Inevitably, any time you have two or more legitimate candidates vying for the top job, you have the makings of a horse race whether you want one or not. However, a disciplined succession process provides some powerful ways to de-politicize what might otherwise become a seriously destructive experience. For example:

Assessing candidates against specific criteria tied directly to the organization's strategic, organizational and cultural requirements helps to reduce the influence of purely subjective factors such as image and reputation;

- Explaining to the candidates that during the selection process they will be evaluated on their collaborative behavior and their focus on enterprise rather than self helps to keep candidates on their best behavior and discourages political maneuvering;
- Gathering data from multiple sources (peers, direct reports, etc.) creates a broader sense of accountability that encourages candidates to do more than just deliver numbers or impress their boss;
- Positioning the process as a developmental intervention involving the entire senior team demonstrates a broad commitment to senior-level professional growth while, at the same time, providing individuals with clear insights as to why they are—or are not—viewed at this moment as viable candidates for particular jobs; and
- Focusing on career development for the entire team opens the door to developing attractive opportunities for valuable candidates who might otherwise leave once they see they're not likely to be next in line for the top job.

Consider, for example, the succession situation at a large healthcare company. The CEO believed that two members of his senior team would be strong candidates to succeed him; the board wasn't

so sure. Yet the CEO was reluctant to begin a selection process that would inevitably turn into a horse race and, he feared, destroy the team environment he had worked so hard to create. The last thing he wanted was to see his top performers start focusing more on themselves than on the company. Finally, he was worried that starting the process too soon would hasten the day when he might lose one of his top people.

The board, while sympathetic to those concerns, insisted that it was in the company's long-term best interests to launch the process with the help of experienced professionals. As a first step, the CEO sat down with each of the two leading candidates, in turn, and laid all his cards on the table: he described the context (the need to plan for his eventual retirement), the process to be used, and what would happen over the next two years. He told each who the other candidate was, and then made it absolutely clear that it would be a mistake to view this as a competition—to the contrary, “collaborative teamwork” would be a major consideration when the board evaluated the two candidates at the end of the process.

Did those conversations, and subsequent coaching support to each leader, ensure that the company would avoid all the potential pitfalls associated with horse races? Of course not. But they went a long way to surfacing the central issues and managing the inevitable politics underlying the succession process.

The Emotional Component

There is usually some emotional component present in any transition situation, but it absolutely permeates the CEO succession process from start to finish.

The most obvious manifestation is the situation we discussed earlier: CEOs' resistance to “letting go” of the powerful role that has become so central to their professional—and often personal—identity. For many, the prospect of life outside the C-suite ranges from terrifying to literally unimaginable. Not surprisingly, the notion of succession takes on such enormous emotional overtones that many CEOs will put it off interminably unless pressed into action by the board. And even after the succession process is finally in place, the board must keep

a sharp eye out for signs that the CEO is sabotaging the process, finding excuses to eliminate promising candidates and thereby start the process all over again.

A CEO's maneuvering to delay the succession process can play out in various ways. The CEO might be hypercritical of all potential candidates, subjecting them to endless scrutiny. Or, the decision can become clouded by unrealistic comparisons: the long-time CEO compares candidates to his own current performance, rather than stepping back and remembering what he was like at the moment he was selected as a novice CEO.

Consequently, he sets the bar so unrealistically high—and some board members, uneasy about having to deal with a new CEO, readily go along—that any candidate who doesn't have some CEO experience can't possibly hope to pass muster. In other cases, the CEO seeks ways to push the process farther into the distance by prolonging the succession process or even seeking changes in company by-laws to eliminate or extend retirement deadlines.

We have seen this scenario manifest itself time and time again—CEOs who are so reluctant to give up the job that they become, in effect, serial successor killers. The pattern became particularly conspicuous at a successful insurance company whose founder ran the company for more than two decades. As he entered his 70s, he kept repeating his history of positioning likely successors, then knocking them down once they had become viable candidates. The board saw what he was doing, but was reluctant to directly confront the founder. It took dramatically worsening business results for the board to finally decide it was time for him to leave. In retrospect, board members admit that they waited far too long—allowing their judgment to be clouded by personal loyalty and fear that no one else could run the place—and should have begun an orderly succession process years earlier.

The emotional issues extend to the CEO's choice of a successor as well. Typically, both the incumbent and the candidates have known and worked with each other for years, possibly decades. There might well be strong friendships, or bonds of loyalty, or feelings of obligation, or all of the above. CEOs often find themselves torn, weighing a candidate who has been loyal, steadfast, conscientious, and competent against someone with whom they share

little history but who has the potential to become a superstar.

Beyond that, the stakes are incredibly high for both the winner and the losers; those who lose out generally have to forget about the job or go somewhere else to find it. That is a heavy emotional burden for some CEOs to deal with as they think about a pool of candidates with whom they have long-term relationships.

The recent succession situation at a global manufacturing company clearly demonstrates the emotional component of the succession process, as well as the interplay of the other two components of succession dynamics. The CEO, who had been in his job for ten years and at the company for more than two decades, had become ambivalent about his own career plans. He was torn between going off to travel, write, and teach, on one hand, or staying a few more years to see through the strategy he had helped implement.

Complicating the issue was the absence of an obvious successor. Opinions varied regarding the strongest candidate, who was the current head of a major business. As part of a disciplined process, relevant data regarding the candidate was gathered and assessed; as a result, it became clear to the CEO and the board that the candidate had great strengths but was not the person to lead the enterprise. The result was that the board persuaded the CEO to stay for another four years and, in that time, to not only identify and develop other CEO candidates, but also to design an enhanced role that would keep the business leader committed to the company rather than leaving for an opportunity somewhere else.

The Rational/Analytical Component

This component comprises the rational aspects of CEO succession, and is strongly guided by the collection and analysis of objective data through an explicit and defined work process. It is all about gathering dispassionate, hopefully quantifiable data about each candidate's strengths and weaknesses and then matching those profiles against the explicit requirements of the job. Ideally, the process clarifies the trade-offs involved with each candidate, thus leading to a final selection decision based on objective evaluation of the best available data.

The problem is that all too few CEOs and boards have actually seen this kind of rational, analytical process in action. In their experience, the succession process is dominated by the political and emotional components. They have no firsthand knowledge regarding what the process could look like, how long it might take, how much work it might involve—and in the absence of that information, there is a strong tendency to assume that the work is too complex, too costly, too time-consuming. The flip-side of the argument, of course, is to look at the enormous cost to countless companies—including major global corporations—that failed to cultivate qualified leaders who were ready to become CEO when the company needed them.

The situation we recently encountered at a mid-sized investment bank was fairly typical. The company's CEO was in his mid-40s, doing a great job, and in perfect health. The last thing in the world he was interested in was a CEO succession process that would distract his team's intense focus on the business.

Furthermore, he really did not see a logical successor in the bunch—they were all highly specialized, and excellent within their specialties—and he saw nothing to be gained by rocking the boat and raising succession questions years before he was likely to move on. In other words, it just was not on his near-term radar screen. Nevertheless, some of his board members—particularly those who had experience at larger financial institutions that practiced sound corporate governance—were not satisfied.

At the very least, they said, the CEO needed to address the “what if you were hit by a bus” scenario. And so, with our help, and an exposure to what succession planning looked like at other companies, they set about the work of describing the criteria they would use to select a future CEO. They then designed a candidate identification and development process that could be triggered at some appropriate point in the not-too-distant future as the CEO grew more comfortable with the entire situation. All the while, the process was carefully positioned as good governance, with assurances that the business was fine and the CEO wasn't going anywhere.

At a larger financial institution we have worked with, the need to start thinking seriously about succession came to the fore as the company dramatically increased its size through a single acquisition.

Up to that point, the CEO had easily deflected the succession issue, and his board—delighted with his performance and reluctant to contemplate the implications of his departure—was happy to go along. But the sudden and dramatic increase in the organization's complexity in terms of size, globalization, and diversity of business activities created urgent concerns among board members about succession planning for all of the executive positions, including that of the CEO.

Prompted by board members experienced with succession “best practices” at other companies, the CEO engaged us to help design a leadership model based on future strategic and leadership requirements and then conduct multi-source assessments of the CEO and executive committee to create robust succession plans for all the top positions. Clearly, this was a situation where the rational/analytical component played a huge role. But as is often the case, it wasn't that simple or clear-cut; there was a decidedly emotional component as well.

One reason why the company had avoided creating a succession plan before the merger was that the CEO found it difficult to imagine a time when he would leave the company or, if he did, who might possibly be qualified to take the reins. The succession process we ultimately helped the board put in place resulted in the president—the CEO's likely successor—being given more responsibility and room to grow. The process worked; as the president grew into the job, the CEO grew more comfortable with the idea that one day he could actually leave with the confidence that the company was in good hands. Over time, the rational process for developing a potential successor through redesigned roles and responsibilities also became an emotional process that vastly increased the CEO's level of comfort with the notion of eventually letting go.

Conclusion

A sound succession process should take into consideration all three components—political, emotional, and rational/analytical—and, as a consequence, help to address and overcome the barriers that so often get in the way. What's more, our experience is that a well-developed and well-implemented succession process also provides additional benefits beyond the identification and

preparation of the next individual to lead the company. More specifically:

1. A process that enables the CEO and the board to explicitly identify the criteria they will use in selecting the next CEO can actually serve double-duty as a first step toward creating an overall “leadership model” to guide the recruitment, development, and selection of leaders throughout the organization.
2. The approaches, tools, and process used for CEO succession can be leveraged to initiate (or revamp) succession planning at other levels so that the organization is effectively building a pipeline of future talent.
3. The process helps the CEO enhance his relationship with the board, creating a deeper shared understanding about how the CEO adds value, how he should be rewarded, what he needs from the board, and what they need from him.
4. The process is an opportunity for a significant senior-team-building intervention involving the development of leadership models, design of

assessment processes, participation in assessment and feedback activities, and discussions of the organization’s future and its leadership needs. One of the foremost causes of dysfunction and poor performance among senior teams is the unspoken issue of succession, which often feeds competition, mistrust, and anxiety. Making succession a legitimate and natural part of the team’s work goes a long way toward demystifying and depoliticizing it, creating instead an opportunity to build trust, reinforce desired behavior, and engage the team in working together in new ways.

There is a consistent theme underlying this entire discussion, which is that every aspect of envisioning, planning, and implementing a transition at the top of the organization is fraught with complex dynamics. But failing to confront them doesn’t make them go away; they simply operate in the shadows, exerting a powerful but unmanaged influence on relationships and performance. In fact, it is precisely putting the issues on the table—which is undeniably difficult at first—that enables the CEO and the board to finally work together in ways that will protect the organization’s best interests.

Independent Board Chairs: A Trend Picks Up Speed

By Carol Bowie

A trend toward independent chairs—and away from lead directors—as the standard board leadership model is underway, according to the latest analysis of corporate board practices from RiskMetrics Group. The development is among several key trends identified in RiskMetrics Group’s recently released *Board Practices* study, which each year analyzes public disclosures of companies in the S&P 500, MidCap and SmallCap indexes (collectively the S&P 1,500).¹

The 2009 study reveals that fewer than half the companies studied had a lead director as of 2008, down eight percent in the last two years—and the first time since 2004 that this prevalence has dipped to a minority of companies. At the same time, the prevalence of board chairs separate from the CEO continued a slow, but steady, climb, rising to 46 percent in 2008 from 37 percent as recently as 2005. See Figure 1.

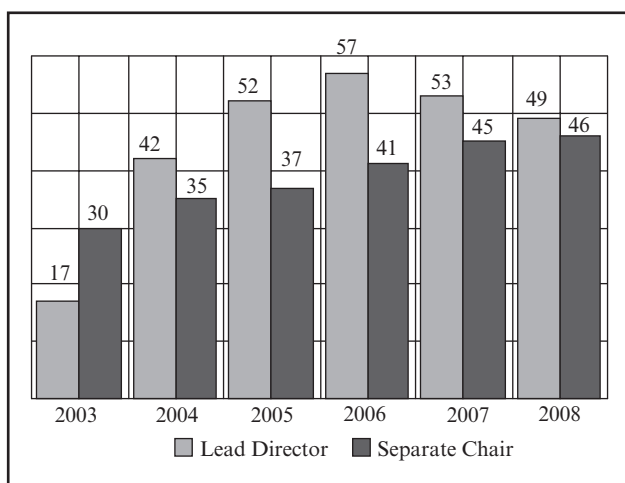
Of course, not all separate chair positions are permanent; some companies establish the structure temporarily during a CEO transition. And not all are independent—only 48 percent of the separate

chairs identified in the 2009 study were classified as independent directors by RiskMetrics’ standards (which are somewhat more rigorous than those of the stock exchanges). Overall, that means that 22 percent of study companies now have an independent board chair, up from 17 percent previously. Notably, the prevalence of companies with *either* an independent lead director or an independent chair has remained steady, at about 67 percent, for several years, suggesting that more companies are now choosing the independent chair model and eliminating their lead director positions.

The growing trend toward both separate and independent board chairs has no doubt been fueled in part by investor activism, which has persisted over the years despite modest voting support for related shareholder proposals (typically no more than 30 percent, on average). The issue gained new traction with the credit crisis, as some observers questioned whether stronger independent board leaders might have led to better oversight of risk management systems maintained by the homebuilders and banks that engaged in subprime lending.

One of the 2008 shareholder proposals seeking an independent board chair received majority support—at Washington Mutual, which responded by stripping CEO Kerry Killinger of the chairmanship, and subsequently firing him before the company collapsed into the arms of JPMorgan Chase. Similar shareholder proposals are expected to be numerous in 2009, and overall voting support may also rise.

Figure 1: Trends in Lead Directors Vs. Separate Chairs(%)



Source: 2009 Board Practices

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The Demise of Staggered Boards

Pressure on companies to elect all directors annually also continues, marking a sea change in board structure this decade. The number of companies with classified boards continued to decline in 2008 across all S&P indices, with just 50 percent overall maintaining them as of 2008. That is a two point drop from the prior year—and the first time on record that a clear majority of companies do not maintain a classified board. At this point, 64 percent of S&P 500 companies elect all directors

annually, compared to 43 percent at S&P MidCap companies and 44 percent among S&P SmallCaps.

Thus, the steady decline in classified boards among all S&P 1,500 companies can be attributed to a marked reduction in their use by S&P 500 firms. Again, the impact of shareholder activism is apparent, since the large caps attract disproportionate scrutiny and attention from activists of all stripes. From 1999 to 2007, S&P 500 companies dealt with roughly 275 shareholder proposals seeking to declassify the board, for example. During the same period, MidCap companies faced only 51 such proposals and SmallCap companies faced just 29.

Shareholder proposals to declassify boards have commonly garnered majority support for several years. During the first half of 2008, such proposals received over 67 percent support from votes cast “for” and “against,” on average, which is among the highest support level for any type of shareholder proposal. Over the past two years, activists have begun to push further down their portfolios to target smaller companies with board declassification proposals, suggesting a more significant dip in the prevalence of classified boards at MidCap and SmallCap companies will occur in the coming years.

More Emerging Trends

The 2009 edition of Board Practices tracks several other developments of interest to corporate governance practitioners:

CEO Succession Planning. Issuers are demonstrating the increased importance placed on CEO succession planning, with 88 percent now disclosing a board committee with formal responsibility for that function. This is up eight percentage points from 2007 and more than double the level in 2006. While it is not clear whether the latest trend reflects new committee responsibilities or simply changes in disclosure practices, there is no doubt that the prevalence of such committees has grown as investors have focused on CEO succession as a key board responsibility.

“Overboarding.” The latest statistics also indicate some increase in the proportion of directors holding multiple board seats within the study company universe. As of 2008, 83 percent of the individual directors tracked were serving on only one study

company board, while 13 percent sat on two, and four percent served on three or more of these major corporate boards. In 2007, 88 percent of the directors served on only one board in the study company universe, while just 8 percent sat on two. This is a reversal of previous trends and may reflect companies’ revived tendency to recruit “experienced” directors.

Lack of Diversity. That phenomenon may also help explain one stagnant trend: the persistent lack of diversity on boards, as measured by the prevalence of women and minority directors. Women, for example, continue to hold just 12 percent of all directorships, which is unchanged since 2005. The percentages of African-American, Asian, and Hispanic directors all rose slightly between 2007 and 2008, but overall minorities continue to hold just 10 percent of all directorships. That is unchanged since 2004, although it rose by one percentage point following a dip in 2007.

The explanation for this stagnation is not clear, but it is perhaps notable that shareholder activism on the issue has had little impact. Although the majority of shareholder proposals related to board diversity are ultimately withdrawn, few are filed in the first place—eight are pending so far for 2009 shareholder meetings, an increase from six in 2008, but down from a recent peak of just 16 filed in 2006. Further, investors have not significantly supported those proposals that come to a vote. That said, average support levels have been rising in recent years, from 6.9 percent in 2004, for example, to 21.3 percent in 2007. (Only two proposals came to a vote in 2008, with disparate results: 3.2 percent at Activision Blizzard, Inc. and 47.5 percent at Mueller Industries, Inc.).

A key finding from this year’s study does show that the proportion of companies with at least one minority director jumped from 37 percent as of 2007 to 43 percent as of 2008. This reflects an increase in the number of minority directors who were new to boards since the last edition of the study and are the only minority representation on those boards. Examples include new board members at computer maker Apple, financial services companies such as Safeco and ProLogis, and smaller firms such as Lee Enterprises, Jeffries Group and Sonoco Products.

Whether this change portends a more significant uptick in minority representation on boards in the

future remains to be seen. The 2009 board study did find more minority CEOs in 2008 (56) compared with the prior year (49) and far more than in 2006 (22). The number of female CEOs of study companies also climbed, from 35 in 2007 to 46 as of 2008.

Conclusion

The latest analysis of board and director attributes among S&P 1500 companies indicates that some key practices favored by most shareholders are taking hold, including annual director elections and establishment of formal independent leadership roles on boards. Further, the tide appears to

be turning away from the “lead director” approach in favor of separation of the chair and CEO positions. In recent years, boards have also recognized the need to acknowledge succession planning as a key responsibility. Director diversity, however, has essentially stagnated, even as women and minorities continue to push through the glass ceiling to top executive positions.

Note

1. The full 2009 Board Practices study, which analyzes numerous trends in board practices and director attributes (including benchmarks and company-by-company details), is available from the RiskMetrics Governance Bookstore at <http://www.riskmetrics.com/bookstore>.

Successful Board Meetings: Participation Begins Before the Meeting Starts

By Harold Weston

Newcomers to boards often believe that the board meeting is the sole conference time because ... well ... that is why there is a meeting. And because that is how they have seen it on the television and the movie scenes: important issues are first presented, wise experienced heads bring immediate critical perspicacity to the issues, hard questions are asked, cleverness brightens the atmosphere, positions are taken, scintillating discussion ensues and unanimous resolution results.

Experienced hands may have learned to expect tedium or futile bickering instead.

What is probably happening is that important issues are first presented at the meeting, thus catching directors off-guard; they then either nod and yawn and let the issue slip by, or react with startled hostility and sink the issue. Neither is a good outcome.

There can be many causes for unproductive meetings such as board organizational problems, imperial management, confused purposes of boards (micromanage or daydream about strategy), routine agendas, and so on, but the cause addressed here is the mistaken notion that board work is to be done only within the bangs of the chairman's gavel. This idea is especially prevalent in not-for-profit boards, which may be a person's first contact with a board of directors. Sorry—board work may be part-time work, but it is not time-bound work.

Board work requires preparation by every director. Review precedes debate. This means board members should be having informal conversations about major board items long before the meeting. Informal conversations in advance do not preempt the meeting nor curtail discussion nor turn the meeting into a transactional moment that mandates favorable votes.

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Nor do they eliminate the importance of executive sessions with the full board where a freer discussion takes place. Rather, the advance conversations can address minor questions, point out correctable errors, air doubts and facilitate adjustments, which can then lead to vigorous and thoughtful discussion on the important points of major items at the meeting. Without the advance work, doubts are not suitably addressed, adjustments cannot be made, and positions will harden quickly.

Early informal discussions can even avert the calamity of a trial balloon proposal - that if misjudged by the directors can be incinerated like a hydrogen dirigible, leaving the proponent singed. Informal discussions can also follow meetings, where it can carry out instructions and decisions already made.

Recommended Steps Before the Meeting

Here are some recommended steps to improve preparations before the meeting:

(1) *Tee-up.* For major issues that require the board to actually understand something of importance and complexity before acting (rather than just be informed about something), the chairman should consider introducing the issue at one meeting and deferring discussion and questions for the next meeting.

This gives directors an overview of the situation and time for study. Then at the next meeting useful discussion can occur. Maybe the issue should be referred to a standing or ad hoc committee for initial review and recommendations before return to the full board; or maybe to the executive committee. "Here's something important that is coming up. It has to be studied and worked up, but we want to let you know what the issue is so you can start to think about it. We will have the subcommittee do the initial assessment, with management, and next meeting they will report on the directions this is probably going. Anyone can work with the committee if they want."

This tee-up avoids surprises to the full board, and allows directors with an interest or knowledge in the subject to get involved early, rather than pounce later. Of course, not every issue needs to be foreshadowed to the full board. The point is not to expand to unnecessary work but to give necessary work the expansion it deserves.

(2) *Work-up.* Written materials need to go to the directors in sufficient time prior to the meeting. How much material is judgment and art, which is a fancy way of saying “it depends.” Too much and it will not be read, and the directors may suspect they are being given a snow job. Too little and the directors may suspect inadequate work-up or something is being hidden.

(3) *Read-up.* Now the directors need to read the materials—in advance. Directors cannot do their job properly if they only read the papers during the trip to the meeting or at the start of the meeting. Being a board member is not a walk-on part. Those great questions and energized discussions that seemingly erupt spontaneously in the movies are neither reality nor ideals. Movie scenes are not spontaneous: writers spent weeks thinking about the lines. Real people don’t do that; they usually need time to think, and they always do better when they have time to think.

If a director routinely relies upon his or her quick mind or inspiration to fully assess a complex issue in minutes, which others spent weeks analyzing, then that director should have brought his/her mental gifts to the work-up team long before the others plodded through.

(4) *Talk-up.* This puts us back to the mistaken notion of board meeting as sole conference event. The gavel bang is not the sole signal to discuss. On appropriate topics directors and the chairman should have informal discussions long before the meeting, not as a group but one on one, or small groups; in person over breakfast or drinks, or by telephone—whatever suits the personalities and problem. These should be conducted days or weeks in advance.

The pre-meeting informal conversations are vital to allow questions to be asked, doubts raised, preliminary views to be aired, directors brought up to speed, and sentiments gauged. As author Ram Charan writes in *Boards That Deliver* (about the

use of executive sessions, and which is true in these other informal settings): “The greatest value of executive sessions is that by lowering the hurdles for asking questions and expressing opinions and instincts, they give directors a chance to test their thoughts and insights among their peers By creating a candid and trusting atmosphere, directors can air their concerns before they become too acute and without sounding threatening.”

Does this sound like dirty backroom deal-making or back-channel communications? Deal-making stuff is left to politics, where something can be traded. In boards there is little to deal because directors generally do not represent different constituencies, (except where board seats are so designated, e.g. creditor representatives, labor representatives, and so). Even where directors are representing different interests, early discussion can facilitate understanding of director concerns.

As for back-channel communications, yes, that’s exactly what it is. The advantage for these communications is to balance doubts and improve the decision process before positions are taken. This is how things can and should work. “The reality is that

the Corporate Governance Advisor

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The **CORPORATE GOVERNANCE ADVISOR** (ISSN 1067-6171) is published bimonthly by Aspen Publishers at 76 Ninth Avenue, New York, NY 10011. Subscription rate, \$515 for one year. POSTMASTER: Send address changes to **THE CORPORATE GOVERNANCE ADVISOR**, Aspen Publishers, 7201 McKinney Circle, Frederick, MD 21704. Send editorial correspondence to Aspen Publishers, 76 Ninth Avenue, New York, NY 10011. To subscribe, call 1-800-638-8437. For Customer service, call 1-800-234-1660. This material may not be used, published, broadcast, rewritten, copied, redistributed or used to create any derivative works without prior written permission from the publisher.

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these members [senior management and directors], who are normally the most experienced in the firm, talk to each other a great deal outside the board meeting on strategic issues,” write Philip Stiles and Bernard Taylor, *Boards at Work. How Directors View their Roles and Responsibilities*. “Often these discussions will be the early test bed for future proposals, and agreement among the inner cabinet will ensure that a plan will be investigated further. In this sense, the inner cabinet is less a circumventing device against board procedure, or a subversive of the power of the board, than a key part of the informal strategic control process, where key directors will discuss progress and assess opportunities without the formality of convening either the exec committee or the board.”

Informal conversations may indicate the need for an executive session for all the directors to speak off the record.

Balancing Doubts and Positions

Two contrary concepts have to be balanced throughout the board review process: doubts and positions. Doubts are better. Doubts do not mean criticisms; here they mean questions, hesitancy, uncertainty, skepticism and “let me think about it.”

A director may have doubts whether he or she understands something. Perhaps the doubt is to the entire proposal, or some assumption or technical matter that is not within his particular expertise or the reason why this is important. These are very important doubts that should be spoken.

Maybe the director has missed something—better to get him or her to the starting line. Maybe the director has doubts that others have but no one wants to say in a roomful of people because “They’ll think I’m dumb for not knowing this.” That means a lot of smart people are keeping quiet about dumb things they vote to approve. A director might therefore call the chairman or committee chairman informally outside of the meeting and say, “I’m unclear on the company’s financials at this juncture. Maybe I’m just not knowledgeable enough about this stuff, but it’s confusing me, and I wonder if maybe some other directors are also confused. Could we get the financial officer to explain this again, or have the finance committee

take another look, or maybe get us non-financial types some training?”

That kind of question can help the chairman set the next agenda. Perhaps more importantly, it is just that type of question that can force others to look harder at something that is askew that was passed over, or can result in improved understanding for everyone in a second review, or point out the need for a training session for some directors.

Maybe the director isn’t sure whether the problem is her own, or in the proposal. She needs to find out where the problem is. This is an inquiry, not a dare. She may have found something that was overlooked in the proposal, such as some links missing in the analysis, or errors in calculation, or faulty assumptions, or unspecified assumptions. It is better to get the problem back to the originator before the board takes much time. This can be easier done in a committee or an informal conversation for some people. The proposal might then be withdrawn or re-worked. “I don’t understand how you get to that conclusion. Is there some assumption here that is not stated, or some context I’m lacking, or some data that is not yet in place?”

Writers Richard Hardin and Judith Roland in *Building Better Boards* have remarked that, “Perhaps the most critical rule that should govern board discussions is the simple notion that there are no dumb questions—and perhaps even more important, no dumb follow-up questions. That may sound silly, but the fact is that the corporate boardroom is a place where it’s sometimes incredibly difficult for someone to say, ‘I don’t understand. Please explain that again.’ After all, there’s a presumption that everyone around the table is smart, experienced, and sophisticated.” Leadership at the board should encourage this kind of questioning, the authors point out.

Thus, informal discussions allow doubts to be raised and embarrassment avoided, with the result that better decisions are made and board meetings are more effective. These informal conversations also allow positions to be tested and withdrawn. Maybe several directors have unfavorable positions, suggesting this idea isn’t going anywhere. The proponent might decide to withdraw the proposal as ill-conceived or ill-received. This spares the proponent embarrassment, which is important to foster cooperation and trust.

Whether this is best done in advance or at the full board debate or both is something that will depend on many factors.

Not just bad ideas get vetted in informal discussions. Good ideas, too, get vetted and gain advocates. “A board can con itself into unity and take a unanimous adversary stance to a proposal unless there is a lot of preliminary conversation on a one-on-one basis to develop advocacy for the idea within the board,” writes Peter Drucker in *Managing the Nonprofit Organization*. Thus advance spadework pulls out the weedy proposals and encourages the growth of the desirable stock.

Five Pitfalls to Avoid

Informal conversations in advance of a board meeting can have some pitfalls, and directors and the chairman should be mindful of these. One is turning informal pre-conferences into substitutes for the meetings. That is unfair to the organization and other board members, and thus instead of fostering effective meetings, it can foil them by turning the meetings into mechanical sessions that merely vote up or down on things already decided, without record of how that decision came to be. This could also violate state laws on the conduct of board meetings. Informal pre-conferences can also suggest the need for an executive session.

Another risk is that cliques or cabals can form where only some directors are regularly consulted. While not everyone on the directors’ phone tree needs to be contacted about everything—that would be burdensome without adding efficacy—beware of excluding people regularly. The goal is to develop trust and foster progress, not breed dissent and exclusivity, or develop a backroom power group. The chairman and the committee heads have reason to talk; a few directors dealing with some particular issues have reason to talk; committees’ members and their heads have reason to talk with other committee members about common items (for example, an investment committee with the finance committee, or personnel with operations—if the board is so organized); any director should be able to call any other director including the chairman about particular issues and concerns. While friendships and trust should develop from these external efforts, this should expand towards inclusiveness of the board, not shrink to a gossipy coterie of directors.

A third risk is undermining the chairman. Generally the chairman should know about any informal conferences of significance. This allows the chairman to monitor committee work, sense any problems that are developing before they turn into crises, and set the agendas based on this awareness.

A fourth risk is denying outcomes. If a decision has been made by the board, that decision (or resolution) is done. Sometimes a dissenting member wants to keep up his or her opposition, or a consenting member is more interested in the debate (the process) than the outcome. Other reasons to prolong the debate after a decision can also exist. Regardless of the reason, the board needs to move on, or in extreme cases go back and revisit the problem afresh. If the board meeting allowed for a fair exchange of views and the decision was made in due course, then the revisionist must either accept the decision or resign.

A fifth risk is e-mail. E-mail has risks and benefits in every organization from the staffer to the senior management, and is not a problem exclusive to board work. For one, we have too many e-mails to read, so adding more is already going in the wrong direction. Worse, it is not a total solution to communication and is no substitute for conversation. That said, let’s look at the risks particular to boards:

- Use e-mail to convey information such as facts, charts, supporting documents, or to convey information to a group.
- Do not use e-mail as a substitute for a conversation. The back and forth of e-mails is a scripted dialogue useful for some purposes, not a conversation. E-mails don’t communicate tone or sense very well. A self-doubt can be twisted into an admission. A questioning doubt can turn into criticism.
- Do not list questions that are really taunts. Often we list questions that we claim we want answers to, but in fact the questions are intended to shut down the issue. Thus the 20 questions a correspondent wants answered are intended to show that once the answers are given the proposition will be demonstrably wrong. This is intimidation, not inquiry. Unless the correspondent is willing to re-examine the positions when

the answers come back, he or she shouldn't proffer questions that are cloaks for position-taking.

- Once in writing an idea or statement is attributable. Tentative positions can be attacked or harden into pride of ownership. And e-mails can be forwarded inadvertently or maliciously.

Thus e-mails are a terrible way to do informal conferences that require sensitivity and receptivity.

“Real” Discussions at the Board Meeting

With small stuff out of the way on a proposal (the errors corrected, the assumptions made explicit, the data verified), and the directors having informed themselves about the subject, then a real board-level discussion can ensue at the meeting. In some situations the board discussion might be shorter on a topic than it would have been in olden days because the small stuff is out of the way. This can be desirable, with the acknowledged risk that the proposal might glide through because “we’ve chatted this up already.”

In other situations, the discussion might be much longer. In every event the discussion should be on the merits of the proposal, how it fits with the mission, goals and strategy, with the capabilities of the organization, the external operating environment, the organizational culture, the risk upwards and downwards, and other concerns which the expertise and judgment of the directors might bring to bear. These are big questions that go to both strategy and ability to execute – in other words, the governance function of the board. These discussions are hard to generate when, say, two members have no background to evaluate the proposal, two are struck dumb by the charts and numbers, one is double-checking the calculations, another is trying to recall some reported study or magazine article not listed in the appendix, and so on.

The Bottom Line: Confidence and Competence Building

In addition to improving board meetings by getting the small stuff out of the way, a second and equally strong reason for advance conversation is to facilitate conversation, information and trust, particularly about significant issues. Board chairmen should encourage informal conversations among the directors, which the chairman him- or herself should initiate. “I’m trying to get a sense of how the directors think about this idea. I don’t want a position or a decision, and you can change your mind, just a sense of what you think right now.” Directors should initiate conversations with the chairman, the committee heads, and with the co-directors.

None of this is to circumvent the chairman. Indeed, the chairman or committee chairman should probably be the hub around which many of these conversations take place. Further, every director—and especially the chair—must be ever mindful to avoid cabals developing from these off-the-record talks (as discussed earlier). Confidence, not a conspiracy, is to be built.

And none of this is to circumvent board process. Every board must comply with statutes and the organization’s bylaws so that meetings are held, minutes reflect issues addressed and the summary positions in favor and opposed board resolutions are properly made and recorded, and so forth.

Not every issue requires advance work and conversation. Often just reading the materials well in advance is sufficient, although some items require more. Preparation, then, is not just the chairman’s responsibility for setting the agenda and getting packets in place, and not the CEO’s or CFO’s in ginning up dazzling PowerPoint presentations, but a task for every board member. Thus tee-up, work-up, read-up and talk-up, as a simple phrase to direct the preparation, can accomplish a lot. Directors who therefore think their duties start when they walk in the boardroom should keep walking out the other door because they have already skipped half their workloads.

SEC No-Action Determinations: Different Fates for Individual and Institutional Shareholders and the Impact of Reform

By Beth M. Young

Shareholder proposals have come to play a key role in promoting corporate governance reforms at US companies and spurring dialogue between companies and shareholders. Each year, hundreds of proposals on a wide variety of topics are submitted to companies pursuant to the SEC's Rule 14a-8, which gives shareholders the right to submit proposals to be included in company proxy statements and voted on by shareholders at the annual meeting.¹

Many submitted proposals do not end up in the company proxy statement, though. Some proposals are not voted on by shareholders because the proposals are settled and withdrawn. Others do not appear in the proxy statement because the company was successful in obtaining a determination from the staff of the SEC's Division of Corporation Finance, which administers Rule 14a-8, stating that the staff will not recommend enforcement action for violation of the proxy rules if the company excludes the proposal from the proxy statement. Such a determination, often referred to as a "no-action letter," can be based on a procedural defect in the proposal submission or the fact that the substance of the proposal itself ran afoul of Rule 14a-8's strictures.

Reports on the 2008 proxy season noted two patterns in the SEC no-action process. First, companies sought no-action relief on a higher proportion of proposals in 2008 than in 2007.² Second, companies were more likely to obtain a favorable determination allowing exclusion this year than last year: A March 2008 analysis by RiskMetrics Group stated that the SEC staff had granted no-action relief in 69 percent of requests in 2008, compared with only 48 percent in 2007.³

Some activist investors have expressed concern that these trends reflect a shift on the part of the SEC staff to a less shareholder-friendly approach. Emboldened by the election of President Obama, whose SEC chairman Mary Schapiro is expected to expand shareholder rights, investors have begun urging the SEC to make the shareholder proposal

regime less, rather than more, restrictive. Certain hot-button substantive issues, including the staff-created rule that proposals addressing company risk are excludable as "ordinary business" and the recent shareholder proposal rule amendment barring proposals dealing with shareholder access to the proxy, are likely to be revisited.

But it's not clear that these kinds of substantive reforms would do much to change the no-action relief patterns seen in the last proxy season. To discern the reasons why proponents may have been less successful in the no-action process in 2008 than in 2007, we examined data from Board Analyst on no-action determinations at companies in our 3126-company coverage universe regarding determinations issued between November 6, 2007 and August 31, 2008.⁴

Our findings suggest that the success companies had in obtaining favorable determinations in 2008 was due only somewhat to the SEC staff's approach on substantive issues. A quarter of determinations granting relief were based on procedural shortcomings, which the SEC staff has historically approached in a consistent way—albeit a strict one, from the proponent's perspective. A significant number of proposals were deemed excludable because the companies had already taken action to implement the proposal. Substantial numbers of exclusions in several proposal categories were the result of drafting choices that can be easily remedied and not any fundamental problem with the subject matter of the proposal.

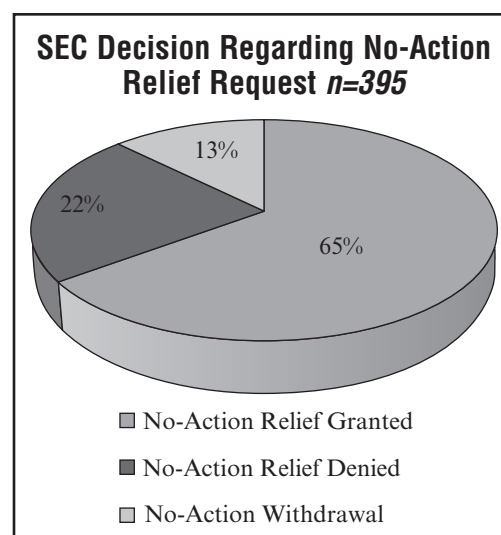
Activists' efforts to use the shareholder proposal process to address issues related to the credit crisis were, however, thwarted in many cases by the SEC staff on substantive grounds. Proposals on succession planning (focusing on the large financial services companies that experienced bumpy leadership transitions in 2007), credit policies and relationships between companies and credit rating agencies were all allowed to be omitted. Reforms pressed by activist shareholders would result in a different outcome for many of these proposals, as well as proposals dealing with risks related to climate change, whose proponents have been forced to draft around staff interpretive approaches in order to avoid exclusion.⁵

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Findings

In our coverage universe, companies made 395 requests for no-action relief. Of those, 256, or 65 percent, were granted, a somewhat lower proportion than was previously reported. (The difference may be due to the fact that we included events occurring after March 2008, the cut-off for the previous analysis.) The SEC staff received notice that 50 proposals, or 13 percent, had been withdrawn by the proponents; as a result, the staff declared the no-action requests moot and did not issue determinations. The staff denied 89 or 22 percent of the requests.

Companies experienced greater success in obtaining favorable determinations on proposals that fell into certain subject-matter categories. We categorized each proposal on which a no-action request was made using the same proposal categories affixed to proposals in our Shareholder and Management Proposals database.⁶



The mean number of requests in a category was 4.5. Included below in Table 1 are the proposal categories on which the SEC staff received at least five no-action requests:

Table 1: Disposition of No-Action Requests by Proposal Category

Proposal Category	# requests	% granted	% denied	% withdrawn
Director Conflicts of Interest	8	100.0%	0.0%	0.0%
Business Activities	8	100.0%	0.0%	0.0%
Executive Compensation—Cap or Limit Pay	18	88.9%	5.6%	5.6%
Cumulative Voting	14	85.7%	7.1%	7.1%
Credit Policies	13	84.6%	0.0%	15.4%
Board Declassification	13	84.6%	15.4%	0.0%
Call Special Meeting	29	82.8%	17.2%	0.0%
Simple Majority Vote	14	78.6%	7.1%	14.3%
Animal Welfare	14	78.6%	14.3%	7.1%
Board Elections—Majority Voting for Directors	11	72.7%	18.2%	9.1%
Political Contributions	6	66.7%	16.7%	16.7%
Board Leadership	12	66.7%	25.0%	8.3%
Product Safety	5	60.0%	20.0%	20.0%
Executive Compensation—Pay for Performance	6	50.0%	33.3%	16.7%
Environmental—Climate Change, Renewable Energy and GHG Emissions	30	46.7%	50.0%	3.3%
Executive Compensation—Advisory Vote	17	47.1%	35.3%	17.6%
Poison Pill	5	40.0%	40.0%	20.0%
Environmental—Land Use, Resources and Recycling	5	40.0%	20.0%	40.0%
Homeland Security Report	7	28.6%	42.9%	28.6%
Charitable Contributions	5	20.0%	40.0%	40.0%
Human Rights	13	15.4%	76.9%	7.7%
Health Care	14	14.3%	57.1%	28.6%
Shareholder Proposal Process	11	0.0%	0.0%	100.0%

Two of the five proposal categories with the highest proportion of exclusions were categories exclusively composed of new proposals, submitted for the first time in the 2008 proxy season. All eight of the proposals classified as Director Conflict of Interest challenged by companies were deemed excludable, as were all of the Business Activities proposals. Companies sought no-action relief on 13 proposals categorized as Credit Policies; in 11 cases, the SEC staff granted relief. (The other two proposals were withdrawn.)

We also found substantial differences in the no-action success rate depending on the type of proponent sponsoring the proposal. We categorized proponents according to the descriptions used in the no-action submissions, and these descriptions were most important where multiple sponsors were involved. For example, if a proposal had more than one sponsor but the no-action correspondence consistently referred to one sponsor as the “lead” or “primary,” or described the sponsorship as Fund A “together with” Investors B, C, and D, we used the category for that lead filer or Fund A as the proponent type for the proposal. In a few cases, it was not possible to identify a lead filer where multiple filers falling into different categories sponsored a proposal; those proposals are classified as “Multiple Categories.” Where the proponent designated another person to act as a “designated representative” or to act in a similar capacity, we assigned the category of the designee to the proposal.

Table 2 sets forth the proponent categories, the number of proposals with each type of proponent that was the subject of a no-action request and the

proportion of requests granted for each proponent type.

The number of proposals with Corporation, Multiple Categories and Native American Trust Fund proponent types was too small for meaningful analysis. Among the other proponent types, the variation in the proportion of proposals on which no-action relief was granted was significant. Individuals fared the worst—the SEC staff granted 76 percent of requests to exclude proposals sponsored by them. As discussed more fully below, a high proportion of Individuals’ proposals were found to be excludable on procedural rather than substantive grounds. Sponsors in the Non-Governmental Organizations or NGO category, which includes groups such as People for the Ethical Treatment of Animals, the National Legal and Policy Center and Global Exchange, saw the SEC staff grant 77 percent of requests to exclude their proposals.

Money Managers, Pension Funds and Unions occupied a middle ground, with just around half of their proposals deemed excludable. Religious and Foundation proponents were the most successful in the no-action process, with their proposals deemed excludable only 29 percent and 25 percent of the time, respectively. Religious investors, Unions and Pension Funds tend to sponsor a large number of completely new proposals; such proposals may be more vulnerable to exclusion because the language is untested and every potential company objection may not have been foreseen. However, Individuals’ greater likelihood of experiencing exclusion on procedural grounds and problems with proposal language used in some proposals where Individual

Table 2: Disposition of No-Action Requests by Proponent Type

Proponent Type	# requests	% granted	% denied	% withdrawn
Corporation	1	100.0%	0.0%	0.0%
Individual	204	76.0%	14.2%	9.8%
NGO	17	76.5%	17.6%	5.9%
Money Manager	54	61.1%	29.6%	9.3%
Pension Fund	53	60.4%	24.5%	15.1%
Union	23	47.8%	34.8%	17.4%
Foundation	8	25.0%	62.5%	12.5%
Religious	31	29.0%	38.7%	32.3%
Multiple Categories (no identified lead)	3	0.0%	66.7%	33.3%
Native American Trust Fund	1	0.0%	100.0%	0.0%

sponsorship is predominant, such as Call Special Meeting and Cumulative Voting (both discussed below), caused Individuals to fare more poorly even than sponsors of novel proposals.

Bases for Determinations Allowing Exclusion

When the SEC staff issues a determination granting a company's request for no-action relief, it identifies the ground for exclusion supporting the determination. Table 3 sets forth the bases cited in the 256 determinations allowing exclusion.

Procedural Bases

The frequency of exclusion on procedural grounds is notable. Approximately a quarter of the time, no-action relief was granted as a result of a procedural defect during the timeframe studied. The most frequently cited procedural basis was the failure of the proponent to prove eligibility to submit the proposal, which accounted for 40 of the 64 procedural exclusions or 63 percent.

Procedural problems were the cause for exclusion more frequently for individuals than other types of proponents. Thirty percent of proposals sponsored

Table 3

Subsection of Rule 14a-8	# requests	% of granted requests
PROCEDURAL		
(a)—submission not a “proposal” within the meaning of Rule 14a-8	1	0.4%
(b) and/or (f)—failure to prove eligibility to submit proposal	40	15.6%
(c)—violation of “one proposal” per proponent rule	1	0.4%
(e)(2)—proposal not submitted by deadline	13	5.1%
(h)(3)—failure to present prior proposal at company without “good cause”	9	3.5%
Total Procedural	64	25.0%
SUBSTANTIVE		
(i)(1)—proposal is not a proper subject for shareholder action under state law	2	0.8%
(i)(2)—proposal would cause the company to violate a state, federal or foreign law to which it is subject	9	3.5%
(i)(2) and (i)(6)—violation of law and company would lack the power or authority to implement the proposal	8	3.1%
(i)(3)—proposal would violate one of the other proxy rules, including Rule 14a-9's prohibition on false or misleading statements	24	9.3%
(i)(4)—proposal relates to the redress of a personal claim or grievance	2	0.8%
(i)(6)—company would lack the power or authority to implement the proposal	3	1.2%
(i)(7)—proposal deals with a matter relating to the company's ordinary business operations	80	31.3%
(i)(8)—proposal relates to an election to the board of directors or analogous body	4	1.6%
(i)(9)—proposal directly conflicts with one of the company's own proposals to be voted on at the same meeting	1	0.4%
(i)(10)—company has substantially implemented the proposal	41	16.0%
(i)(11)—proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy statement for the same meeting	8	3.1%
(i)(12)—proposal dealing with the same subject was voted on by shareholders at a meeting within the past five years and failed to achieve specified vote threshold	8	3.1%
(i)(13)—proposal relates to specific amounts of cash or stock dividends	2	0.8%
Total Substantive	192	75.0%
GRAND TOTAL	256	

by individuals on which the SEC staff granted no-action relief were deemed excludable on procedural grounds, five percentage points higher than the rate for all proponents taken together. Out of the 40 proposals where relief was granted for failure to prove eligibility, 30—or 75 percent—had been submitted by individuals.

The frequency with which individuals' proposals are excluded on proof-of-ownership grounds seems surprising, since Rule 14a-8's requirements are straightforward and explained in an easy-to-understand Q&A format. It may be the case, however, that individuals have greater difficulty persuading the record holders of their shares—the entity required under Rule 14a-8 to attest that the proponent has continuously held the requisite amount of stock for at least a year—to furnish a letter meeting Rule 14a-8's requirements. A bank or brokerage department servicing individuals may have less experience producing satisfactory proof-of-ownership letters than a custodian servicing institutional investors and may have less incentive to acquire expertise in this function.

In addition, the SEC staff granted relief on 13 proposals for untimely submission,⁷ and nine proposals were allowed to be excluded because the proponent had failed to appear at the annual meeting (or send an authorized representative) to present a proposal in the prior two calendar years.⁸ Although individuals sponsored only 46 percent of proposals deemed untimely, all of the proposals on which relief was granted for failure to present a proposal in the prior two calendar years had been submitted by individuals. (Indeed, one individual accounted for six of the nine exclusions on this basis.)

The compressed nature of proxy season, the large number of proposals submitted by certain individual proponents, the expense of traveling to distant annual meetings (whose location may not be consistent from year to year and thus may have been unknown when the proposal was submitted) and the fact that an individual does not have the staff employed by many institutional investors to share the burden of meeting attendance, may make it more likely that individuals will face a request for no-action relief on this basis.

Certain categories of proposal were more prone to exclusion on procedural grounds than others. As described in Table 1, proposals in the category of "Executive Compensation—Cap or Limit Pay" fared badly following a no-action request, with the

SEC staff granting nearly 89 percent of requests, or 16 of 18. The numbers alone might suggest that proposals to limit executive compensation are disfavored for some reason by the SEC staff or have been improperly phrased by proponents. All but one of the 16, though, were allowed to be omitted on procedural grounds. The SEC staff deemed seven of the proposals excludable because the proponents—all individual investors—had failed to prove their eligibility to submit proposals. Another eight proposals foundered because the proponent had not appeared or sent a representative to the annual meeting to present a proposal included in the company's proxy statement in the prior two calendar years or because the proposal had failed to obtain the necessary voting support in prior years.

Similarly, the SEC staff permitted exclusion of 85 percent of the proposals seeking board declassification for which no-action relief was sought, a surprisingly high rate for a proposal that is generally considered by proponents to be safe from exclusion because of its straightforward wording and the fact that it has been submitted (and subjected to no-action challenges) over many years. But this statistic should not be read to suggest that there are newfound substantive problems with this category of proposals, or a change in the staff's approach on the substance, because a majority of those exclusions were on procedural grounds: In four cases, the proponents had not proven their eligibility to submit the proposals, and the SEC staff permitted omission of two proposals on the ground that they had not been received by the submission deadline.

Substantive Bases

The substantive basis most frequently relied upon by the SEC staff was the "ordinary business" exclusion, which is often invoked by companies in response to environmental or social proposals, as well as proposals dealing with employee-related matters such as benefits and compensation. The purpose of the ordinary business exclusion is to prevent shareholders from using Rule 14a-8 to micro-manage day-to-day matters that are not well-suited to shareholder oversight.⁹

The SEC staff invoked the ordinary business exclusion in granting relief on 80 proposals or 31 percent of the proposals deemed excludable. The ordinary business exclusion was applied to grant relief on proposals falling into 36 categories, which are set forth in Table 4.

Table 4: Types of Proposals Deemed Excludable on Ordinary Business Grounds

AGM Conduct	2
Animal Welfare	3
Auditor Rotation	1
Business Activities	5
Communication with Shareholders	1
Credit Policies	11
Credit Rating Agency Relationships	4
Director Conflicts of Interest	7
Disclosure of Director Mailing Addresses	2
Dividend Reinvestment Program	1
Drug Prices/Availability	3
Embryo Research	1
Employee Compensation	1
Employee Concerns	1
Employment Discrimination	1
Environmental—Climate Change, Renewable Energy and GHG Emissions	5
Environmental—Land Use, Resources and Recycling	1
Environmental—Sustainability and Other General Reporting	1
Environmental—Toxics and Pollution	1
ESOPs and Employee Pension and Benefit Plans	4
Executive Compensation—Restricted Stock	1
Executive Stock Sales During Buybacks	1
Health Care	2
Homeland Security Report	1
Litigation	1
Privacy Rights	1
Product Liability	1
Product Safety	3
Replace CEO	1
Shareholder Proposal Process	1
Risk Management	2
Sourcing from China	2
Succession Planning	4
Sustainability Board Committee	1
Tax-related Matters	1
Tobacco	1
TOTAL	80

Two new types of proposal, those categorized as Director Conflicts of Interest and Credit Policies, accounted for the largest number of exclusions on ordinary business grounds, with seven and 11 exclusions, respectively. All but one of the Director Conflicts of Interest proposals on which no-action relief was sought asked boards to adopt a policy addressing conflicts of interest involving board members with health industry affiliations, including conflicts associated with company involvement in public policy issues related to these affiliations. (A version that appeared only once among proposals in this study asked the company to require recusal by a director with healthcare-related conflicts.) The proposal was spurred by concerns that pharmaceutical and health insurance company executives were preventing companies on whose boards they served from taking steps to reduce healthcare costs.¹⁰

The SEC staff found that all of the Director Conflicts of Interest proposals could be excluded, citing the ordinary business exclusion for seven of the eight determinations allowing exclusion. (The remaining proposal was not submitted by the deadline.) The SEC staff reasoned that the proposal related to ordinary business because it dealt with companies' conflict of interest policies. Although it is debatable whether all aspects of a company's conflict of interest policy (including those applicable to directors) should be considered off-limits for shareholder involvement, this interpretation of the ordinary business exclusion was not new in 2008.

Three different proposal formulations, all focusing on the impact of the credit crisis, fell into the Credit Policies category:

- The first asked the company to disclose collateral and other credit risk management policies for off-balance-sheet liabilities and exposure in three specific areas.
- The second requested that the board report on the company's potential financial exposure as a result of the mortgage securities crisis.
- The third asked the company to constitute an independent board committee to investigate and report on the regulatory, litigation and compliance risks related to the company's mortgage lending business.

All three proposals were found to be excludable on ordinary business grounds, though the specific

reasons differed. The SEC staff reasoned that the second and third proposal formulations related to “evaluation of risk,” a characterization that has led to exclusion for proposals in many subject areas over the past several years. The first proposal formulation was deemed simply to relate to the companies’ ordinary business operations, without any elaboration.

The SEC staff also relied on the ordinary business exclusion in granting relief on two other proposal categories related to current events. All four challenged proposals in the Credit Rating Agency Relationships category, which suggested best practices for companies in dealing with ratings agencies, were deemed excludable. Similarly, the SEC staff found that the four Succession Planning proposals on which relief was sought could be omitted in reliance on the ordinary business exclusion.

The frequency with which the SEC staff invoked the ordinary business exclusion reflected its popularity in company requests for relief. Of the 89 requests denied by the SEC staff, ordinary business

was cited in 45, or 51 percent; among all requests on which a determination was issued (granted or denied), which totaled 345, companies made arguments based on ordinary business in 126 requests or 37 percent of the time. Table 5 sets forth the 17 proposal categories into which these unsuccessful requests fell.

The second most frequently invoked substantive basis for exclusion was “substantial implementation.” The purpose of this ground is to avoid including in the proxy statement proposals that ask the company to do something it has already done. Approximately 16 percent of granted no-action requests (41 of 256) relied on this basis. Table 6 sets forth the 14 categories of proposals in which exclusion was based on substantial implementation.

It may seem odd that such a high proportion of proposals would end up being excluded on substantial implementation grounds, given that proponents presumably research the companies at which they submit proposals to ensure that they are targeting appropriate companies. To be sure, proponents do sometimes make mistakes and submit proposals at companies where the requested reform is already in place.

Table 5: Types of Proposals Where SEC Staff Rejected Arguments Based on Ordinary Business

Animal Welfare	2
Board Elections—Director Qualifications	1
Charitable Contributions	2
Environmental—Climate Change, Renewable Energy and GHG Emissions	9
Environmental—Sustainability and Other General Reporting	3
Executive Compensation—Advisory Vote	1
Executive Compensation—Pay for Performance	1
Executive Stock Sales During Buybacks	1
Health Care	8
Homeland Security Report	2
Human Rights	7
Legislative and Public Policy Advocacy	1
Lending Practices	3
Militarism and Violence	1
Report on Manufacturing by Licensees	1
Strategic Alternatives	1
Supply Chain	1
TOTAL	45

Table 6: Types of Proposals Excluded on Substantial Implementation Grounds

Animal Welfare	2
Board Declassification	4
Board Elections—Majority Vote for Director Elections	3
Board Leadership	1
Call Special Meeting	7
Disclosure of Bylaw Changes	1
Disclosure of Director Meeting Attendance	1
Employee Concerns	1
Environmental—Climate Change, Renewable Energy and GHG Emissions	5
Environmental—Toxics and Pollution	1
Executive Compensation—Stock Options	1
Homeland Security Report	1
Poison Pill	2
Simple Majority Vote	9
TOTAL	39

However, three other factors are more important in explaining the frequency with which proposals are excluded on this basis. “Substantial” implementation does not mean that the company has to have done exactly what the proponent requested. The proponent and company may disagree on whether substantial implementation has been achieved; if the SEC staff sides with the company, the proposal can be excluded. For example, a proposal at Caterpillar asking the company to produce a “global warming report” was deemed substantially implemented over the proponent’s objection that Caterpillar’s sustainability report did not assess the impact of Caterpillar’s initiatives on global climate, including mean temperature and undesirable climatic and weather-related events, as the proposal had requested.¹¹ This line-drawing by the SEC staff, which has at times been controversial, accounted for a minority of the determinations granting relief on substantial implementation grounds this year.

In addition, a shareholder proposal can be considered substantially implemented if a management proposal taking the action sought in the shareholder proposal will appear on the proxy statement for the next annual meeting.¹² So, a company may exclude a proposal seeking board declassification if shareholders will be given the opportunity at the next annual meeting to vote on a charter amendment declassifying the board. At the time a proponent is required to submit the shareholder proposal—approximately four months before the proxy statement is to be filed on EDGAR and mailed to shareholders—the company may not yet have announced its intention to implement the proposal. Indeed, the board may decide to put up the management proposal in response to receiving the shareholder proposal. Three of the four board declassification proposals and five of the nine simple majority vote proposals excluded as substantially implemented were mooted by upcoming shareholder votes on management proposals to make the requested change.

Similarly, where shareholder action is not required to implement a proposal—such as where a board-adopted bylaw or policy can be used—a proposal may be excluded because the board has responded to the shareholder proposal by taking the action requested in it. This was the case, for instance, with two of the three proposals on majority voting for director elections and the

Executive Compensation—Stock Options proposal the SEC staff determined were excludable due to substantial implementation. In this way, more determinations allowing exclusion on substantial implementation grounds may be evidence of progress in promoting governance reforms rather than a more restrictive attitude on the part of the SEC staff.

Other Bases of Interest

In the 2008 proxy season, the SEC staff allowed companies to exclude a significant number of “tried-and-true” corporate governance proposals such as Call Special Meeting and Cumulative Voting due to drafting problems. Of 14 cumulative voting proposals companies sought permission to exclude, the SEC staff denied relief on only one, where the bases for the request were solely procedural. Twelve proposals were excluded on the ground that they would cause the companies to violate state law and/or were beyond the companies’ power to implement because of state-law constraints.

The proposals asked that “the board” adopt cumulative voting. The companies argued that state law does not permit the board to adopt cumulative voting unilaterally; rather, shareholders must approve a charter amendment to afford cumulative voting. The proponents unsuccessfully countered that the proposal should be read as asking the board to “take the steps necessary” to provide cumulative voting, including submitting a management proposal amending the charter to afford cumulative voting for a vote of shareholders at the next annual meeting. Such language is commonly found in proposals, such as those seeking board declassification, where shareholder action is needed in addition to board action. The SEC staff declined to read in this language, and allowed companies to exclude the proposals. It seems likely that the proponents will add the necessary language before submitting the proposals again next year, so companies obtained only a one-year reprieve from including these proposals in their proxy statements.

Likewise, of 29 proposals asking that shareholders be given a right to call a special shareholders’ meeting not less restrictive than the right afforded by state law, the SEC staff allowed companies to exclude 24. Three were excludable on procedural

grounds, and seven on the ground that they had been substantially implemented.

The SEC staff cited Rule 14a-8(i)(3), which allows omission of proposals that violate the Commission's other proxy rules, in 12 of the determinations. Specifically, the SEC staff sided with the companies that the proposals were false or misleading (and therefore in violation of the SEC's Rule 14a-9) because they falsely implied that the companies' special meeting rights were more restrictive than state law. This argument was compelling in the case of Delaware-incorporated companies because Delaware affords shareholders no right to call a special meeting; thus, it would not be possible for any company's own right to be more restrictive than Delaware law. As with the cumulative voting proposals, these proposals will likely resurface next proxy season with the kinks worked out.

Conclusion

Aggregate statistics regarding the disposition of no-action requests in 2008 conceal the existence of two disparate phenomena. Individual shareholders saw their proposals excluded on procedural grounds at much higher rates than institutional investors, and individuals sponsored the bulk of proposals excluded on substantive grounds because of drafting problems. It seems unlikely that a new, more shareholder-friendly administration in Washington will have much impact on these kinds of exclusions.

Proposals submitted by institutional shareholders, however, were more likely to be omitted on substantive grounds, especially the ordinary business exclusion, that are not amenable to easy drafting fixes. A change in the staff's interpretive approach, which activists are urging the new administration to pursue, could significantly lower companies' success rate in obtaining favorable determinations on several categories of proposals.

Notes

1. See Georgeson Annual Corporate Governance Review 2007, at 13.
2. Subodh Mishra, "Spike in No-Action Requests Worries Investors," Mar. 26, 2008, available at http://blog.riskmetrics.com/2008/03/spike_in_noaction_requests_wor.html.
3. *Id.*
4. We do not collect data on proposal submissions, which are not subject to any uniform public disclosure requirement.
5. See Robert Kropp, "Investors Ask Obama to Improve Corporate Financial Disclosure," SocialFunds.com, Dec. 23, 2008 (available at <http://www.socialfunds.com/news/article.cgi/2600.html>) (discussing letter from 60 investors asking the Obama Administration to rescind a staff interpretation of the ordinary business exclusion to allow proposals dealing with the evaluation of risk to be included in company proxy statements).
6. A few proposal types have not been assigned a category in our database because no proposal of those types has appeared in a company proxy statement. (We enter in our database only proposals that appear in proxy statements.) In those cases, we developed a category to describe the proposal for purposes of this study.
7. Rule 14a-8(e)(2) provides that "[t]he proposal must be received at the company's principal executive offices not less than 120 calendar days before the date of the company's proxy statement released to shareholders in connection with the previous year's annual meeting." Special rules apply if the company did not hold an annual meeting in the previous year or if the date of the annual meeting has been changed by more than 30 days from the date of the previous year's meeting.
8. Rule 14a-8(h)(3) states that "if you [the proponent] or your qualified representative fail to appear and present the proposal, without good cause, the company will be permitted to exclude all of your proposals from its proxy materials for any meetings held in the following two calendar years."
9. See Exchange Act Release No. 40018 (May 21, 1998).
10. Press Release of AFL-CIO Office of Investment dated Oct. 5, 2007 (available at <http://www.aflcio.org/corporatewatch/capital/upload/Healthcare%20Director%20Conflicts%20Press%20Release%202010-5.pdf>).
11. See Caterpillar Inc. (publicly available Mar. 11, 2008).
12. Shareholder approval is required for any change that must be accomplished through a charter amendment and for changes that are made through a bylaw amendment under some circumstances.

Securities Lawyers: Beware of Clarity

By Michael H. Friedman and Joshua Ashley Klayman

From their very first law school classes, lawyers are taught to research and rely upon precedent when determining how to interpret a given law. Litigators learn early that a statute is given its meaning by the cases that test it, not just by the treatises that explain the statute's rationale or the legislative history that accompanied its adoption.

For securities lawyers, precedent appears in the form of prior debt and equity financings, mergers, tender offers and other capital markets transactions. Another source of precedent is found in transaction-based guidance provided by the US Securities and Exchange Commission (the SEC), as well as by the rules and regulations promulgated thereby. The "precedent" transactions and SEC interpretations that guide securities lawyers ultimately may not serve as binding precedent in court if litigation ensues. Nonetheless, it is understandable that securities lawyers look to "peer" transactions and SEC guidance when reaching a judgment that a particular transaction complies with securities laws.

One challenge when assessing securities law compliance is that, despite similarities or "resemblances" among capital markets transactions, most transactions include features, or reflect circumstances, that could differentiate significantly any one from the others. Perhaps, for example, in one transaction, the issuer is a "well known seasoned issuer," whereas in another seemingly similar transaction, the issuer only recently completed its initial public offering. Or, maybe, in one transaction, an operating subsidiary issues unsecured debt without a parent guaranty, while in another transaction, an operating subsidiary issues unsecured debt that is guaranteed by the parent.

In the absence of SEC guidance that is directly on-point, how is a securities lawyer to know whether and when such "transaction differentiators" change the result, or matter at all? How can a securities

lawyer first identify those transaction features that make a difference and which, if not addressed, would expose a transaction to challenge from the SEC or an aggrieved stockholder?

Securities lawyers are faced with these difficult questions every day. It is no simple or easy task to research and analyze every recent "precedent" transaction, let alone to consider all of the nuances thereof. For that reason, when the SEC has spoken on a given topic, it is tempting to rely on the SEC's clear words as authority when assessing legal compliance. Even when the SEC has addressed a particular issue, when counseling clients, corporate practitioners must be careful to identify the limits on inferences that can be drawn from such SEC guidance and to learn to recognize transaction aspects that can alter the compliance analysis.

The SEC's Division of Corporation Finance (the Division) typically provides guidance, in the form of no-action letters and interpretive advice that is limited in scope to the facts presented to the Division. Moreover, the Division specifies that the guidance provided in the no-action letters is to be relied upon only by the addressee of the no-action letter and not by other parties, and the Division often in the no-action letters states that the Division expresses no opinion as to the merits of the analysis provided by the party that submitted the no-action letter. In this way, even the Division's clearest explanations often are narrow in scope and do not address all of the transaction variables or provide an overarching framework that is generalizable to other potentially analogous transactions. Identifying relevant "transaction differentiators" requires a close textual reading of applicable rules and regulatory interpretations, but attention to detail is not enough. Imagination and expanding the scope of one's analysis beyond the written words also is required.

Consider the Division's Compliance and Disclosure Interpretations, Securities Act Section (November 26, 2008 Update) (the CDI). The CDI uses a straight-forward "question and answer" format, with the intention to simplify and address head-on many recurring issues encountered by securities lawyers. Each presented scenario, and the

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accompanying answer, is concise, fact-light, and, on its face, clear. Indeed, the brevity of each “Q&A” is enticing, for it seems to indicate that the guidance provided by such “Q&A” may be applied to a variety of transactions.

Because the questions posed are drawn from actual transactions, however, it is challenging for one to discern, or divine, the SEC’s rationale that underlies each scenario. Without a comprehensive framework or decision tree that maps the SEC’s analysis, it is unclear how much, and in what ways, each proposed transaction can be modified before the Division’s guidance no longer applies. One cannot be certain in what circumstances one must look beyond the text of each “Q&A,” and real transactions, unlike those appearing in the CDI, are fact-intensive. In that way, the clarity provided by the CDI may be deceptive. Corporate practitioners are well advised to consider SEC guidance, such as the CDI, not as containing the answer as to whether a transaction complies with securities laws, but, instead, as the baseline for their analysis and as one component of the applicable precedent.

Consider Q&A 103.01 of the CDI, addressing Securities Act Section 2(a)(3) to illustrate this proposition, which states:

“Question: If a company declares a dividend that is payable in either cash or securities at the election of the recipients, does the declaration of the dividend need to be registered under the Securities Act?

Answer: No, as there is no sale of the dividend shares under the Securities Act. [Nov. 26, 2008]”

If a client calls his or her corporate and securities counsel, explaining that the client wishes to declare a dividend that is payable in either cash or securities at the election of the recipients and asking whether the client needs to register such declaration under the Securities Act, based solely on Q&A 103.01, counsel might advise such client that, no, registration is not necessary, because there has been no sale of securities.

If the same client inquires as to why registration is not required, when the cash that is paid pursuant to the dividend could be used to purchase new shares, the counsel might conduct additional research and

identify SEC Release No. 33-929. SEC Release No. 33-929 states a conclusion that appears to hinge on the absence of “consideration” or (to use the terminology in Section 2(a)(3) of the Securities Act) “value.” Accordingly, counsel might advise the client that registration of the cash-stock dividend is unnecessary because, on the client’s facts, the stockholders are giving no consideration or value in exchange for the dividend shares. Counsel might explain to the client that the concept of consideration is broad and includes not only the giving of money but also, for example, the forbearance of a vested right to do or receive something.

The client, or counsel, then poses a follow-up question: If the absence of consideration and the logic set forth in SEC Release No. 33-929 underlies the Division’s rationale in Q&A 103.01 in determining what constitutes a sale, then why is a Section 3(a)(9) registration exemption available in the scenario described by Q&A 125.04? Q&A 125.04 asserts that a Section 3(a)(9) registration exemption is available for the conversion of preferred stock into common stock, even where a condition of such conversion is the waiver by the preferred stockholders of accrued but unpaid dividends on the preferred stock.

The final paragraph of SEC Release No. 33-929, states, in pertinent part,

“...upon the public declaration of a cash dividend out of surplus, the holders of the stock in respect of which the dividend is declared acquire immediately the rights of creditors of the corporation, and cannot be divested of these rights by subsequent action of the board of directors. If, therefore, there is declared a cash dividend payable to all stockholders, and if the board thereafter determines to grant to stockholders the opportunity to waive their pre-existing and vested right to payment of the dividend in cash, and to receive the dividend in the form of securities, the stockholders electing to take securities would in my opinion be regarded as giving value for the securities so received.”

Based on SEC Release No. 33-929, one might have thought that the preferred stockholder described in Q&A 125.04 would have been in the position of a creditor of the corporation and that the waiver by such preferred stockholder of the accrued but

unpaid dividends owed by the corporation to such stockholder would constitute the giving by such stockholder of consideration or “value.”

Section 3(a)(9) of the Securities Act provides the following exemption from registration:

“Except with respect to a security exchanged in a case under title 11 of the United States Code, any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;”

If, in Q&A 103.01, there was no sale because no consideration was given by the stockholder, then why doesn’t the waiver of a vested right to receive dividends constitute consideration (or, to use the language of Section 3(a)(9) “remuneration”), and, if it does, then how is one to explain this unanticipated result?

Read narrowly, Section 3(a)(9) would seem to posit that a security that is exchanged by a corporation with its existing stockholders is exempt from registration under the Securities Act, provided that no additional consideration is given for such exchanged security. If that is Section 3(a)(9)’s proper interpretation, then, in Q&A 125.04, it would appear that a condition to the Section 3(a)(9) exemption would not be met, because the waiver by the preferred stockholders of accrued but unpaid dividends on the preferred stock would have constituted additional consideration or “value” for the exchanged security. Accordingly, because the Division has indicated in that the Section 3(a)(9) exemption is available in the scenario described in Q&A 125.04, does that mean that the words “no commission or other remuneration” do not include “value” that is derived from and attributable to an exchanged security (e.g., the accrued and unpaid dividends), or, instead, does the Division’s answer indicate that Section 3(a)(9) should be construed even more broadly?

Finally, suppose that the client contacts counsel later in the week, explaining that the client now would like to declare a dividend that is payable in cash or securities, at the stockholders’ election, and wants to pro-rate the cash component if the aggregate amount of cash that the stockholders elect to receive exceeds a certain, predetermined threshold. Counsel might analyze the scenario under Q&A

103.01 and SEC Release No. 33-929 and determine that there still is no sale because the stockholders gave no value, and advise the client that registration of the election feature is unnecessary. Counsel would not be incorrect in his or her determination that the text of Q&A 103.01 is clear and unambiguous. The plain meaning of such Q&A seems to suggest that, absent a sale of securities, no registration is required.

Interestingly, issuers declaring cash-stock dividends that include formulaic proration features have registered such election features. The CDI, however, makes no mention of such “precedent” registrations. In the presence of seemingly on-point SEC interpretations and guidance, how does a securities lawyer infer the need to look beyond the four corners of the CDI? In the case of registration for cash-stock dividends with proration features, by what rationale would a securities lawyer counsel a client to register the election feature?

Securities lawyers are responsible for determining the correct answer. Identifying relevant “transaction differentiators” requires a close textual reading of applicable rules and regulatory interpretations and a mindset conditioned to asking “*what if*.”

Note what is *not* said in Q&A 103.01. For instance, there is no identification of whether the issuer is a “well known seasoned issuer”; indeed, there is no description of the issuer at all. There is no indication of whether the cash component of the cash-stock dividend includes a proration feature, nor is there any information concerning the magnitude of the dividend. For that reason, it is tempting to assume that Q&A 103.01 is generalizable across a multitude of issuers and across any number of cash-stock dividend transactions. In reality, this and other Q&As could be narrow in application and apply only to transactions where there are no “added characteristics,” such as proration features, or the answer may be somewhere in between.

It may be and often is difficult to determine at which point one reaches the end of a particular inquiry. Just as one researches case law in a contract dispute, however, one must carefully research recent “peer” transactions and filings and keep abreast of corporate governance periodicals and trends. As the scenario presented above demonstrates, the CDI should be viewed as a starting point, not necessarily the final answer. The final step may vary depending

upon the proposed transaction and may include requesting from the Division a no-action letter.

“Precedent” transactions may supplement, lead, and shape the law and potentially could result in new Division guidance. The Division’s rationale may not always be comprehensive and forward-looking, and, due to developments of new “transaction features,” laws, and other shifts, may not be

consistent over time. There may be important, yet unstated and even unconsidered, transaction features that would change the SEC’s answer. At what point can a securities lawyer be confident in counseling a client that a proposed scenario complies with securities laws? There is no easy answer, except that as securities lawyers, you must be vigilant. Beware of the easy answers that you find. Beware of “clarity.”

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