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Enhanced Shareholder Rights Under Dodd-Frank: Tools for Ensuring That Proxy Votes Are Informed and Independent

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gave investors additional rights and responsibilities. Investors now have the right to cast advisory votes on executive compensation (say-on-pay), the frequency of say-on-pay votes (say-on-frequency) and to approve certain "golden parachute" compensation arrangements in merger proxy statements. Moreover, shareholders were given the right to nominate director candidates directly on the company's proxy without going through the cost of staging a proxy contest (*i.e.*, access to the proxy), though the legality of this provision is currently being litigated.

One challenge for issuers in preparing for the enhanced shareholder rights under the Dodd-Frank Act is to better communicate relevant features of their compensation programs and modify pay practices in response to shareholder concerns, which will require companies to understand shareholder views. Communication between shareholders and companies about this and other board issues will become even more important with growing adoption of majority vote requirements for the election of directors and the likelihood that access to the proxy will eventually be implemented.

In light of the new rights and responsibilities issued to shareholders under the Dodd-Frank Act, many corporate issuers have expressed concern that proxy voting advisors will have greater influence over how shareholders vote on proxy issues. However, companies and shareholders have tools available to reduce the influence of proxy voting advisors.

Shareholder-Director Communication

Communication with long-term shareholders can be a very effective way for companies to meet the challenges presented by the Dodd-Frank Act. Long-term institutional shareholders often have a comprehensive understanding of the company's operations, governance structure, and performance and take time to listen, analyze, and ask insightful questions of the board and management.[1] By engaging with these shareholders, companies may identify key issues, address

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shareholder concerns and improve proxy disclosures. These measures will help shareholders make informed proxy voting decisions. Ultimately, it is in both companies' and investors' interests to ensure that shareholders have an accurate understanding upon which to base proxy votes.

Fifth Analyst Call

One way that has been suggested by institutional investors for companies to engage with shareholders is to hold what is called a "Fifth Analyst Call." The Fifth Analyst Call is modeled on quarterly financial analysts' calls and is proposed to serve as a dedicated company teleconference with shareholders. It would be focused exclusively on corporate governance issues reflected in the annual proxy statement. Because proxy issues typically involve the election of directors and matters that are board responsibilities (for example, executive compensation, selection of director candidates, approval of auditors, board leadership structure), proponents have requested that independent directors with oversight of those matters participate in the calls.

Shareholder Access to Independent Directors

Some companies may be hesitant to encourage the independent board chair or lead independent director to participate in shareholder interactions, such as Fifth Analyst Calls. One of the reasons cited is that directors might become overburdened by demands to participate in shareholder meetings.

However, long-term shareholders value directors that understand the material governance issues and have time to communicate their views to shareholders. This does not mean that the independent chair or lead independent director needs to be the primary point of contact or that other company personnel should not participate in shareholder-director engagements and provide guidance to the directors. However, it does mean that their presence and participation is of great importance to effective communication with shareholders.

Most boards that practice good governance have a shareholder-director communication policy and process in place, which includes identification of a board spokesperson from the independent directors and the development of board positions on governance issues in the proxy, so that the spokesperson can represent views that have been developed by the entire board (and not venture into personal views).

Companies that are not familiar with how to approach shareholder-director communications might benefit from what other directors with relevant experience have to say. In that regard, valuable insights are presented in the Second Quarter 2010 Issue of Directors & Boards.

Benefits of Shareholder-Director Communication

Educate Investors

Proxy statements are often drafted by the company's corporate counsel and are intended to satisfy legal requirements rather than communicate important information to the company's shareholders. Improved shareholder-director dialogue can help companies understand what issues are confusing to shareholders, answer questions, and learn how to do a better job writing transparent and understandable proxy disclosures. Improved disclosures would likely reduce the need for future shareholder engagement requests.

Obtain Valuable Insights

Dialogue with long-term shareholders can provide valuable insights to the board and management. Long-term institutional shareholders make their proxy voting decisions in the context of a deep understanding of the company's strategy, its current performance, and its potential to create long-term value. Many of those investors have dedicated significant resources to evaluating the company and have large holdings. McKinsey & Company encourages companies to focus on communicating with such "intrinsic investors" whose insights may add value to the company, rather than concentrating on mechanical investors or traders who may have little to contribute.[2]

Reduce Influence of Proxy Voting Advisors

The benefits of dialogue may become evident in results of proxy votes and through reduction of the influence wielded by proxy advisors. Long-term investors who have been able to engage with the board of directors and understand the company's governance choices are unlikely to blindly follow the recommendations of proxy voting advisory firms. Ongoing dialogue with those investors is one way for companies to reduce the influence of proxy advisors.

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Compliance with Regulation Fair Disclosure

Companies have sometimes hesitated to engage with shareholders because of fear of violating Regulation Fair Disclosure (Reg FD). Reg FD prohibits a company and its officers and directors from privately or selectively disclosing "material, non-public information" regarding the company or its securities to select market participants, including shareholders.[3]

Materiality

As a threshold matter, it is unlikely that information discussed during engagements with shareholders that is limited to proxy governance issues would qualify as "material" under Reg FD. Courts have generally treated information as "material" if there is a substantial likelihood that a reasonable investor would consider the information important to his or her investment or trading decision and disclosure of the information would have significantly altered the total mix of information available to the investor. The Securities Exchange Commission (SEC) has identified seven categories of information or events that have a higher probability of being considered "material," and corporate governance matters are not included.[4]

Strategies for Compliance

The SEC has made clear that shareholder-director communication regarding governance issues is not likely to be considered "material non-public information" covered by Reg FD. SEC Chairman Mary Schapiro made the following statement at the International Corporate Governance Network Conference in Sydney on July 15, 2009:

> Reg FD does not restrict communications between companies and their shareholders. Rather, it restricts selective disclosures of material nonpublic information. Reg FD was aimed...[at] the selective or private disclosure of material non-public information to certain investors who can use that information to make decisions to buy or sell stock ahead of other investors and the public. Reg FD does not prevent companies from seeking out and listening to the views of investors. Indeed the Commission encourages dialogue between companies and shareholders. I know of some investors who, prior to or at the beginning of individual meetings with company executives, clearly state that they do not want to receive material non-public

information. This seems to be a strategy that can keep Reg FD from becoming the focal point of discussion.

As stated by Chairman Schapiro, Reg FD does not restrict communications between shareholders and companies, provided that material, non-public information is not disclosed. As a practical matter, steps may be taken to reduce the likelihood of a Reg FD violation arising out of officer or director communications with shareholders. For example:

- Participants could develop an agenda that is limited to publicly available information and pre-approved by company or board legal counsel;
- Company or board legal counsel could participate in shareholder engagements to ensure that discussion does not turn to material, non-public information;
- If there is concern that the line was crossed, then shareholders could be asked to agree to keep material, non-public information confidential and not trade on it for a short period, to allow sufficient time for the company to make public disclosure;
- Companies could provide advance notice and webcast or post transcripts or recordings of shareholder meetings on their websites;
- Participants could be required to sign limited duration non-disclosure agreements and confirm internal firewall arrangements prior to the meeting, which would be operative in the event information identified as material, non-public information is inadvertently disclosed; or
- Interaction could be limited to hearing shareholder concerns.

These measures have been identified as "best-practices" in Reg FD compliance by the SEC's Investor Advisory Committee.[5]

With appropriate limitations, such as those described above, Reg FD should not prevent shareholders and companies from engaging in productive dialogue. Through ongoing engagement with long-term shareholders, companies may understand and address, shareholder concerns in advance of the annual meeting to ensure that shareholders' votes are informed and independent.

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[1]Robert N. Palter, Werner Rehm & Jonathan Shih, Communicating with the Right

Investors, McKinsey on Finance, Spring 2008, http://corporatefinance.mckinsey.com/_downloads/knowledge/mckinsey_on_finance/MoF_Issue_27.pdf.

[2] *Supra*.

[3] 17 C.F.R. § 243.100(a). Note 243.100 amended by 75 FR 61031 (but not (a)).

[4] *Selective Disclosure and Inside Trading*, 65 Fed. Reg. 51716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249).

[5] Investor as Owner Subcommittee, Investor Advisory Committee, SEC, *Proposed Resolution on Reg FD and Board-Shareowner Dialogue* (Feb. 22, 2010), available at http://www.sec.gov/spotlight/invadvcomm/iacproposedresregfd.pdf.