

AN OFFERING FROM BDO'S CORPORATE GOVERNANCE PRACTICE

BDO BOARD REFLECTIONS



CONSIDERATIONS FOR NOMINATING COMMITTEES

MUCH HAS TRANSPIRED AND CONTINUES TO CHANGE IN THE WORLD OF GOVERNANCE.

Numerous rules have been put into place by regulators since the enactment of the Sarbanes-Oxley Act (2002) and the passage of the Dodd-Frank Act (2010), including revisions to national stock exchange listing requirements. These rules, coupled with current proposals, are being designed to address the unease and unrest of shareholders and the public left by the global financial crisis and scandals that climb the corporate ladders right on up into the boardrooms. The onus has been thrust onto boards to ensure these rules are being followed to protect the future interests of the organizations that they serve.

In terms of corporate governance initiatives, demand for change has focused attention prominently on the audit, risk and compensation committees of the board¹. What about nominating committees of company boards? Selecting appropriate and qualified board members has become more important than ever. Independence continues to be emphasized and underscores the flurry of recent rule-making and legislation. Shareholders are becoming more and more vocal regarding board composition and are expressing discontent with simply allowing company executives to continue to hand pick board members. What should be the balance and what role should the nominating committee have?

BDO USA CORPORATE GOVERNANCE PRACTICE

BDO USA's Corporate Governance Practice was developed to provide guidance to corporate boards. The firm works with a wide variety of clients, ranging from entrepreneurial businesses to multinational Fortune 500 corporations, on a myriad of accounting, tax, risk management and forensic investigation issues.

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¹ For recent thought leadership in these areas refer to: <http://www.bdo.com/library/boardreflections.aspx>

► NOMINATING COMMITTEE RESPONSIBILITY

A nominating committee's primary responsibility is to lead the company's efforts to identify and ensure suitable members serve on the company's board of directors. Specific duties may include:

- Developing selection criteria
- Assessing current board composition and dynamics, including skills and competencies
- Anticipating current and future requirements (strategy, skills, relationships, experience, etc.)
- Ensuring periodic evaluation of the board
- Screening potential candidates
- Making hiring recommendations to the board
- Providing orientation for new board members

► REQUIREMENTS

Board nominating committee guidelines generally encompass composition, independence and disclosure requirements.

Both the NYSE and NASDAQ require listed company nominating committees to be:

- a) composed entirely of independent directors; and
- b) governed by a written charter

The NYSE specifically indicates that the charter address:

- the committee's purpose and responsibilities which, at minimum, must be to: identify individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; develop and recommend to the board a set of corporate governance guidelines applicable to the corporation; and oversee the evaluation of the board and management; and
- an annual performance evaluation of the committee.

For a listing of nominating committee disclosure requirements as required by the SEC for public companies, refer to the callout box.

► SHAREHOLDER PROXY ACCESS, NOMINATING AND VOTING ACTIVITY

How has recent shareholder, regulatory and legal activity affected the responsibilities and role of nominating committees? In addition to significant attention given to say on pay², golden parachutes³ and clawback⁴ measures, shareholders are currently focused on demanding more of a voice in the board selection process. The prospect of shareholder-nominated director candidates is sparking fears that nominating committees will not be able to thoroughly determine whether these candidates meet the specific qualifications required for service on company boards. Whether they are disgruntled with existing director composition (e.g., heavy representation on boards by those

The following summarizes the current SEC proxy statement disclosures for public companies:

- A statement as to whether the company has a standing nominating committee or a committee performing similar functions and, if not, why not;
- The following information regarding the company's director nomination process:
 - Whether the committee has a charter and instructions on how it can be accessed or if it does not have a charter then a statement to that effect;
 - Whether the members of the nominating committee are independent;
 - Whether the nominating committee has a policy with regard to the consideration of any director candidates recommended by security holders, a description of the material elements of that policy, which shall include, but need not be limited to, a statement as to whether the committee will consider director candidates recommended by security holders;
 - If the nominating committee does not have such a policy, a statement of that fact and a statement of the basis for the view of the board of directors that it is appropriate for the company not to have such a policy;
 - If the nominating committee will consider candidates recommended by security holders, a description of the procedures to be followed by security holders in submitting such recommendations;
 - A description of any specific, minimum qualifications that the nominating committee believes must be met by a nominating committee-recommended nominee for a position, and a description of any specific qualities or skills that the nominating committee believes are necessary for one or more of the company's directors to possess;
 - A description of the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether the nominee is recommended by a security holder;
 - With regard to each nominee approved by the nominating committee for inclusion on the company's proxy card (other than nominees who are executive officers or who are directors standing for re-election), a statement as to which one or more of the following categories of persons or entities recommended that nominee: security holder, non-management director, chief executive officer, other executive officer, third-party search firm or other, specified source;
 - If the company pays a fee to any third party or parties to identify or evaluate or assist in identifying or evaluating potential nominees, disclosure of the function performed by each such third party; and
 - If the company's nominating committee received, by a date not later than the 120th calendar day before the date of the company's proxy statement released to security holders in connection with the previous year's annual meeting, a recommended nominee from a security holder that beneficially owned more than 5 percent of the company's voting common stock for at least one year as of the date the recommendation was made, or from a group of security holders that beneficially owned, in the aggregate, more than 5 percent of the company's voting common stock, with each of the securities used to calculate that ownership held for at least one year as of the date the recommendation was made, identification of the candidate and the security holder or security holder group that recommended the candidate and disclosure as to whether the nominating committee chose to nominate the candidate, provided, however, that no such identification or disclosure is required without the written consent of both the security holder or security holder group and the candidate to be so identified.

² Say on pay refers to a shareholder's right to vote on compensation packages for company executives.

³ Golden parachute refers to an agreement between a company and an employee that establishes the employee's rights to certain, usually significant, benefits if employment is terminated.

⁴ Clawback refers to a provision within a compensation contract that allows a company to recover performance-based compensation to the extent it is determined that the performance goals were not achieved.

Regardless of where proxy access ends up, we encourage companies and their boards to look at existing policies/procedures for selecting board candidates and shoring these up to clearly define director qualification requirements.



with close-knit relationships with the CEOs and other top company executives) or simply want to promote their own interests through hand-picked directors, shareholder activists have the attention of legislators.

As such, in response to the Dodd-Frank Act as a means to help restore investor confidence, the SEC issued Exchange Act Rule 14a-11 (See SEC [Final Rule 33-9136](#)) in August 2010. The final rule provided that eligible shareholders may nominate director candidates in public company proxy materials, so long as there are no state or foreign laws or company's governing documents that prohibit such activity. Other limitations in the final rule included: a shareholder or shareholder group would have to have held 3 percent of the company's voting stock for at least three years prior to submitting a nomination and shareholders in the aggregate may not nominate more than 25 percent of the company's board or one nominee, whichever is greater. Additionally, nominating shareholders would have to certify that they are not acting with the intent to effect a change in control of the issuer. Read on for current status on this rule.

► CURRENT STATUS

In the fall of 2010, a lawsuit was brought by the Business Roundtable and U.S. Chamber of Commerce against the SEC as a challenge to the validity of SEC Rule 14a-11. As a result, the SEC had stayed the rule's effective date as well as related amendments to Rule 14a-8 (see below). On July 22, 2011, the U.S. Court of Appeals for the District of Columbia Circuit found in favor of the plaintiffs citing that "the SEC acted arbitrarily and capriciously by neglecting its statutory responsibility to determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, completion and capital formation."⁵ The court was particularly interested in how the rule impacted investment companies. As a result, Rule 14a-11 was vacated by the court.

The SEC had 45 days to seek appeal but had indicated in a statement released by Chairman Mary Schapiro on September 6, 2011 that instead the SEC would "carefully consider and learn from the court's objections."⁶ It remains to be seen what the SEC will do next with regard to this rule and just what this will mean for shareholder proxy access going forward.

In the meantime, along with the adoption of Rule 14a-11, the SEC also had amended Rule 14a-8 which was not affected by the court's ruling on Rule 14a-11. Under certain conditions⁷, Rule 14a-8 amendments prohibit companies from excluding from their proxy materials shareholder proposals that seek to establish procedures for the nomination of directors by shareholders. Prior to this, companies were allowed to exclude such proposals. The SEC had opted not to take further action and the amendments to Rule 14a-8 are in effect for the 2012 proxy season. In December 2011, Institutional Shareholder Services (ISS) issued a report itemizing proxy access resolutions filed by 16 U.S. companies to date⁸ and there are likely to be more. As part of its 2012 policy updates⁹, the ISS indicated it supports proxy access but will vote on a case-by-case basis on both shareholder as well as management proposals taking into account company- and proposal-specific factors, including:

- Ownership thresholds proposed in the resolution (i.e., percentage and duration);
- Maximum proportion of directors that shareholders may nominate each year; and
- Method of determining which nominations should appear on the ballot if multiple shareholders submit nominations.

5 Refer to: [http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/\\$file/10-1305-1320103.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf)

6 Refer to SEC Chairman Schapiro's statement at: <http://www.sec.gov/news/press/2011/2011-179.htm>

7 Refer to [SEC Final Rule 33-9136](#) for further information.

8 Refer to ISS report at: <http://www.issgovernance.com/sites/default/files/AccessProposals2012.pdf>

9 Refer to ISS "U.S. Corporate Governance Policy 2012 Updates" at: http://www.issgovernance.com/files/ISS_2012US_Updates2011117.pdf

► NEXT STEPS

As shareholders and regulators continue down the path demanding better governance and more transparency into the workings of corporations and, in particular, in the area of director and executive selection, the following are just a few of the many questions that company boards may wish to consider in the near term as an objective of achieving sound governance practices:

- If your board does not have a nominating committee, should it consider one?
- Who sits on the nominating committee? Should your company perhaps consider having additional representatives outside of the board (e.g., employee representatives or others who are in touch with critical stakeholders, etc.¹⁰)?
- How well do you know your shareholder base – that is, how engaged are your shareholders in proxy access?
- What measures might your company need to take in the near term to be able to proactively respond to shareholder proxy access solicitations?
- Consider succession planning for board members and executives – what policies and procedures are in place to ensure candidates exemplify critical qualities and characteristics needed for the ultimate success of the business?
- How might succession planning procedures be enhanced to address current economic risks and potential crisis being faced by many organizations?

BDO INSIGHT:

Regardless of where proxy access ends up, we encourage companies and their boards to look at existing policies/procedures for selecting board candidates and shoring these up to clearly define director qualification requirements. Going through this process enables streamlining of potentially costly proxy solicitations and assists in reducing some of the administrative elements that go along with enhanced proxy access by shareholders.

Perform an analysis of current selection criteria as compared to current and future board composition needs – align these with the company's strategies and risk management processes. Work directly with the compensation committee to ensure that potential compensatory packages offered to new board members and company executives are compliant and in step with current and anticipated regulatory compensation practices.

Be transparent in these initiatives – transparency and provision of insight into the workings of the board may go a long way in appeasing demands and concerns of shareholders.

For further BDO Corporate Governance thought leadership, including publications, webcasts and archived self-study courses on board and governance initiatives, please refer to *BDO Board Reflections* at: <http://www.bdo.com./library/boardreflections.aspx>.

¹⁰ Refer to February 14, 2011 *Business Ethics* article "Improve Public Trust: Transform the Nominating Committee" by Paul Strebler available at: <http://business-ethics.com/2011/09/27/improve-public-trust-in-your-company-transform-the-nominating-committee/>

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