

Priorities for the 2006 proxy season

Synopsis

In general, shareholder voices are likely to be heard in more boardrooms, more loudly, and more often. For proxy season 2006, the conversations will focus on **executive compensation** and **majority vote** for directors. Among the emerging issues that could impact the proxy season in 2007 and beyond are environmental disclosure and sustainable investing. Hedge funds are emerging as leaders in proxy battles.

Introduction

This issue of *InSights* has been developed to help board and audit committee members gain a deeper understanding of:

- The shareholder community's key proxy-related priorities for 2006
- Why these priorities were chosen
- What actions the shareholder community would like to see from directors

In January and February of 2006, Tapestry Networks spoke with 12 senior leaders drawn from the shareholder community, currently gearing up for the 2006 proxy season. Among these leaders were institutional investors, including pension funds and mutual funds, and the proxy advisory and governance ratings firms whose analyses and opinions may influence them. The 12 leaders were:

- Glenn Booraem, Principal Assistant Fund Controller, Vanguard
- Dennis A. Johnson, Senior Portfolio Manager for Corporate Governance, California Public Employees' Retirement System (CalPERS)
- Patrick McGurn, Senior Vice President and Special Counsel, Institutional Shareholder Services (ISS)
- Jim Melican, President, Proxy Governance
- Nell Minow, Editor and Co-founder, The Corporate Library
- Cynthia Richson, Corporate Governance Officer, Ohio Public Employees Retirement System (OPERS)
- Eric Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company
- Howard Sherman, Chief Operating Officer, GovernanceMetrics International
- Damon Silvers, Associate General Counsel, AFL-CIO
- Lynn Turner, Managing Director of Research, Glass Lewis & Company
- John Wilcox, Senior Vice President and Head of Corporate Governance, TIAA-CREF
- Ann Yerger, Executive Director, Council of Institutional Investors (CII), with Cambria Allen, Analyst

All interviews were given on the record, and interviewees had the opportunity to review their own comments before publication.

Executive summary

Shareholder leaders agree that most of the important issues for audit committees have been resolved in the last few years. They believe the Sarbanes–Oxley Act of 2002 has helped clean up American corporations, with some positive spillover effect on the public perception of audit firms. Said Howard Sherman of GovernanceMetrics International, *“Sarbanes–Oxley effectively eliminated a lot of bad practices. Audit firms are now going back to what they should have done: provide very diligent outside scrutiny. They are no longer distracted by trying to sell other lines of business to the companies they audit. They know that they work for audit committees today, not the management, which is a significant improvement in the governance process.”*

We identified two major priorities that the shareholder community has for the 2006 proxy season and that board directors need to focus on, as well as some key emerging issues.

- **Executive compensation** (page 3)

Shareholders have several objectives: linking pay more closely with performance and avoiding what one interviewee called *“pay for failure,”* ensuring the quality of general oversight, and encouraging transparency and disclosure. Some shareholder groups are pushing for companies to expand disclosure voluntarily, ahead of regulation or shareholder campaigns.

- **Majority voting for directors** (page 5)

This issue may be coming to a boil. Shareholder interest in majority voting for directors has increased significantly in the past two years. According to one respondent, there were virtually no proposals in 2004, and up to 60 proposals in 2005. Some analysts expect at least 80 majority vote proposals during the 2006 proxy season. However, not all shareholders agree. At least one opposes the idea for practical concerns: namely, what will happen if the board is decapitated or suffers a number of rejections?

- **Emerging issues** (page 6)

Shareholders also gave us a glimpse into their early thinking on the issues that will impact the proxy season in 2007 and beyond. Environmental disclosure and sustainable investing were the main issues mentioned. Increasingly, these issues are being viewed as corporate risks that should be addressed at the board level because of their potential for affecting long-term financial returns. Hedge funds and other financial participants are emerging as increasingly important influences on the proxy landscape.

- **Appendix A: How does the shareholder community determine its proxy vote?** (page 9)

- **Appendix B: The proxy process – how it works** (page 10)

Executive compensation

When members of the audit committee network have touched on the issue of executive compensation, the discussions have focused on the need for audit committees to interact more with compensation committees and to be aware of performance-based triggers in compensation packages that might tempt executives to engage in financial manipulation.¹ Shareholders' concerns over executive compensation are broader.

SEC-mandated disclosure

In January the Securities and Exchange Commission (SEC) proposed full disclosure of the total dollar value of an executive's complete compensation package, including stock-based awards, and clear identification of perks and severance arrangements.² This level of disclosure is in line with the desires of many of our interviewees. *"I always wanted companies to apply a platinum standard to disclosure around all things, including executive pay. We applaud companies that ... provide good plain-English disclosure in all aspects of communication,"* said Ann Yerger of the CII.

ISS's Patrick McGurn also praised the recent regulatory support for increased transparency: *"At the outset of 2006, investors were looking at a long struggle to upgrade compensation disclosure on a company-by-company, board-by-board basis. Now, with the flick of a pen, [SEC chairman Christopher] Cox has proposed a once-in-a-generation boost in disclosure. If adopted, these new rules will correctly calibrate the disclosure radar to capture forms of stealth compensation, such as Supplemental Executive Retirement Plans and perks that currently go undetected. While these new disclosures won't kick in until 2007, we're already tracking some boards that plan to front-run the rules by boosting transparency in 2006. Given the disinfectant qualities of sunlight, we expect that many of the worst abuses will disappear."*

Other respondents felt that even more disclosure is needed. *"SEC compensation disclosure rules are insufficient,"* declared Lynn Turner of Glass Lewis. *"The UK model is much better – investors have the right to vote on compensation plans."*

Many of the leaders we interviewed hoped that boards would understand the advantage of seizing the initiative rather than waiting for the issue to come to them. *"Companies would do well to follow those guidelines even before they are adopted,"* advised John Wilcox of TIAA-CREF. *"There will be pressure to try to conform this year."*

Pay for performance

The opinions of the shareholder leaders interviewed regarding executive compensation reflect the current climate. Howard Sherman remarked, *"Executive remuneration is at the top of the list for many. There is a growing sense that things have gotten way out of whack. Expect shareholders to withhold votes for*

¹ See for example, Audit Committee Leadership Network, "Audit committee emerging roles and responsibilities," *ViewPoints*, October 15, 2003, 3. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct03_View2.pdf

² Securities and Exchange Commission, "Executive Compensation and Related Party Disclosure," January 27, 2006. Available at: <http://www.sec.gov/rules/proposed/33-8655.pdf>.

directors who have served on compensation committees that have agreed to plans [that are] not clearly performance-based.”

Nell Minow of The Corporate Library minces no words, saying, *“In an overwhelming number of cases, the ROI on a CEO pay plan is the poorest [ROI] in a corporation.”* Ms. Minow believes excessive executive pay is *“the single most powerful indicator of governance risk. Many boards talk the talk, but if they don’t know how to say no to the CEO, they are in for big, big problems.”*

Shareholder leaders want to see a clearer connection between executive pay and company performance. *“[Our concern] comes down to poor management of a line item called ‘executive compensation.’ We have focused on executive compensation since the end of 2004 with an executive compensation strategic plan,”* stressed Dennis Johnson of CalPERS. *“Number one: we are not anti-pay. Number two: we are against pay for failure. We want to see executive compensation more closely linked to value creation for the company.”*

Jim Melican of Proxy Governance also noted a worrying tendency to reward poor performance: *“We have frequently found an inverse correlation between compensation and performance. Why is this? Corporate officers should not be very generously compensated, over and above their already substantial base salaries, for below-average or average performance. Why give huge financial bonuses for just doing their job? The sanction for over-compensating the executive is to withhold votes for the members of the compensation committee.”*

Mr. Melican feels that even boards alert to the compensation issue can be misled or confused. *“It is essential that members of the compensation committee understand that they can’t just listen to the presentation by [compensation consulting firms hired by management] about medians, etc., and just fall into line. All will be trying to ‘up the median,’ and the result is upwardly spiraling compensation.”*

And Mr. Melican shared a concern: *“Directors are not spending enough time getting behind the formulas to actually understand the numbers. When presented with a formula for compensation for the long-term compensation plan, they need to understand what is quantitative and what is qualitative and what can be manipulated. Directors clearly need to understand how all these things can interrelate. We really need an all-independent compensation committee with people who have time to do this right, not just other prestigious CEOs, who too often have a sense of noblesse oblige.”*

Some shareholders framed their concerns in purely economic terms, while others see the problem in broader social terms. As Damon Silvers of the AFL-CIO said, *“As a workers’ organization, we have a philosophical problem with the level of inequality in our society, but we also have specific reasons as investors that we are concerned with runaway CEO pay.”* In an efficient market, executive compensation should reflect the value those executives provide to shareholders. However, Mr. Silvers feels that boards do not always act independently and that in many cases, *“it’s not a market. It’s self-dealing that produces waste.”*



Audit committee members share concerns about executive compensation

- Many audit committee chairs see a link between the integrity of the financial statements and the executive compensation structure. In a recent network meeting, members said it was important for the audit committee to understand potential compensation liabilities as well as the timing of liabilities. In addition, “the audit committee should be totally familiar with the triggers for incentive compensation” so it can be sensitive to the potential for management to manipulate the financials to set off the triggers.³
- Several audit committee chairs suggested that the compensation committee chair should make an annual presentation to the audit committee regarding executive compensation plans and employment agreements.⁴ However, not all audit committee members agree with the value of overlapping responsibilities. As one audit committee chair said, “The audit committee shouldn’t be involved in CEO compensation. We don’t need two committees handling the same risk.”⁵

Majority voting for directors

The current policy of electing directors to corporate boards in most companies requires what is known as a plurality vote. Under this system, voters (shareholders) can either vote for a board candidate or withhold their votes. In effect, a single positive vote ensures that the candidate takes a seat, and shareholders lack the power to vote no. The majority voting movement seeks ways to allow voters to say no and thereby directly influence the composition of a board. Majority voting is currently possible only in companies with bylaws allowing it. Some majority voting advocates seek to change the bylaws of individual companies in this proxy season. Other activists are working to amend the Model Business Corporation Act to require all companies to abide by majority vote, although the American Bar Association has continued to support plurality voting.

Shareholder leaders feel that the emphasis on majority voting is both understandable and inevitable. Howard Sherman called the withhold vote “*a very weak tool*,” and said that “[*majority vote*] is the change that has the most potential to give institutional investors real influence in corporate governance. At a small but growing number of U.S. companies, directors who do not receive a majority of votes cast are required to submit their resignations for consideration by the board. In other companies, the standard is a majority of the shares outstanding. Interestingly, in some non-U.S. markets, all directors are forced to submit resignations prior to the annual meeting and can only rejoin the board if elected by a majority vote.” Mr. Sherman went so far as to predict that “*the majority vote will be a standard in the U.S. in the coming years.*”

Ms. Minow believes that the withhold vote, while not preferable to majority vote, is still a useful tool. “*I would have no hesitation to tell clients to withhold votes, whether or not there’s majority vote*,” she said, pointing out that insurers might not issue directors’ and officers’ policies to directors who do not get a

³ Mid-Atlantic Audit Committee Network, “The audit committee and the board: four keys to sharing responsibility,” *VantagePoint*, October 27, 2005, 5.

⁴ North Central Audit Committee Network, “Audit committee leadership: Balancing art and science,” *VantagePoint*, October 28, 2005, 5.

⁵ Audit Committee Leadership Network, “Shared responsibility: the audit committee and the board,” *ViewPoints*, December 20, 2004, 6.

majority of the votes cast in favor, and that the Delaware courts might not give such directors the benefits of the business judgment rule.

Glenn Booraem of Vanguard expressed reservations about adopting majority vote as the new standard: *“What is unique about majority voting is that it went from a fringe issue two years ago to an item of significant interest in 2005, with momentum moving into 2006. We [at Vanguard] continue to evaluate our position on these proposals. In the end, we want to ensure that the election process is characterized by responsiveness and accountability, but mindful of the potential unintended consequences of a failed election or a decapitated board.”* Fidelity is in the process of formulating its policy on majority vote. Executives at Fidelity want to know whether majority voting will increase shareholder value. Eric Roiter of Fidelity remarked, *“There isn’t one answer that applies to all companies. If it would directly enhance a company’s profitability, we would support it.”*

Mr. Booraem’s stance is similar to that put forward in a recent preliminary report of the American Bar Association (ABA), which states that wholesale acceptance of majority voting practices is unwarranted. The ABA’s Corporate Laws Committee instead recommends using tools such as company bylaws to change the way directors are elected at individual companies, if so desired.⁶

Some shareholder leaders disagreed with the ABA’s position. John Wilcox said, *“The plurality voting approach has led to problems, but the ABA says it can’t be changed. We need to start fresh with a simple majority vote default. If problems occur with a failed election, they should be disclosed to the shareholders. Let them vote – that’s the point.”*

Several interviewees thought that boards would be wise to get out ahead of possible proxy votes. *“On the eve of the proxy season, Intel and Dell pushed the envelope by rewriting their bylaws to create a majority vote standard,”* shared Patrick McGurn. *“Both boards gave teeth to these tighter vote requirements by adopting director resignation policies. These boards have set the gold standard in voting rights.”* In contrast, the SEC derailed efforts by two companies to block activist shareholders’ calling for a majority vote standard in director elections.⁷

Emerging issues

Shareholders also gave us a glimpse into their early thinking on the issues that will impact the proxy season in 2007 and beyond. The issues include improved environmental disclosure and sustainable investing. Some hedge funds are emerging as investors with increasing influence on the outcome of proxy battles.

Sustainable investing

A new paradigm around responsible investment is slowly emerging: generating superior returns while making explicitly socially responsible choices. The European Commission has urged companies to

⁶ Committee on Corporate Laws (American Bar Association), *Preliminary Report and Annex of the Committee on Corporate Laws on Voting for Directors* (Chicago: American Bar Association, 2006). Available at: <http://www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20060117000001.pdf>.

⁷ Phyllis Plitch, “Intel Gets Activists Nod with Majority-Vote Plan,” Dow Jones Newswires, January 20, 2006. Available at: http://money.excite.com/jsp/nw/nwdt_rt.jsp?section=news&feed=dji&src=704&news_id=dji-00088320060120&date=20060120.

voluntarily integrate social and environmental concerns into both their business operations and their interactions with shareholders: “Voluntary business initiatives, in the form of corporate social responsibility (CSR) practices, can play a key role in contributing to sustainable development while enhancing Europe’s innovative potential and competitiveness.”⁸

Given the global nature of capital markets and their key participants, such as investment banks, most of the shareholder leaders interviewed predicted this issue will hit the U.S. markets in the next few years. “*Around the globe, views on corporate social responsibility are changing in executive suites and in boardrooms,*” said Patrick McGurn. “*Many CSR issues – such as climate change and international labor standards – are viewed as potential risk areas. No sane board wants to become the poster child for global warming or human rights abuses – to simply ignore the evidence and pretend there is no risk. The CSR wave has arrived at our shores – it is going to crash down on directors who try to hide their heads in the sand.*”

However, there is some disagreement about how investors should respond:

- **Sustainable investing is an emerging priority:** “*We are looking for improved environmental disclosure. We are pushing for disclosure of regulatory compliance. For example, auto companies – looking at the quantity of CO₂ emissions – to what effect? What are you doing to reduce emissions? To incorporate effects of any unknown risk?*” said Dennis Johnson.
- **Sustainable investing is not a priority:** Eric Roiter shared an alternative viewpoint: “*People who seek to advance objectives other than enhancing shareholder returns may want shareholders to intervene in company affairs for a supposedly higher purpose. That is not our business model, and is not what we offer to our customers. Don’t look to us to act as if we are the government. Our focus, for our customers, is an economic one.*” Lynn Turner agreed: “*We will generally defer to the board on the softer issues, [such as] Green [issues or] political lobbying, unless the case is made for why the shareholder value is being impacted.*”

Hedge funds

In general, hedge funds seem to be raising awareness of shareholders’ ability to influence corporate actions – and to rearrange corporate boards. “*Proxy campaigns do need dedicated leadership. There is a bit of a free-rider problem here as it is hard to justify the time, energy, [and] expense when all shareholders benefit [from the efforts of a few]. Challenges could come from hedge funds [and aggressive individual investors such as] Carl Icahn...*” said John Wilcox. Howard Sherman agreed: “*A growing number of activist investor hedge funds use the proxy system to raise challenges.*”

Patrick McGurn described hedge funds’ leadership of shareholder activism: “*In the past 12 to 24 months, there has been a change of guard, and the leadership of shareholder activism has shifted away from public and union pension funds to hedge funds. There are about 8,000 hedge funds today managing more than \$1 trillion in assets.*” He continued, “*Hedge funds and other active investor vehicles put direct pressure on boards to change senior management, to improve governance, and to put more cash into shareholders’*

⁸ European Commission, “Corporate Social Responsibility,” http://europa.eu.int/comm/enterprise/csr/index_en.htm.

hands. If a board hasn't done a good job communicating the merits of its current value-creation strategy, long-term investors may look at these catalyst investors as knights in shining armor."

However, while many shareholder advocates recognize hedge funds' growing influence, some worry that their interests may not be aligned. Damon Silvers noted that hedge funds' short-term objectives are fundamentally different from those of long-term shareholders. Mr. Silvers said that in resisting the governance objectives of long-term shareholders, the corporate community has inadvertently created a vacuum into which hedge funds have been able to step. He argued that *"the people who run corporations know more than the people who trade, and they deserve some insulation in order to run the business."*

Conclusion

Ultimately, most shareholder groups would prefer a constructive dialogue with corporate management and board directors, and few seek to engage in an expensive, contentious proxy battle. As Damon Silvers said, *"Shareholders write letters, sponsor shareholder actions, vote no. In some cases, people will sue. However, these are all blunt instruments. In most ordinary situations, what we really want is to have a substantive conversation with the board about the issues that matter to us – a conversation that leads to action that is in the interests of the company."* Unfortunately, conversations between shareholders and corporate directors may be the exception rather than the rule. Although boards are more accountable to shareholders than ever before, shareholders say there are few effective mechanisms for shareholders and their representatives to engage in productive, trusted communication.⁹

Of course, communication does not automatically lead to agreement, and thoughtful, well-intentioned people may draw different conclusions. This is the nature of healthy discourse. However, a vigorous discussion of important issues will often lead to positive outcomes. Board directors might advise management to seek nuanced solutions to thorny questions of corporate governance. Otherwise, they could find themselves at the receiving end of the "blunt instruments" wielded by angry shareholders.

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committees. Initially, *InSights* will be distributed to network members, who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

The views expressed in this document represent those of the individuals who participated in the research. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.

⁹ For a more complete examination of board-investor communications, see Audit Committee Leadership Network, "Communication between corporate boards and investors," *InSights*, July 25, 2005. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Jul05_InSights7.pdf.



Appendix A – How does the shareholder community determine its proxy vote?

Different shareholder constituencies view themselves as having quite distinct issues. In the words of Cynthia Richson of OPERS, *“There tends to be a lumping together of all communities. From the socially and environmentally conscientious to hedge funds. We’re all different. It is unfair to lump us together. We [at OPERS] have a core mission. When we call [a board], it is for a reason. We act when we see a board of directors act against our interests and the interests of the company.”*

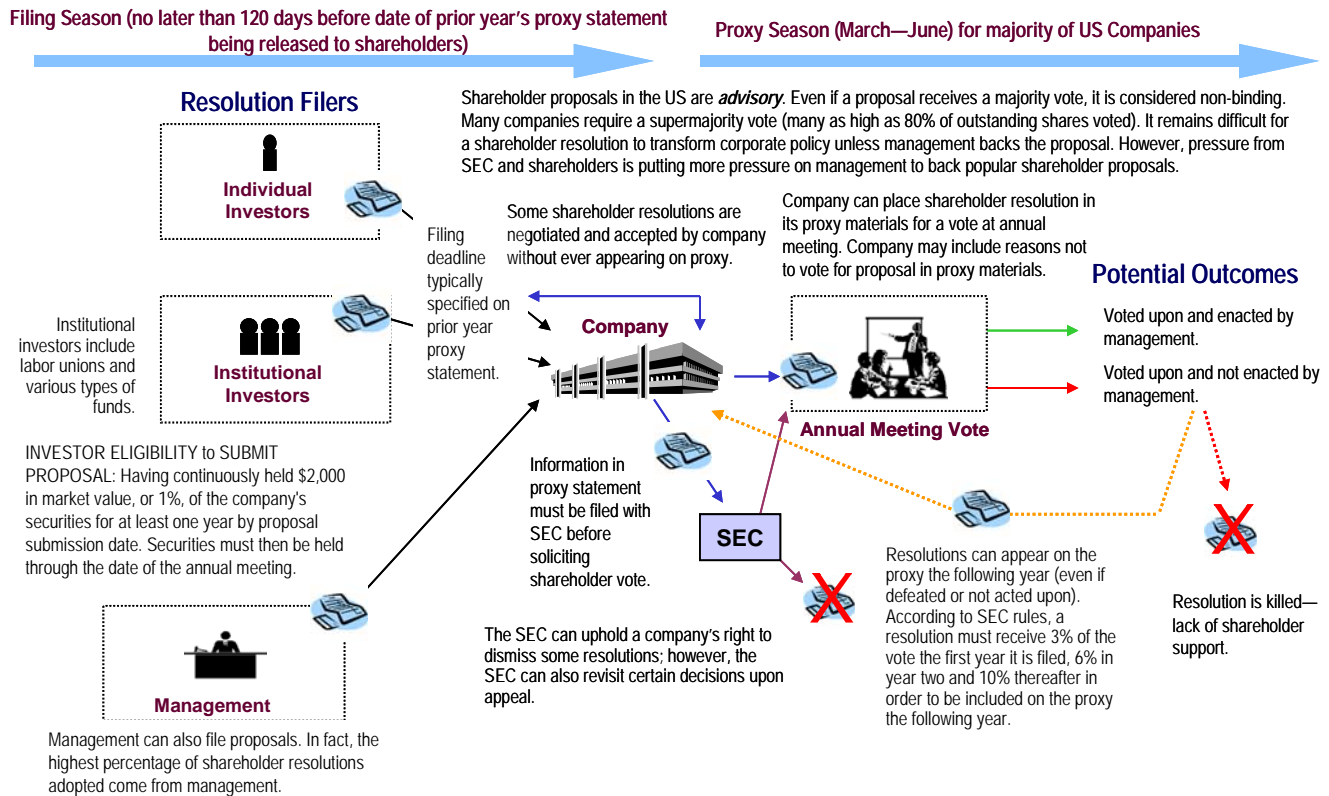
The various investors use a combination of proxy advisory services to supplement their own research or to act on their behalf in researching a company’s governance and assorted metrics. They want to know what advisory services recommend, but generally make their own judgments. Eric Roiter said, *“If a company is being mismanaged and the board is unresponsive or weak, then shareholders will look to see what levers they can pull.”*

For the pension funds, who view themselves (in the words of Dennis Johnson) as *“permanent shareowners,”* being active *“is not about changing stocks held but about dealing with management.”* Like any smart investor, pension funds focus on elements in their portfolios that have the largest material impact. They focus their resources on the issues perceived to have the greatest traction in their largest holdings – those issues primarily being majority vote and executive compensation – both of which they see benefiting long-term returns.

Glenn Booraem reinforces the connection that Vanguard makes with large companies in its portfolios. *“Our communication with companies takes a variety of forms, from discussions regarding specific proposals initiated after reviewing the proxy statement to taking calls on the eve of the annual meeting. However, our most productive contacts come well in advance of the proxy season when we can discuss general issues in the context of the company’s plans and our voting guidelines – when we can engage in a consultative or prescriptive dialogue as opposed to a hostile one. The basic idea is, if you simply vote no and wait until next year to vote no again, what is going to change?”*

Board and audit committee members may keep in mind the words of Lynn Turner: *“There is also a lot of time between now and the proxy for investors to work with the company behind closed doors. A lot of progress could be made, in which case the issues [could] go away. However, if the board becomes entrenched, then there could be a blow-up.”* Dennis Johnson noted, *“It is very important to have a line of communication with the CEO, CFO [and] appropriate board members so that CalPERS can express its findings and point of view, [and then everyone can] have a dialogue to move forward in everyone’s best interest. Remember: we are trying to enhance the value of a company.”*

Appendix B – The proxy process: how it works



Source: Ernst & Young LLP, 2006. Diagram based on The Corporate Library, "Filing Shareholder Resolutions," http://www.thecorporatelibrary.com/Help/educational/Rule14a8_Filing-Shareholder-Proposals.html