What's Next for Governance?

Forces Fueling Engagement to Grow in 2008

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ISS

INSTITUTIONAL SHAREHOLDER SERVICES

2099 GAITHER ROAD
SUITE 501
ROCKVILLE, MD • 20850-4045
(301) 556-0500
FAX (301) 556-0486
www.issproxy.com

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Introduction

Investors and U.S. corporate issuers came together as never before in 2007 to address a wide range of concerns and to better align views on corporate best practices.

That trend is expected to carry into 2008, observers on both sides of the divide say, particularly if the Securities and Exchange Commission empowers shareholders by eliminating undirected "broker" votes in uncontested director elections, and allows investors to nominate corporate directors.

If these key regulatory changes are approved later this year, investors will have additional tools to bring companies to the negotiating table, analysts say. These changes may also provide some activists an incentive to initiate "vote no" campaigns, conversely.

But such campaigns may never materialize if, as expected, the trend toward engagement and away from confrontation continues. While a substantial increase in the level of shareholder proposal withdrawals is the most tangible evidence of the trend toward dialogue, other indicators also suggest that engagement is taking root and is measurably altering the governance landscape.

The creation this spring of an investor-issuer working group to tackle the nuances of advisory voting on executive compensation is one key example. The decision by pharmaceutical giant Pfizer—a governance trailblazer on such issues as director resignation policies and compensation disclosure—to formally engage its top shareholders is another.

Meanwhile, the growing use of the Internet to foster and promote communication between corporate managers and owners, coupled with the relative paucity of high-profile "vote no" campaigns during the 2007 proxy season, also serve as potent reminders that investors and corporate issuers are favoring constructive engagement over confrontation.

Finding Common Ground

"There's been an unprecedented level of engagement between companies and shareholders" this year, notes Richard Ferlauto, director of corporate governance and pension investment at AFSCME, the American Federation of State, County, and Municipal Employees. "Engagement is now part of the landscape."

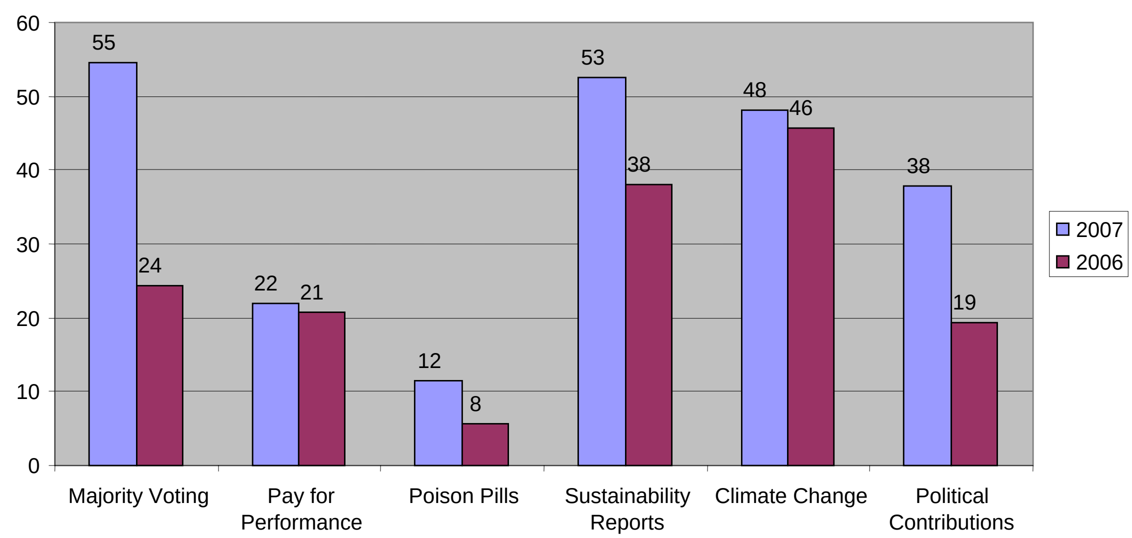
AFSCME pioneered last year's breakout proposal, which calls for a yearly advisory vote on compensation. The proposal, which received roughly 40 percent support at a handful of companies in 2006, this year saw support in a variety of quarters, including Congress, with the House of Representatives passing advisory vote legislation this spring.

Political and shareholder support for the measure also led to the creation of an investor-issuer working group to address issuer concerns about the resolution, dubbed the "say on pay" proposal. The group, which is similar to one formed in 2005 to address majority voting in director elections, was initially comprised of roughly one-dozen companies, as well as investor advocates of an advisory vote on pay who will explore the nuances, costs, and benefits of implementing the proposal. Members, whose numbers have since swelled, say corporate interest in joining the group has been strong, as companies seek a voice in the negotiations.

The skyrocketing level of shareholder proposal withdrawals on a number of key governance and social issues this year also buttresses the conclusion that investors and companies have been more willing to talk.

As detailed in Figure 1, investors and corporate issuers were able to find common ground on a number of critical issues, including majority voting in director elections, linking pay to performance, and redeeming poison pill takeover defenses. Withdrawals were as high as 55 percent on the issue of majority voting this proxy season, which compares with just 24 percent in 2006 and 23 percent in 2005, the first year the issue gained wide support.

Fig. 1: Percent of Withdrawals on Key Shareholder Proposals



Meanwhile, discussions around many social issue resolutions have, on average, fared as well as those pertaining to governance.

Indeed, settlements achieved on one such proposal provided a text-book case of how dialogue is working, according to those negotiating on behalf of corporations. "A perfect example of engagement this year was proposals on political contributions," notes Amy L. Goodman, a Washington-based partner at Gibson, Dunn & Crutcher, which represents corporations in their dealings with the SEC and shareholders.

According to Goodman, companies and investors agreed this year to a scalable solution on political contribution disclosures whereby smaller companies would have less onerous disclosure demands than larger ones. "They were able to tailor something that worked for each company," said Goodman.

Such agreements were not always the case. In 2005, just 17 percent of proposals calling on companies to disclose political contributions were withdrawn by filers, according to ISS records, while in 2006 the number edged up slightly to 19 percent. This year, however, the number swelled to just under 38 percent, or 22 of 58 proposals filed.

Why the change? "It's the votes, for which there's been growing support in recent years," notes Bruce Freed, co-director of the Center for Political Accountability, which has helped coordinate efforts between investor proponents of political contribution disclosure. "The votes are strong, and companies are responding to that. They're saying 'we need to engage.'"

Freed also attributes the growing corporate willingness to negotiate to a broader trend of greater board accountability and transparency, as well as a focus on such issues by the mainstream media. As an example, Freed notes how Home Depot reached out to investors almost immediately after the departure of CEO Robert Nardelli early in 2007. The company said it had decided to act on a 2006 political contributions proposal that received the support of 34 percent of those voting at the annual meeting, according to Freed.

Others, including Ferlauto, say the trend toward engagement was propelled by the SEC's new compensation rules. Boards were motivated to engage, they say, in a bid to mollify pay-related concerns and preempt negative publicity.

Moreover, companies' willingness to engage is not limited to large institutional investors when it comes to addressing corporate best practices, retail shareholders say. According to Los Angeles-based shareholder activist John Chevedden, there's been much greater engagement "as far as adopting proposals either submitted this year or in prior years."

"They're acting on proposals," Chevedden says, pointing to roughly 20 cases this year where management proposals were submitted on the heels of earlier filings by Chevedden or members of his shareholder network. "I would guess we saw about half that number in 2006, and that was the best [showing] to that point." According to Chevedden, companies are largely responding to calls to declassify the board and to allow for a simple majority vote.

But while individual shareholders like Chevedden are seeing more success when it comes to negotiations, most of the action is taking place between corporations and their much larger institutional counterparts, who are coming together in working groups such as those for advisory voting on compensation.

Fostering Communication

A key development this proxy season, with broad implications for 2008, was Pfizer's announcement that it would begin meeting regularly with its largest investors to discuss the company's governance policies and practices, including those related to compensation.

Pfizer said its board will invite representatives "who evaluate governance practices and who vote the proxies of the company's largest institutional investors" to meet starting this fall. The representatives own in aggregate approximately 35 percent of Pfizer's shares, the company said.

"These meetings reflect the view … that we must listen to shareholder viewpoints on governance so that we can continue to improve our practices," said Pfizer Chairman and CEO Jeff Kinder in June.

Pfizer's move will likely spur other firms to follow suit, and at least one institutional investor tells ISS that it is now in negotiations with a "handful" of companies to take similar steps in advance of the 2008 proxy season.

It is precisely this development that worries some, including well-known corporate lawyer Martin Lipton, whose firm advises clients on governance matters. In a June 28 memo to clients, Lipton branded Pfizer's step "another example of corporate governance run amuck."

But Pfizer's move and the broader trend toward engagement are not likely to be reversed, observers say, regardless of efforts by critics to staunch formal discourse between corporations and investors. "It's like a congressman refusing to talk to a voter," when companies ignore shareholders, notes University of Delaware Professor Charles Elson. "I disagree with Mr. Lipton's view of the Pfizer action; Pfizer's done it right."

While formal, direct links between companies and shareholders is one novel development; others also are likely to have an incremental impact on governance reforms in the long-term.

For example, the recently formed International Roundtable on Executive Remuneration, which seeks to encourage pension fund managers to engage portfolio companies on pay issues, is now reaching out to institutional investors and others to promote its approach to engagement. While the movement is nascent, pay specialists say this new twist on engagement holds the potential to affect the nature and scope of pay reforms in the long-term.

The growing use of the Internet as a means for shareholders to communicate with corporate managers also will help shape the governance landscape in 2008. An online forum for Verizon shareholders, launched in June, will focus largely on compensation, giving investors access to information and corporate managers, as well as a means to voice concerns, for example. AMERCO, which owns U-Haul rental trucks, also has introduced an online forum for shareholders.

Similarly, ExxonMobil encouraged shareholders to ask questions on proxy materials before the company's annual meeting in May. That, in turn, may have led to the blunting of a "vote-no" campaign--whereby investors come to together to "withhold" votes from or vote "against" a given director typically over governance failings--against Exxon board member Michael Boskin, which was initiated by a coalition of public pension funds, socially responsible investors, and others. News reports put the level of withhold votes against Boskin at less than 10 percent.

The trend toward more and better communication between investors and corporate issuers is also evidenced by the paucity of high-profile vote-no campaigns in 2007. Such campaigns were essentially limited to Boskin, compensation committee members at Affiliated Computer Services, Terry Semel at Yahoo!, Ivan Seidenberg at Verizon Communications, and two directors at CVS/Caremark who supported the sale of Caremark at a price some investors deemed inadequate.

At CVS/Caremark, director Roger Headrick was elected with just 56 percent of votes cast, according to officials at the company, which has a majority vote threshold for director elections. The investors behind the vote-no campaign, including the Change to Win labor federation, argued the company relied on undirected broker votes to give Headrick the majority needed for reelection.

The vote served to sharpen the focus on the effect of broker votes in director elections, and Headrick stepped down from the CVS board in July.

Activism in 2008 Will Hinge on Broker Votes and Access

The vote at CVS/Caremark has been cited by investor groups that are lobbying for a New York Stock Exchange (NYSE) proposal to bar broker votes from board elections. Critics of the practice contend that broker votes are routinely cast for management nominees and thus undermine the integrity of director elections. Corporate advocates point out that some small and mid-size companies need to count broker votes so they can meet quorum requirements.

The proposed NYSE rule is now under consideration by the SEC and its decision on whether or not to adopt the measure may determine engagement levels and scope of reforms in 2008 and beyond. As proposed, the rule would not eliminate broker ballots for quorum purposes but its implementation would remove the last substantive issue on which uninstructed broker votes could be cast.

Many investors see the barring of broker votes as providing shareholders an additional lever in discussions with management over compensation and other thorny issues. Eliminating broker votes "may serve to promote engagement and may modify pay practices," notes Cornish Hitchcock, an attorney representing the Amalgamated Bank's LongView Fund.

But Hitchcock also notes that the potential barring of broker votes, coupled with the growing prevalence of a majority voting threshold at U.S. corporations, could result in more confrontation come 2008. "We could find more directors being voted out of office," he said.

One pension fund investor, speaking on background, told ISS that the possible elimination of broker votes will allow his organization to sharpen the focus on executive compensation by potentially giving teeth to any "vote no" campaigns targeting compensation committee members, for example.

While the SEC has yet to finalize the proposed rule on broker voting, analysts predict it's a question of "when" rather than "if." "I think at some point [an SEC rule barring broker votes] goes through," Elson, the University of Delaware professor, said. "At some point it will become the rule, which will make directors more receptive to shareholder input, though not necessarily their demands."

If past practices are any guide, investors will likely capitalize on the measure should the SEC take steps to eliminate or limit broker votes in board elections. When broker votes were banned on equity-based compensation plan proposals in 2003, opposition to such resolutions rose, according to ISS records. In 2004, after the rule took effect, opposition jumped to 24.6 percent from 21.9 percent the year before, and rose to 25.5 percent in 2005.

In late July, the SEC voted to issue two competing proposals on proxy access, or the ability of shareholders to nominate corporate directors. Under one of those proposals, shareholders who hold a 5 percent equity stake for at least a year would be allowed to propose an access bylaw. The filer would be free to set the terms of director nominations, so long as that procedure complied with applicable state law and the company's charter and bylaws.

That would make the proposal tailor-made for hedge funds, AFSCME's Ferlauto warned, and likely keep public pension funds, labor funds, and other indexed-investors from filing access proposals, given that their holdings are often well below that level.

Some observers note, however, that the 5 percent level, should it hold, will prompt investors to target small and medium companies with the prospect of a boardroom shakeup, rather than their larger peers.

That would be in keeping with another trend likely to extend into 2008: the targeting of smaller companies for governance reforms.

Since the corporate scandals of 2001 and 2002, traditional activist investors have primarily targeted large corporations, according to ISS records on shareholder proposals, with many smaller companies falling under the radar. But that trend maybe changing, analysts say, noting how many hedge funds have successfully targeted S&P MidCap and SmallCap firms.

LongView, for example, plans to push "further down in its portfolio," to smaller companies, Hitchcock said, a sentiment echoed by other investors with whom ISS spoke.