

# The 2010 proxy season: a forewarning of what's to come in 2011

## Executive summary

Companies and boards currently preparing for the 2010 proxy season to follow are doing so amid a wave of reform that some observers suggest will represent a tipping point in the role and influence of shareholders in corporate decision making. Though calls for increased shareholder power are not new, "the financial crisis of 2008 and the ascendancy of the Democratic party in Washington have created an environment in which proponents of expanded shareholder corporate governance rights are making considerable progress."<sup>1</sup> New governance disclosures have been approved, and changes to the director election process are expected. The result, according to one commentator, is that in the 2010 proxy season, "public companies will face the greatest challenges that most have experienced in recent memory."<sup>2</sup>

The range of anticipated corporate governance changes has created concern among many directors. However, being able to anticipate the changes and understand the mechanics surrounding them may help directors prepare for much of what seems certain. To aid in this effort, Ernst & Young commissioned Tapestry Networks to engage with a range of stakeholders, particularly from the investment and proxy adviser community, to find out their views on what may happen in the 2010 proxy season and beyond. For a list of research participants, please see Appendix 1 on page 13.

Certain themes emerged from the research:

- ▶ **The financial crisis spurred advancement of a multifaceted shareholder rights agenda** (page 3) The perception that governance failures contributed to the financial crisis, combined with Democratic control of Congress and the White House, has facilitated shareholder activists' agenda to gather momentum. Taken together, the reforms could significantly alter the relationship between shareholders and boards.
- ▶ **Director elections, separating the chairman and CEO roles, and compensation will be issues in 2010** (page 5) Citing delays in key legislation and differences in investor views, most participants do not expect a "big bang" in 2010. However, they do acknowledge that changes under way could prove to be the start of greater challenges to board rosters, and they expect a continued focus on say on pay and splitting the roles of chairman and CEO.

- ▶ **Proxy access could bring on the “big bang” in 2011** (page 9)  
Many directors and other corporate advocates view proxy access as the most troubling governance change, yet the investor advocate-backed proposal will likely be adopted and impact the 2011 proxy season. Investor advocates see it as another tool to increase board accountability to long-term shareholders. Views on its long-term effect on director elections are mixed. However, some directors and corporate advocates fear collateral damage to corporate behavior that may not benefit long-term objectives.
- ▶ **Companies can take proactive steps in light of the impending changes** (page 11)  
Participants highlighted a number of ways in which companies can address governance concerns head on, including, when necessary, focusing attention on the policies of the leading proxy advisory firms, such as RiskMetrics, Glass Lewis and others. New disclosures provide a means to address investor desires and potentially ward off misplaced activism. In cases where governance concerns seem legitimate, independent director involvement in shareholder outreach could prove highly beneficial.
- ▶ **Conclusion: a tipping point may come, as 2010 foreshadows 2011** (page 12)  
There is reason for corporate directors to pay attention to the potential for greater empowerment of activist investors. Many directors fear boardroom upheaval and that long-term corporate performance may suffer. Many investors, particularly institutional money managers and less activist investors, believe these concerns are overstated. Regardless of which view proves correct, there are significant opportunities for companies to proactively address governance concerns.



# The financial crisis spurred advancement of a multifaceted shareholder rights agenda

The financial and economic crisis has led to renewed calls for change as investors seek ways to hold boards accountable for what some see as critical governance failures that contributed to the significant destruction of shareholder value. In February 2009, Nell Minow, co-founder of the Corporate Library, stated, "Corporate governance is about managing risk. It's about incentive compensation. It's about corporate strategy and sustainability. And all of those things are what boards failed to do."<sup>3</sup>

## An investor-focused policy agenda

Not surprisingly, President Obama, the Democratic majority in Congress, and the newly appointed Securities and Exchange Commission (SEC) chairman, Mary Schapiro, are highly receptive to advancing shareholder rights. Chairman Schapiro referred to the SEC's agenda as "one of the most significant, investor-focused rulemaking agendas in our history."<sup>4</sup>

The weight of governance reform initially focused on financial institutions - which are still the subject of the most attention - but calls for reform have spread to all public companies, bolstered by populist anger. An op-ed in the *Wall Street Journal* in November warned, "The world of politics is about to intrude on all corporations."<sup>5</sup>

Other than changing the way broker votes are counted in director elections, discussed below, the SEC has largely focused on empowering investors by arming them with more information, by mandating more proxy disclosures for the 2010 proxy season.<sup>6</sup> The legislative agenda goes much further. With support from President Obama, proposed bills in the Senate and the House of Representatives include many governance changes for all public companies. Final versions of them are likely to be voted on in early 2010, in time for the 2011 proxy season. The content of the proposed legislation differs, in some cases, materially, and nothing final is expected until the second quarter of 2010.<sup>7</sup> The legislation is highly fluid, and subject to change, not least because of the broader policymaking environment. However, generally, the SEC and proposed legislative reforms focus on director qualifications and elections, board structure and leadership, compensation, and risk management. For a summary of the key legislation, please see Appendix 2 on page 14.

	New SEC proxy disclosures	House and Senate bills
<b>Director qualifications and elections</b>	Increased disclosure of director skills, experience, attributes, and qualifications, with an emphasis on each individual's fit with the full board and, where appropriate, with committee assignments. More detail on directors' past public company directorships and relevant legal proceedings. New commentary on how diversity is factored into director selection, if at all.	Include mandatory majority voting for all public companies, although they differ on how tough to be: one bill would require the resignation of any director not receiving a majority vote, while the other bill would allow the board to decline the resignation.
<b>Board structure and leadership</b>	For companies that have combined the roles of chairman and CEO, the SEC will require an explanation of the leadership structure and why the company believes the leadership structure is most appropriate.	Several of the proposed bills include mandatory separation of these roles and prohibit staggered boards (that is, boards in which only a portion of the directors are up for election at each annual shareholder meeting).
<b>Compensation</b>	Increased disclosure on any material risks associated with employee compensation, the impact of pay on risk taking more generally, and the fees paid to compensation consultants and conflicts of interest. It will also require changes to existing disclosures; in particular, it will require the use of grant-date present values for option grants rather than the current practice of using the accounting value.	Legislators are considering an advisory vote on compensation (say on pay) for all companies, not just financial institutions.
<b>Risk management and oversight</b>	Increased disclosures on the board's role in risk oversight and, where appropriate, key aspects of the risk management structure. (In our research, investors did not expect to gain much from these risk disclosures, other than in financial institutions, and expect much "boilerplate" in this area.)	The original bill from Senator Schumer would require all public companies to have a risk committee, but the subsequent bill from Senator Dodd limits that requirement to financial institutions.

Some participants suggested a better approach to reform might be changing the New York Stock Exchange (NYSE) listing requirements, which "are easier to change than acts of Congress." In November, the NYSE announced the formation of its Commission on Corporate Governance, chaired by Larry Sonsini of Wilson Sonsini Goodrich & Rosati, to "work with policymakers and other constituents to evaluate and make recommendations on pressing corporate governance and proxy reform."<sup>8</sup>

## Corporate angst over proposed changes

Critics worry that the proposed changes could increase the influence of shareholders in the boardroom in ways that are not constructive or contemplated. As Holly Gregory, corporate counsel in the corporate governance practice at the law firm Weil, Gotshal & Manges, put it, "I think that the reform proposals if enacted in whole certainly will increase shareholder power, and will change the balance of shareholder and board power. Whether the roles change will depend on how shareholders use their new power in the real world and how their use of their power interacts with other forces."<sup>9</sup>

This uncertainty has translated into a degree of anxiety among executives and directors about how governance changes may affect boards' ability to function effectively. They fear potential abuses by short-term investors and that special-interest groups may gain undue influence over corporate board decisions. As one director put it, "The underlying substance - and the critical change in corporate governance - is about placing people on boards who answer to constituents, not investors."<sup>10</sup>

Some are concerned that the balance is swinging too far: "You need an even balance. If there is misalignment, you start to have a decision-making process that becomes almost arbitrary, that doesn't consider all the interests of the corporation." In addition, as one director recently told Tapestry Networks, "The bigger problem is the cumulative effect of these provisions. If you stacked them all together, you would have a dramatic change in board membership over the first two or three years after they were implemented."

## Questions for directors:

- ▶ Has your board or one of its committees discussed the new disclosure or proposed governance changes, in general?
- ▶ Which changes are considered potentially most challenging to your corporation?
- ▶ Have any of your committees started a detailed discussion on the new governance disclosure rules?
- ▶ What must you do to prepare, and how you using your external advisors to help develop the disclosures?

# Director elections, separating the chairman and CEO roles, and compensation will be issues in 2010

What do investors and other corporate governance experts expect for the 2010 proxy season? *InSights* research participants generally do not expect a major wave of investor activism in the 2010 proxy season. Instead, they anticipate a focus on director elections and board leadership in the run-up to a more dynamic 2011 season.

## 2010 will see heightened instability in director elections

All of the research participants recognized that next year could mark the start of more instability in US-listed board rosters. They suggested that the adoption of majority voting and the end of staggered boards at many companies will drive this instability. Under majority voting, a director would be required to receive a majority of votes cast in his or her election to be elected to a board, and the failure of a nominee to receive majority support would necessitate some subsequent action by the board.<sup>11</sup> The majority of large companies have already adopted some form of majority voting.<sup>12</sup>

Importantly, research participants highlighted the SEC's approval, in July, of a New York Stock Exchange rule banning broker discretionary voting of proxy ballots for uncontested elections of directors.<sup>13</sup> Under the old rule, brokers had the discretion to vote shares held in their clients' accounts when they did not receive voting instructions, and, typically, they voted with management. Broker votes accounted for 16.5% of overall votes during the 2008 proxy season<sup>14</sup> and can represent much larger percentages at some companies. Some experts predict that "eliminating broker votes 'could tip the balance' against board members opposed by activist institutional investors."<sup>15</sup>

One participant stated that as a result, "the thing to watch will be director elections. With broker votes going away, there could be some close tallies." A study by Proxy Governance shows that opposition votes have been increasing over the last three years: "Despite fewer organized 'Vote No' campaigns against directors in 2009, at least 84 directors at 48 companies failed to attain majority support from shareholders."<sup>16</sup> One participant noted, "We saw a tripling of directors with 50% negative or withhold votes last year." Without broker votes, the number of directors who would have received less than 50% of votes would have been higher.

Several participants said that the use of echo voting or mirror voting, whereby uninstructed shares are voted in the same proportion as instructed shares, may limit the impact of removing broker discretionary voting: "Many [brokers] have been doing mirror voting for a long time, and they are not all in favor of management. They are already accounted for. Also, you're taking votes off of both the denominator and the numerator." However, other participants noted that mirror voting was not commonplace.

Several research participants anticipate some "unexpected" outcomes. One said, "I wouldn't be surprised to see 10% of companies have some issues. Even more could have 30%-40% withhold votes." This participant suggested the fear of facing embarrassment could impact board decisions throughout 2010, as they consider the potential implications on director elections if and when proxy access comes into play.

However, several participants said that in practice, this uncertainty regarding potential outcomes will mean that institutional investors become more cautious with their use of no votes because a no vote will now be more than just a symbolic gesture. One participant suggested that "investors will become relatively selective about no votes." A participant from an institutional money manager said that in choosing which directors to target for no votes, "we will look at the [board] committees and consider where the problems have been." Another participant noted that directors that serve on the boards of financial institutions considered to have failed may be targeted at other companies on whose boards they serve. A third participant suggested that boards that have ignored shareholder votes in the past may feel the adverse effects of more targeted voting: "At some companies, things have been building up for a long time, and now, you have a harmonic convergence of things: majority voting, broker non-votes going away. Companies and directors that have ignored majority votes year after year will be targeted. We have a list."

Not surprisingly, research participants expect considerable attention to be paid to the new disclosures regarding directors' experience, skills, attributes, and qualifications, especially in instances where there may be close director elections. As one put it, "[This focus on directors] puts the nomination process into the spotlight for the first time." That participant recommended that companies carefully examine their board composition and articulate its reasoning: "It is the same exercise activist hedge funds or labor unions will go through in the future if [proxy] access passes." One participant said he hoped companies will explain "why directors are the right people for this board at this time, for the strategic direction of the company, in a more nuanced way now that connects how an individual rounds out gaps, fits the puzzle in this way."

## Splitting the roles of chairman and CEO may be the one “big idea”

Research participants believe that the idea of separating the roles of chairman and CEO is likely to prompt a relatively large number of shareholder proposals in the 2010 proxy season. Advocates of such a change interviewed for this research, generally agree with one who asserted, “It’s about personal power,” in terms of individuals’ desire to retain both roles. One participant maintained, “It is a basic conflict-of-interest issue.” Another participant added, “When the CEO is chairman, the board is loyal to the CEO, and it is very difficult to tell him, ‘You need to step off.’”

It is difficult to predict how successful such arguments will be in garnering support for proposals to split the roles. Corporate directors and business leaders are more favorably disposed toward the notion of splitting the roles than they have been in the past, but they still believe that mandating a split for all companies is too simplistic. They also note that there is little evidence that doing so improves performance.

Institutional money managers participating in Tapestry Networks’ research are “agnostic” on this issue; they prefer to leave the decision to split or not split the roles to individual companies and boards. For this reason, such investors are unlikely to support some of the anticipated 2010 proposals, because the sponsors may introduce binding, rather than advisory, proposals at a number of large companies. Even some of the most fervent supporters generally accept that making the change may not be possible immediately, and so they are pushing companies to work the separation into succession planning, to take effect when the current CEO steps down.

Participants pointed out that companies can turn the new disclosures on board leadership to their advantage. For example, when the roles of CEO and chairman are combined, companies can use the new disclosures to explain how the lead independent director role is broadly in line with what proponents of an independent chairman are seeking.

## Pay will remain a lightning rod issue for investors

It is difficult to predict what aspect of pay will cause friction in 2010. Coming out of the financial crisis, boards, regulators, and legislators are trying to determine to what extent incentive compensation may have contributed to excessive risk taking and how best to avoid incentivizing similar behavior in the future. Yet, when asked to describe the key components of a preferred pay approach, few investor participants in this research could or would provide specifics, beyond the need for long-term, equity-based incentives. As one put it, “How on earth can I put myself in the compensation committee’s seat and determine how that company’s executives should be paid? They know better than I do.” Nonetheless, companies will continue to feel pressure to adopt different pay structures in those instances in which investors disapprove of the current structure.

One participant observed that, in some ways, “executive compensation is always [priority] issue one through five.” Investors will always view pay as a proxy for board effectiveness. Another participant pointed out that compensation is “one of the more visible and quantitative ways of looking at how management and the board are managing the company.” Another noted that compensation packages can provide insight into directors’ understanding of corporate strategy and objectives because “there has to be a clear understanding of the strategy and a plan in place in order for compensation to be effectively structured.”

Many expect Congress to pass say-on-pay legislation, to go into effect for all companies for the 2011 proxy season. Critics view say on pay as a “blunt instrument” that doesn’t identify specific investor concerns or provide feedback on how directors might address them. Some believe it intrudes too far into board decision making. In a discussion among compensation committee chairs orchestrated by Tapestry Networks, one compensation committee chair said, “I think say on pay is different from the proxy issues of majority voting and classified boards because those give the impression of entrenching management, whereas say on pay is attacking board members’ responsibilities.” Nevertheless, many agree that say on pay is “inevitable.”



Participants encouraged companies to get ahead of this issue. Compensation disclosures should “hit the hot buttons” by explaining how the company’s pay practices are in line with expectations and showing that they do not include practices seen as egregious by some investors, such as excessive perquisites or tax gross-ups. Others expressed interest in learning how companies integrate the activities of the audit and compensation committees, an issue many directors are contemplating themselves.<sup>17</sup> As one participant put it, “Disclosures have to be like a movie trailer: action up front to get people engaged because people can’t read through 50 pages. If not, it may cause them just to read the movie reviews, which RiskMetrics, Glass Lewis, and other proxy advisers write. It’s like speed dating in reverse: you’ve got five minutes to convince people they never want to see you again.”

For those companies that have pay practices that may attract the attention of proxy advisers and activist investors, some participants recommended the company consider the voluntary adoption of say on pay to provide investors with a way to show their disapproval of compensation practices without targeting the compensation committee: “It’s probably better from the issuers’ perspective. It takes the compensation committee off the hook a little bit.” Some investor participants said they would be open to a triennial say-on-pay vote, similar to that recently adopted by Microsoft.<sup>18</sup> For more on RiskMetrics, see page 8.

## Why will there be no big bang in 2010?

Given the media, political, and investor attention directed toward the dawn of a new era of investor power, it is reasonable to ask why the impact will not be greater in 2010. Participants identified a number of factors:

► **A delay in the key legislation.** Many of the most significant changes under consideration by Congress and the SEC – proxy access, mandatory separation of the chairman and CEO, mandated risk committees, and say on pay – will not be in place for the 2010 proxy season, and some may not pass at all. A participant observed, “There are some players in the field fanning the flames, portending doom. Most of these changes will not be in place for the 2010 proxy season ... We’re expecting a low flow of proposals this year.” Some governance experts expect fewer contentious shareholder votes in 2010 because some shareholder groups are taking a wait-and-see approach to broader governance reforms, and others, such as active union pension funds and investor groups, will be focused on lobbying, out of concern that governance reform “will be forgotten in the rush to regulatory reform.”

- **Divergent investor views.** Participants emphasized that investors do not share a common agenda, which will make it difficult for any activist or even like-minded groups of investors to wield the kind of influence some directors fear, at least in terms of director elections. As one investor put it, “The louder voice of investors has revealed that investors don’t have one voice ... You’ll find there will be more separation in how shareholders act. It will become more complex for companies to manage that.” Another participant contended, “Many corporations are worried about what labor unions or hedge funds might do, but special interests are not going to be calling the shots. It is going to be the big investors, who are typically conservative and supportive of management.”
- **Resource constraints on investor activism.** Institutional investors are generally constrained by limited resources, and that constraint limits their ability to scrutinize and target a mass of companies: “We are in a resource-constrained environment.” Therefore, most investors go through a “triage” process to identify companies with issues that require further attention. A participant remarked, “We own [shares in] 2,500, 3,500, 5,000 companies ... A triage effort is needed ... [and it] will be complex.” Some participants also agree with Senator Schumer, who has stated on multiple occasions, “Well-run companies don’t fear their shareholders,”<sup>19</sup> suggesting most companies have little reason for apprehension about the 2010 proxy season. While a variety of governance “red flag” issues will drive some of the triage effort, most participants agreed with a representative from an institutional investor who said, “Our activities follow our money. If we have a huge stake in a company, we will go after them ... It’s all connected to our economic interest: how do we try to improve performance through governance?”

## The influence of proxy advisers looks set to grow and grow

Directors, and some institutional investors, are deeply concerned about the rising influence of proxy advisers such as RiskMetrics and governance raters such as the Corporate Library. They are particularly concerned about the power that RiskMetrics (formerly Institutional Shareholder Services, or ISS) wields. As one director put it, "I have grave concerns about the role of organizations like ISS/RiskMetrics ... You have ... unregulated organizations with huge influence." Most research participants expect RiskMetrics' "influence over the [proxy vote] outcome will increase dramatically." That influence manifests in several ways:

- ▶ **"Controlling" proxy votes.** It is generally agreed that RiskMetrics' clients account for, on average, between 20-30% of votes. There is disagreement about what this means in practice. Directors assert that many institutions follow RiskMetrics' recommendations without sufficient analysis. One director asserted, "The [investors'] governance people listen to RiskMetrics ... [and] just vote according to [its] recommendations." Others in our research disagreed, noting, "People have it backwards. Proxy advisers vote reflecting the views of most of their clients." Nonetheless, all agreed that RiskMetrics' already significant influence will increase with the removal of broker votes, because those voting - their clients - will be proportionally more influential.

- ▶ **Driving the triage process.** Several participants stressed RiskMetrics' role in helping investors conduct triage: "RiskMetrics and Glass Lewis will play a larger and larger role over time ... We won't have more resources, especially because of the economy, so we need to be more effective and more efficient, and the only way to be more efficient [in our triage] is to use RiskMetrics or Glass Lewis."
- ▶ **Influencing investor policy.** Several participants noted that RiskMetrics' clients' policies are heavily influenced by RiskMetrics' own policies, so even when they are voting according to their clients' policies, those policies have been heavily influenced by RiskMetrics' guidelines. As one put it, "The role and impact of RiskMetrics is actually grossly understated ... They are the leading corporate governance policymaker in the US."

## Questions for directors:

- ▶ Has your board discussed the effect that removal of broker non-votes would have on your company?
- ▶ Have the various committees involved in disclosure determined whether they will proactively use the new governance disclosures as a means to illustrate the strength of your company's governance practices?
- ▶ Has your compensation committee or full board discussed voluntary adoption of say on pay?
- ▶ Where is outside advice most helpful?

# Proxy access could bring on the “big bang” in 2011

Although, as discussed before, participants thought a big bang was unlikely in 2010, they see the potential for greater upheaval in 2011, with the implementation of proxy access, which provides investors with the ability to nominate their own directors to the board. While the SEC has deferred implementation, participants expect legislation will be passed in 2010 authorizing the SEC to set rules for proxy access for all public companies, for the 2011 proxy season. In December, the SEC reopened the public comment period on proxy access, but still expects to make a final decision in 2010.<sup>20</sup>

Directors and corporate executives generally agree with one director who said that of all the proposed governance changes, “proxy access is by far the most troubling.” For some, it represents a “momentous change” in the manner in which companies are governed in the United States. Some say that the “holy grail” for activist unions and state funds is proxy access - the governance change for which they would be willing to forgo some other governance changes in the proposed legislation to ensure proxy access gets passed. As evidence of the potential political horse-trading that may take place, they point to the fact that a mandatory risk committee and the mandatory separation of chairman and CEO roles, included in the Schumer-sponsored Shareholder Bill of Rights, are not in the draft Dodd bill, whereas proxy access remains. One participant said, “Proxy access is the fight.” The question is, what effect will proxy access have?

## Will the empowerment of activists increase instability in director elections?

In the wake of changes put in place for 2010, which, as noted above, could increase instability in director elections, directors are greatly concerned about the additive effects of proxy access. In a conversation with other directors orchestrated by Tapestry Networks, one director contended, “You will end up with fractured boards or boards composed of warring camps and certainly not cohesive boards functioning in the best interest of shareholders.”

### Fears of abuses

Corporate board members fear two specific types of investors will abuse proxy access:

- ▶ **Labor-dominated pension funds.** Directors are concerned that proxy access could lead to the election of special-interest directors from union pension funds who would pursue ulterior agendas that are not necessarily in the best interests of the corporation or its broader shareholders. Additionally, one participant suggested companies might become embroiled in distracting “permanent campaigns” for annual director elections. However, by contrast, institutional money managers and less activist investors interviewed for this research were of the opinion that “special-interest candidates have a zero-percent chance of winning a board seat.”
- ▶ **Short-term activists and hedge funds.** Several participants fear that short-term activists may gain access to the board. One participant suggested activist public pension funds may have “opened Pandora’s box,” and are now “realizing they will not be the primary beneficiaries of the rule changes - it’s going to be the hedge funds.” The fact that the SEC appears to re-considering the amount of stock an investor must hold, and for how long, to use proxy access suggests that they are aware of this potential problem. Hedge funds and other activists generally make their aims very clear: they want access to the board because they want to press for a change in strategy or short-term asset disposal. Mainstream institutional investors may support this agenda for companies that are not performing. Research participants acknowledge that the option to use proxy access could make a short-term activist’s threat to destabilize the board more potent and may encourage more investors to use director elections as a vehicle to create change. However, mainstream investors interviewed for this research noted that the activist still has to convince other investors that the activist’s concerns about the company’s strategy and performance are valid and that the activist’s board candidates will build or release value for all investors. That being the case, several participants believe activist funds may decide not to use proxy access for director campaigns because they prefer to control their own ballot process and retain the ability to provide a full explanation of why they are proposing a change of directors and strategy in their own proxy materials.

### A reality check

While some participants expect some disruption in director elections in the short term, few expect proxy access to cause massive upheavals of corporate boards if and when it passes: "I don't think proxy access means that at every company in the US there will be contested elections. Investors will use the most moderate option first." But, as several participants noted, the sheer threat of more proxy elections could dissuade directors from joining boards. As one put it, "What are the odds of director nominees [being] willing to serve, knowing they will face a competitive race? Nobody likes to lose. Even if you get 6%, 8%, 10% no vote or withhold, it is a reputational hit."

But most research participants believe proxy access is "like the nuclear option" and will only be used in "extreme cases" in which both performance and governance issues are present. One participant said, "90% to 95% of all companies on US exchanges won't have a problem with [proxy access]. But those with chronic underperformance at the same time that executives are taking large compensation packages, etc. - those are the situations where shareholders want this power, because the board clearly hasn't got it."

Moreover, even when proxy access is used, participants do not expect it to materially affect the composition of US boards. Several participants said that the diversity of investors will make it difficult to win director elections: "I don't see it creating volatility. It is going to take a fairly significant number of investors to vote someone off the board from proxy access." As one participant explained, "For it to be successful, candidates put up will have to be credible candidates. If you're an institution looking to put up a dissident, who is credible and could win election, that person is going to say, 'There is no deal to be cut [with the company before the shareholder vote]. I don't want my name associated with a failed effort. And you need to put resources behind the campaign' ... And they will ask, 'If I get on that board, what's it going to be like for me?' They will want to influence the company's long-term performance. It's their reputation on the line."

### Questions for directors:

- ▶ Has your company discussed scenarios in which activists could use proxy access to push for changes in corporate behavior?
- ▶ Will your company take steps to limit the likelihood of this happening?
- ▶ How are you gaining outside perspectives on your company's potential vulnerabilities in the context of shareholder activism?

### What's the big deal, then?

How can we reconcile the notion that the effect of proxy access on director elections may be limited with the fact that some investors have been pressing for it for over 20 years? As one participant asked, "Why do [some investors] want [proxy access] so badly if they don't intend to use it?" The participant predicted, "Union funds will use it," and pointed to the fact that some public pension funds are already building databases of potential candidates to serve on boards.

Only time will tell what effect proxy access has on director elections. However, several participants stressed that overall, proxy access is not just about union or state funds getting their candidates onto US corporate boards. One said, "It may be a gun you never have to shoot ... It will be the point of leverage that activists use to change the behavior of the company." Just the threat of a proxy battle may cause companies to "do what is necessary to placate activists" because companies naturally want to avoid controversy and the cost of an expensive and distracting proxy battle. Several participants agreed with one who said, "I expect activists to use it as a means to accomplish something else ... wrapped in the cloak of good governance."

One participant cited former New York governor Eliot Spitzer's recent call for state comptrollers and treasurers to vote against directors of companies that are members of the US Chamber of Commerce because of the chamber's position on climate change<sup>21</sup> as an example of governance rights being used for political objectives: "That is not a fiduciary pathway; that is a public-policy pathway." Another example that was mentioned was activist investors' push, several years ago, to have corporations disclose their political donations to political action committees. As one participant noted, "This information was already public ... What they really wanted disclosed was donations to [lobbying groups] on public-policy issues they viewed as important, such as climate change or health care."

If these participants' analysis is correct, proxy access could cause a "momentous change" not in director elections but in corporate behavior. Armed with their new leverage, activists could push for incremental changes over time: "It will be like being nibbled to death by ducks." In the face of that possibility, one participant said, "Every board has to understand their vulnerabilities in the context of their harshest criticisms from activists." This could include knowing what other boards their directors serve on, so the board can be forewarned of the possibility of being hit by "collateral damage," or evaluating director and corporate memberships in organizations or support for causes that some large, activist investors oppose. However, the focus will be on the largest US companies because, as one participant noted, "If you go after small, midsize companies, it's not news. Nobody cares what happens at [a small corporation] in Wyoming."

# Companies can take proactive steps in light of the impending changes

Participants outlined several ways in which directors can encourage their companies to address governance issues proactively, ahead of the 2010 proxy season:

- ▶ **Ensure your corporate secretary is actively monitoring governance changes.** Participants recommended that directors communicate more with their corporate secretaries to get a sense of where there is the potential for governance issues. Several participants recommended companies be more proactive in reviewing the governance policies of leading proxy advisers and investors: "We are likely to see a lot of changes to [investors' and advisers'] policy this year, so engage on that to see if there are any changes year-to-year."
- ▶ **Use the new disclosures to best effect.** On the whole, participants in our research were skeptical that the new governance disclosures will be useful. Indeed, investors complained that they already have too much information, emphasizing the need to "avoid providing so much information that we provide no information." Nevertheless, participants advised companies to use disclosures effectively. As one put it, "It is good for companies to consider where they might be vulnerable, review those [issues], then tell their story through disclosure."
- ▶ **Focus on RiskMetrics.** Participants recommended ensuring governance and pay disclosures are written with a view to their fit with RiskMetrics' policies, given these are so influential in voting patterns and help resource-constrained investors handle their workload. As one put it, "[Expanding disclosure] is a way to engage. Companies can defend themselves better, launch a preemptive strike, knowing what RiskMetrics will say." Engaging RiskMetrics directly, participants reason, is important if the company is facing a no-vote or if an important element of the company's governance practices fall foul of RiskMetrics' policy.
- ▶ **Ensure management understands their major investors.** A participant said, "You should understand who your shareholders are and call them up." Another remarked that many directors and executives don't understand their investors' investment strategies and governance policies: "Many people don't realize who they're talking to ... Do your homework." Additionally, a participant recommended, "You have to know where governance sits within the investor organization." A participant from an institutional money manager stated, "You can't rely on long-term shareholders thinking the same way. Therefore, you need to be present with the key folks ... We've seen a substantial uptick in the calls to us ... The outcome of votes becomes much harder to predict and manage. Out of that will come a desire to have a closer, more informed engagement with the shareholder base."
- ▶ **Have directors reach out to top shareholders when problems develop.** Although investors say they lack the time and resources to engage with outside directors on a regular basis, most agreed with one participant who said, "Engagement is important once you've failed that first [governance] screen." Another said that having directors make contact is more desirable than having management make contact regarding certain issues: "It is a better strategy to get directors to call shareholders because we feel better that directors are representing us. If management calls, then we immediately get a little suspicious." Directors are generally uneasy about contacting investors directly, for fear of violating Regulation Fair Disclosure or getting into "legal hot water," but participants suggested that directors may need to overcome these obstacles and engage more often in the new environment: "Communication is going to be an important issue." Directors can also help ensure that "the largest shareholders fully understand and support the company's strategy, and whether there are hedge funds or other activists that may raise particular issues."<sup>22</sup>



# Conclusion: a tipping point may come, as 2010 foreshadows 2011

Shareholders' rights have increased in recent years, in many cases because companies have chosen voluntarily to adopt practices that are beneficial in this regard, notably majority voting. Changes that have already been passed regarding how votes are cast will affect the 2010 proxy season. These developments are leaving many corporate directors feeling that the pendulum is swinging too far, opening the door for abuses by certain investors.

Research participants acknowledge that the cumulative governance changes will have an effect, most likely in 2011. In the short term, in 2010, director elections will likely be more volatile, and campaigns to further shape governance practice will continue to garner support. They also acknowledge that the reforms have the potential to empower investors who have agendas that are not in the long-term interests of corporations or their broader shareholder base.

Participants highlight that directors have an opportunity to influence the outcome for their companies. Participants encourage directors to engage with top shareholders to better understand their range of perspectives and new governance disclosures provide an opportunity to tell their story. Moreover, with investors now articulating their governance concerns more openly, companies can proactively review and where necessary revise their governance practices so as to keep from attracting the negative attention of activist investors. As a participant said, ultimately, "you evaluate the quality of directors by the quality of their decisions."

## About this document

*InSights* is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members. It will be distributed by Ernst & Young and Tapestry Networks. 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.

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Tapestry Networks is a privately held professional services firm that brings leaders together to solve complex problems. Since 2002, networks convened by Tapestry Networks have tackled some of the most significant strategic challenges facing institutions and society, including raising standards in corporate governance in the United States, Canada, and Europe, developing strategies for a more sustainable health care environment in Europe, and enhancing national security in the United States through public-private collaboration. Tapestry Networks convenes eight audit committee networks sponsored by Ernst & Young that collectively consist of more than 120 individuals, who chair more than 170 audit committees and sit on over 300 boards at some of the world's most admired companies. For more information, please visit [www.tapestrynetworks.com](http://www.tapestrynetworks.com).



# Appendix 1: Interview and discussion participants

In November and December 2009, Tapestry Networks spoke with senior leaders from the shareholder and analyst community in one-on-one conversations and small group discussions and individually with representatives from proxy advisers and corporate lobbying groups (for corporate compliance reasons, some were unable to be listed below). All discussions were held under a modified version of the Chatham House Rule, in which views expressed during private discussions are not attributed to individuals or their organizations. The participants that could be listed were:

- ▶ **James Allen**, Head, Capital Markets Policy, CFA Institute
- ▶ **Vineeta Anand**, Chief Research Analyst, Office of Investment, AFL-CIO
- ▶ **Kenneth Bertsch**, Executive Director, Corporate Governance, Morgan Stanley
- ▶ **Amy Borrus**, Deputy Director, Council of Institutional Investors
- ▶ **Les Brorsen**, National Policy Director, Ernst & Young
- ▶ **John Castellani**, President, Business Roundtable
- ▶ **Hye-Won Choi**, Senior Vice President, Head of Corporate Governance, TIAA-CREF
- ▶ **Rich Ferlauto**, formerly Director, Corporate Governance and Pension Investment, American Federation of State, County and Municipal Employees
- ▶ **Matthew Filosa**, Proxy Voting Specialist, MFS Investment Management
- ▶ **Nancy Florek**, Vice President, Putnam Investments
- ▶ **Drew Hambly**, Vice President, Corporate Governance, State Street Global Advisors
- ▶ **Patrick McGurn**, Special Counsel, ISS Governance Services, RiskMetrics Group
- ▶ **Meredith Miller**, Assistant Treasurer, State of Connecticut, Office of the Treasurer
- ▶ **Alesandra Monaco**, Vice President of Research, Proxy Governance
- ▶ **Bridget Neill**, Director of Regulatory Policy, Ernst & Young
- ▶ **Tom Quaadman**, Executive Director, Financial Reporting Policy and Investor Opportunity, US Chamber of Commerce
- ▶ **Michael Ryan**, President and Chief Operating Officer, Proxy Governance



# Appendix 2: Legislation

## **The Financial Regulatory Reform Bill - Sponsored by Senator Christopher Dodd (D-CT)**

This bill would merge the four bank regulatory agencies (the Federal Reserve, the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (OCC)) into a single "superagency." In addition, the bill would reduce the power of the Federal Reserve. The Fed would lose authority over banks, as well as its ability to regulate mortgages and credit cards. The legislation also includes a nonbinding say-on-pay vote and tighter oversight of the derivatives market. Earlier this year, the White House had considered a proposal to consolidate banking regulators, similar to Senator Dodd's recommendations, but opted instead for a less sweeping measure to merge only the OTS and the OCC.

*To read this bill in full, please see: [http://banking.senate.gov/public/\\_files/AY009D44\\_xml.pdf](http://banking.senate.gov/public/_files/AY009D44_xml.pdf)*

## **Wall Street Reform and Consumer Protection Act (HR 4173) - Sponsored by Representative Barney Frank (D-MA)**

This bill includes five major financial reform bills approved by the committee earlier this year, including measures to establish an independent executive agency to oversee consumer protection for all financial services, allow shareholders a non-binding say on pay vote, regulate derivatives markets, and improve investor protections.

*To read this bill in full, please see: <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>*

## **Consumer Financial Protection Agency Act (CFPA) (HR 3126) - Sponsored by Representative Barney Frank (D-MA)**

This bill establishes an independent executive agency to oversee consumer protection for all financial services. In September 2009, Representative Frank modified the draft legislation, extracting a requirement that companies providing financial products offer a "plain vanilla" option, such as fixed-rate mortgages or no-frills credit cards. In addition, the bill explicitly exempts certain businesses, such as securities, commodities, investment, and general insurance products, from CFPA oversight.

*To read this bill in full, please see: <http://www.govtrack.us/congress/billtext.xpd?bill=h111-3126>*

## **Shareholder Bill of Rights Act (S 1074) - Co-Sponsored by Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA)**

This bill has three main provisions: an annual advisory vote on executive compensation and golden parachute agreements, proxy access, and new listing standards for stock exchanges. The new listing standards include requirements for chair independence, annual elections, majority voting, and risk committees. Senator Schumer is seeking inclusion of this language in the financial reform legislation being drafted by Senator Dodd.

*To read this bill in full, please see: <http://www.govtrack.us/congress/billtext.xpd?bill=s111-1074>*

## **Corporate and Financial Institution Compensation Fairness Act (HR 3269) - Sponsored by Representative Barney Frank (D-MA)**

The Compensation Fairness Act includes an annual advisory say-on-pay vote and independence requirements for compensation committee members and compensation advisers. In addition, all financial institutions with more than \$1 billion in assets would need to disclose to federal regulators the structure of their compensation packages and would be prohibited from providing compensation that encourages "inappropriate risks." The bill also requires that the Government Accountability Office conduct a study analyzing the relationship between executive compensation structure and excessive risk taking.

*To read this bill in full, please see: <http://www.govtrack.us/congress/billtext.xpd?bill=h111-3269>*

## **Shareholder Empowerment Act (HR 2861) - Sponsored by Representative Gary Peters (D-MI)**

The Shareholder Empowerment Act is similar to the Shareholder Bill of Rights, but proposes some additional restrictions on executive compensation. The Shareholder Empowerment Act requires majority voting, proxy access, and the creation of an independent chairman. The bill also requires independent compensation advisers for the compensation committee, clawbacks for unearned pay, improved disclosure of compensation targets, and restrictions on severance pay. Like the Schumer bill, this bill also requires that the SEC adopt rules pertaining to an annual say-on-pay vote for all public companies. The bill is unlikely to receive committee consideration given House approval of the Compensation Fairness Act (HR 3269). Chairman Barney Frank has said he is interested in some of its provisions, but would not take any action on the Peters bill until after the House completes action on the broader financial reform legislation.

*To read this bill in full, please see: <http://www.govtrack.us/congress/billtext.xpd?bill=h111-2861>*

# Endnotes

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<sup>3</sup> Zachary A. Goldfarb, "SEC to Examine Board's Role in Financial Crisis," *Washington Post*, February 20, 2009. Available at <http://www.washingtonpost.com/wp-dyn/content/story/2009/02/19/ST2009021903215.html>.

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<sup>5</sup> Clark S. Judge and Richard Torrenzano, "Capitalism by Proxy Fight," *Wall Street Journal*, November 22, 2009. Available at <http://online.wsj.com/article/SB10001424052970203440104574404780012592404.html#printMode>.

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<sup>7</sup> Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA) introduced the Shareholder Bill of Rights in May, and Senator Christopher Dodd (D-CT) has incorporated some elements of that bill into the Restoring American Financial Stability Act. The House Committee on Financial Services is working to harmonize proposals from Chairman Barney Frank (D-MA) and the Shareholder Empowerment Act sponsored by Representative Gary Peters (D-MI). Among the changes proposed by the bills are majority voting, proxy access, the creation of an independent chairman, and advisory say on pay.

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<sup>9</sup> The Altman Group, "The Altman Interview: Holly J. Gregory of Weil, Gotshal & Manges, LLP - Part II," *Governance and Proxy Review* 1, no. 25 (November 6, 2009). Available at [http://www.altmangroup.com/gpr/vol1\\_issue25.html](http://www.altmangroup.com/gpr/vol1_issue25.html).

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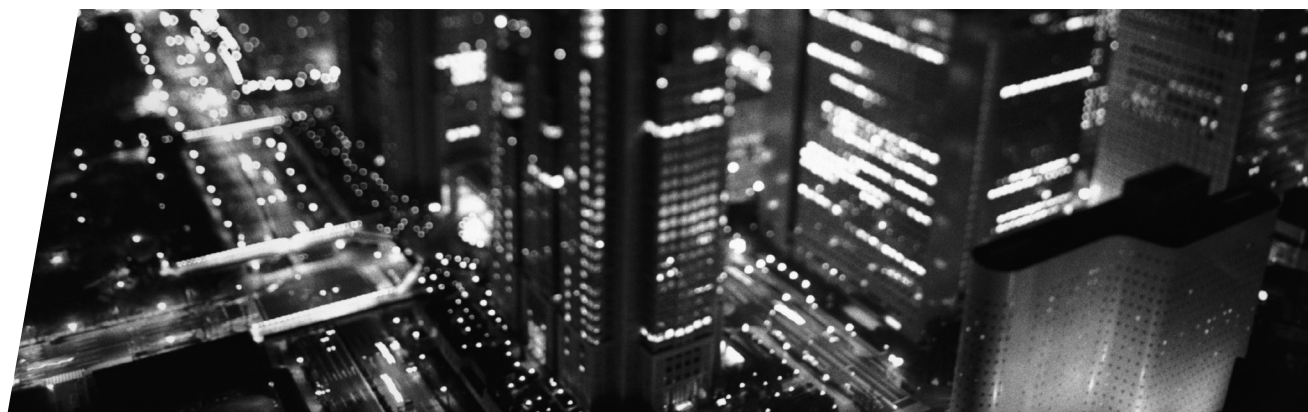
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<sup>19</sup> Patrick Yoest, "US Sen Schumer Pushes Shareholder Rights, Executive Pay Limits," *NASDAQ*, May 19, 2009. Available at <http://www.nasdaq.com/asp/stock-market-news-story.aspx?storyid=200905191336dowjonesdjonline000558>.

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<sup>21</sup> Eliot Spitzer, "Chamber of Horrors," *Slate*, October 15, 2009. Available at <http://slate.com/id/2232441>.

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