

# Proxy Perspectives

April 2011

This year represents a turning point for shareholder rights. To maintain positive shareholder relations, boards will need more effective communication programs to support practical disclosure and a rich dialogue with shareholders.

## Proxy season preview: board priorities in 2011

### What you need to know

- ▶ The focus of shareholder proposals is changing – boards are facing growing pressure on the qualifications of directors and corporate responsibility. At the same time, the sponsor landscape is shifting – shareholders are forming non-traditional alliances to achieve common goals.
- ▶ The traditional “check the box” approach to governance is becoming less relevant as shareholders press boards on new issues with no simple answers. Firms will need to be proactive about understanding and mitigating shareholder concerns, especially at companies with rising opposition votes in director elections.
- ▶ Companies favoring a two- or three-year say-on-frequency rate for say-on-pay proposals must make their case directly to shareholders. Most institutional shareholders support annual votes absent a compelling reason, and Institutional Shareholder Services, Inc. (ISS), a leading proxy advisory firm, also supports annual votes.

### Overview

- ▶ Shareholders, other stakeholders, boards and senior executives across the spectrum are watching to see how companies respond to recent and forthcoming regulatory changes as they file their proxy statements for 2011.
- ▶ This year, the focus will be on the implementation and outcome of new proxy rules, stemming from the Dodd-Frank Act, aimed at enhancing corporate responsiveness and improving disclosure – namely with respect to executive compensation. Complicating the results is the ongoing shift in the governance landscape; topics to monitor in the coming months include:
  - ▶ Rules and guidance issued by the SEC as part of its implementation of the Dodd-Frank Act
  - ▶ Proxy access – the ability of shareholders to add their candidates on management’s proxy card
  - ▶ Continuing activity around the proxy voting process (“proxy plumbing”)

## The 2011 proxy-voting landscape

Following the economic downturn, the confluence of shareholder pressure and increasing legislative and regulatory requirements are driving boards to take a more active role in managing corporate strategy and engaging stakeholders. At the same time, post-retrenchment and as markets improve, shareholders are demanding that boards maximize returns and enhance accountability.

### Board/Management priorities

Boards have to manage new and evolving regulatory requirements along with the expectations and, in some cases, the demands of more vocal and influential shareholders. Also, directors, regulators and shareholders will closely monitor how other boards address the relationship between risk management and compensation policy, and how both work to support broader corporate strategy.

- ▶ Boards are increasing their direct engagement of shareholders on a full range of issues, due, in part, to concerns over levels of no-votes (see table below), increased activist filings and a higher perceived threat of proxy contests.
- ▶ In this first year of mandatory “say-on-pay” and “say-on-frequency” proposals,<sup>1</sup> proxy filings for 1Q 2011 meetings show that 46% of companies favor triennial votes, 37% annual and 9% biennial votes; 8% did not make a recommendation to shareholders. However, vote results to date show that companies will be hard-pressed to receive approval for anything other than annual votes since most institutional investors support annual votes barring compelling reasons for an alternative.
- ▶ Boards are increasingly focused on competitive positioning, with mergers, acquisitions and restructuring matters the focus of special meetings so far in 2011; in contrast, such proposals in 2010 largely dealt with raising capital.

Boards will need to better know their shareholders – understanding their investment philosophies, voting policies and knowing who is responsible for making proxy voting decisions. Directors also need to become familiar with shareholders’ history of activism with other target companies.

#### Nominees exceeding various thresholds of opposition or no-votes

	2010	2009	2008	2007
>20% opposition	8.0%	9.8%	5.5%	4.8%
>40% opposition	1.8%	2.1%	1.0%	0.8%
Majority opposition	0.6%	0.6%	0.2%	0.2%

### Trends in shareholder proposals

In 2011, we expect boards to see a decline in shareholder proposals that deal with executive compensation, primarily because of mandatory say-on-pay and the additional disclosure expected in this area. However, the quality of corporate disclosures will impact the extent to which shareholders press on these matters beyond 2011.

<sup>1</sup> Say-on-pay refers to the right of shareholders to cast an advisory vote on executive compensation. In January 2011, in accordance with the Dodd-Frank Act, the SEC adopted the requirement that issuers must provide for non-binding shareholder votes at least every three years. Issuers are also required to provide for non-binding shareholder votes at least every six years on whether the say-on-pay vote should occur every one, two or three years (say-on-frequency).

Innovative new alliances, such as between hedge funds and public pension funds – as well as increasing activism by overseas investors – are working to ensure that shareholder concerns and voting agendas carry more weight.

In contrast, we expect shareholder proposals centered on director qualifications and social and environmental issues. Growing awareness of the correlation between a company's social and environmental policies and its risk management approach and financial performance resulted in social and environmental issues making up the largest portion of shareholder proposals for the first time in 2010 – a trend that is expected to continue in 2011.

“Hot” shareholder proposals and emerging trends in 2011 include:

- ▶ Requests for disclosure on CEO succession planning to ensure that boards are adequately planning for the long-term stability and growth of the company.
- ▶ Demands for independent board chairs.
- ▶ New proposals linking social and environmental issues to other traditional governance issues, such as compensation (performance metrics tied to environmental goals) and director qualifications (environmental expertise).
- ▶ A projected increase in environmental proposals, particularly on topics related to sustainability and environmental risk.
- ▶ Shareholders will also press for lower thresholds for proxy access than what is provided under pending SEC rules.

Shareholders will still continue their long-standing efforts to improve board responsiveness and accountability. Large US public pension funds continue to seek declassified boards and majority voting in director elections. Requests for reforms on political contribution policies, labor and human rights will also continue for similar reasons.

See the overview of the shareholder proposals expected in 2011 (page 4).

## Implications of key developments

In the coming months, all eyes will be on how governance matters play out in the improving marketplace. As the regulatory framework continues to evolve, the rising tide of shareholder activism will increasingly target companies on new and developing issues. In addition, growing shareholder pressure, combined with the improved means for shareholders to impact and engage directors, will further increase the need for boards to better know their shareholders.

### Boards must be prepared to tackle the 4 C's

1. **Corporate strategy:** Board members should take a more active role in overseeing corporate strategy, to maximize shareholder value and manage associated risks.
2. **Compensation:** Boards should configure the company's compensation structure to more closely tie pay to performance in support of the company's corporate strategy while concurrently ensuring an appropriate risk/reward strategy.
3. **Composition of board:** Boards must take the proper action to help ensure that director skill sets support corporate growth priorities and address chief areas of stakeholder concern, including risk management, board leadership and social and environmental matters.
4. **Communication:** Board members should make efforts to enhance dialogue with shareholders and improve disclosure in key areas.

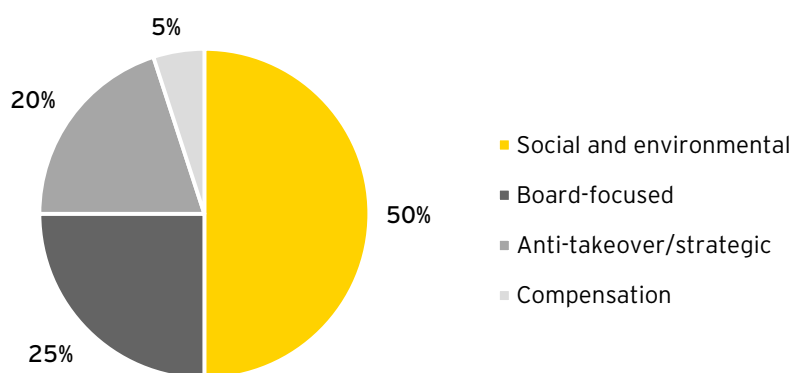
## Overview of shareholder proposal landscape and potential engagement initiatives

The following provides an overview of the key types of shareholder proposals that are expected to guide the 2011 proxy season. As this represents the first year for mandatory say-on-pay, fewer shareholder proposals that relate to compensation matters are expected. In contrast, social and environmental proposals are expected to dominate in terms of numbers.

**>50%** Indicates proposals where average voting support exceeded 50% of votes cast in 2010<sup>2</sup>

**E** Indicates emerging issue

### Estimates for key shareholder proposals in 2011<sup>3</sup>



<sup>2</sup> The 50% threshold is significant because, although most shareholder proposals are submitted in non-binding form (i.e., the company is not required to implement if approved), the proxy voting policies of many institutional investors provide for votes against directors for failure to implement majority-supported shareholder proposals.

<sup>3</sup> Estimates developed by Ernst & Young based on a review of proposals included in proxy statements to date, SEC no action letters, and information provided by shareholder proponents.

## Social and environmental proposals

### Political contributions and lobbying

Improve disclosure and (or) establish guidelines for political activities.

- ▶ Political matters are typically a strong issue; they comprise about a third of all social proposals and receive relatively high support (averaging 30% in 2010).
- ▶ The issue gained renewed attention in 2010 following the U.S. Supreme Court's decision in *Citizens United*.<sup>4</sup>

**E** In 2011, boards will see new variations on the matter, including requests for board oversight of the political contributions process and more disclosure on corporate lobbying efforts.

#### Company considerations

- ▶ Review policies and safeguards associated with political spending, including board approval requirements
- ▶ Consider enhancing disclosure, particularly around political contribution policies and procedures

### Sustainability and greenhouse gases

Report on and (or) establish goals and policies on sustainability issues.

- ▶ Sustainability issues historically represent the bulk of proposals related to the environment (75%-80% in the past three years).

**E** In 2010, a first-time proposal to adopt quantitative goals for cutting greenhouse gas (GHG) emissions received over 50% support at one company; expect more GHG reduction proposals going forward.

#### Company considerations

- ▶ Enhancing disclosure in sustainability reports to include industry-specific performance indicators and quantifiable impacts can bring operational improvements, strengthen compliance and enhance corporate reputation
- ▶ Consider third-party independent review of sustainability reports, which can strengthen the company's standing vis-a-vis stakeholders

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<sup>4</sup> In *Citizens United v. Federal Election Commission* (2010), the U.S. Supreme Court struck down restrictions on independent political spending by corporations and unions.

## Environmental risk and toxic chemicals

Report/Adopt policy on environmental risks related to company operations.

- ▶ This broad category covers environmental risks/standards, the effects of drilling in protected areas, efforts to manage the risks of toxic chemical exposures and the impact of operations on biodiversity.

E

In 2010, a first-time proposal related to hydraulic fracturing received relatively high levels of support, averaging over 30%; expect increased focus in this area.

## Human rights and labor practices

Adopt/Amend policies and procedures on human rights, global labor practices, and equal employment/benefit opportunities.

- ▶ These proposals seek to minimize workplace discrimination, enhance diversity, protect human rights (e.g., the right to clean water) and assess the human rights' impact of doing business in certain countries.
- ▶ In comparison to other social and environmental issues, average support levels for these proposals tend to be lower at 10%-25%.

### Company consideration

- ▶ Commit to constructive and ongoing dialogue with stakeholders which could result in proponents withdrawing their proposals

## Board-focused proposals

### Board composition

Ensure that directors have specific qualifications.

**E** Following the financial crisis and with growing concern over reputational risk, shareholders are pushing for directors with expertise in risk management, including in environmental matters.

- ▶ Large public pension funds are encouraging diversity.

#### Company consideration

- ▶ Use the proxy statement to describe how each director's background and skills contribute to the board's overall ability to manage corporate strategy and mitigate risk

### Independent chair

Require that board chairs be independent.

- ▶ Increasingly submitted as binding bylaw amendments (20% of such in 2010) – now 20% of S&P 500 boards have independent chairs compared to only 1% in 2000.
- ▶ This issue is popular with overseas investors; non-executive chairs are more common outside of the US.

#### Company consideration

- ▶ One alternative is to provide lead directors specific duties including setting board agendas and controlling information flows to the board; board also to disclose the rationale for selecting that individual for lead director role

### Majority voting

Require majority of votes cast in director elections as opposed to plurality voting.

**>50%** Seventy percent of S&P 500 companies now have majority provisions; it is less common among smaller issuers (35% of S&P 1500 companies have this policy).

- ▶ Several large pension funds are campaigning for majority voting in 2011.

### Board declassification

Require annual elections for directors.

**>50%** Number of proposals in sharp decline as companies shift toward annual elections - only 35% of S&P 500 boards are now classified compared to 63% in 2000.<sup>5</sup>

#### Company consideration

- ▶ With average support levels well over 50%, consider that the failure to implement these proposals may lead to votes against director nominees in the following year

<sup>5</sup> All 2000 data from the Investor Responsibility Research Center's (IRRC)'s "Board Practices/Board Pay 2002: The Structure and Compensation of Boards of Directors at S&P Super 1500 Companies."

## Succession planning

Adopt/Disclose a succession planning policy for shareholder viewing.

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This is a new proposal in 2010 after receiving SEC support for inclusion in the proxy statement recognizing that it “raises a significant policy issue.”

- ▶ Targets include large companies, long-tenured CEO/chairmen, family-controlled companies and companies with a history of muddled turnovers.

### Company consideration

- ▶ Challenge process around succession planning including regular reviews and disclosure of process to shareholders; shareholders do not expect companies to disclose the names of potential successors

## Anti-takeover proposals

### Eliminate supermajority vote

Require majority approval for transactions and charter/bylaw amendments.

>50%

This was the most highly supported of all shareholder proposals with average support of 74% of votes cast in 2010.

- ▶ Some proposals ask for reduction to majority of votes cast rather than outstanding shares.

### Company consideration

- ▶ Consider shareholder engagement if the proposal requests a majority of votes cast as the approval threshold; investors may not be aware of the distinction

### Special meetings/written consent

Establish the right for shareholders to call special meetings and act by written consent.

- ▶ Proponents ask for a 10% threshold for calling special meetings; most companies that allow for the right provide for a 20% or 25% threshold.

E

Action by written consent was a new proposal in 2010.

- ▶ Both mechanisms may be used in contest situations to replace directors.

### Company consideration

- ▶ Understand voting policies of the largest institutional shareholders; possibly the board and management should work together to determine an agreeable threshold

# Compensation proposals

## Compensation arrangements

Limit executive compensation

- ▶ Going forward, expect shareholders to focus more on specific components/details of compensation packages, including supplemental executive retirement plans (SERPs), change in control agreements and death benefits.

## Non-traditional performance metrics

Align interests of executives with stakeholders.

**E** In prior years, proponents have sought to link pay to social issues, but in 2011, resolutions seek to link pay to sustainability issues.

- ▶ As investors increasingly believe that environmental factors impact shareholder value, these proposals are likely to receive relatively high support in their first year.

### Company considerations

- ▶ Evaluate compensation policies for non-standard payments that have been the target of shareholder concern
- ▶ Check for reputational risk
- ▶ Assess if inclusion of non-traditional performance metrics will assist in aligning compensation with risk

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