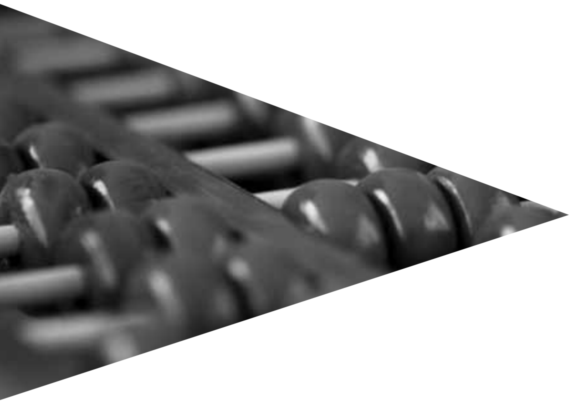
Proxy Perspectives

February 2012



Proxy season 2012: board priorities for shareholder engagement

> Well-developed shareholder engagement plans prepare directors to communicate with investors. This is important, as institutional investors increasingly expect direct and regular access to directors for substantive dialogue on governance and corporate responsibility issues.

The 2011 proxy season outcomes make clear that US boards of directors are under rising pressure to keep up with governance trends and respond accordingly in the 2012 proxy season. To demonstrate the level of accountability and transparency investors seek, boards will be increasingly challenged to commit to ongoing direct engagement with investors and enhance shareholder-friendly disclosure in proxy filings.

This publication offers boards insights into investor priorities for 2012 so they can better prepare for shareholder engagement and communications.

Key observations for 2012

- An increased number of boards have ongoing dialogue with shareholders across a range of corporate governance and corporate responsibility issues and investors are using board responsiveness to this engagement as a measure of director performance.
- US institutional investors continue to work together on governance initiatives and are increasing coordination with European investors, who are also increasingly engaging with US companies. This creates additional shareholder expectations for director-level engagement.
- The range of investors publicly engaging on governance issues is broadening. Some large asset managers, who traditionally have been viewed as passive on corporate governance practices, are starting to engage in dialogue and letter-writing campaigns focused on governance issues.
- Shareholders are beginning to analyze directors in totality, using a director's track record of performance at one company to assess that director's performance at other companies. This potentially could result in targeted "vote no" campaigns that could raise the level of opposition votes in director elections.

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The 2012 proxy-voting landscape

In the 2012 proxy season, shareholders will continue to use the new vehicles provided for under the Dodd-Frank Act and related rule-making to impact governance practices across companies (e.g., say-on-pay [SOP] proposals and shareholder proposals to implement proxy access procedures[1]). At the same time, shareholders will press for additional governance reforms (e.g., majority voting in director elections, independent board chairs). Executive compensation remains in the spotlight, with the sluggish economic recovery and growing concerns around income inequality resulting in closer scrutiny of high pay. Investors also will push for more disclosure around companies' social and environmental practices. The 2012 elections may bring some hot-button issues – particularly corporate political spending – to the forefront.

Key themes for the 2012 proxy season include:

- SOP advisory votes and compensation-related shareholder proposals
  - Shareholders will monitor company efforts to communicate with investors on pay. In particular, steps taken to address pay concerns at companies where the 2011 SOP proposals received less than 70% support (10% of S&P 500 companies[2]) will be closely evaluated.[3] Failure to implement meaningful changes will likely result in votes against SOP proposals and potential votes against compensation committee members.
  - Investors generally view the overall 2% failure rate for these proposals in 2011 as lower than expected and some have indicated that they are comfortable with voting against more SOP proposals in 2012.
  - Shareholder proposals on company-specific pay practices are expected to increase this year following a decline in 2011, when investors were more focused on the newly mandated SOP votes. These proposals will, among other things, seek to:
    - Strengthen clawback provisions on executive pay by extending the conditions for recoupment beyond those that result in a material loss; creating up-the-ladder accountability for supervisors; and increasing transparency around board decisions on whether to recoup pay.[4]
    - Limit the accelerated vesting of equity grants in the event of a change in control or termination. Proposals on this topic in 2011 averaged 42% support. Proponents are expected to expand targeting in 2012.
- Board elections, composition and leadership
  - **Proxy access:** While a federally mandated proxy access rule will not be in place for all companies in 2012, proxy access will be a reality for some companies as shareholders submit proposals and seek to engage on the topic.[5] The outcomes and actions taken in response to proxy access shareholder proposals will be closely monitored as several factors create uncertainty:
    - Although investors generally support the concept of proxy access, no consensus has emerged over how best to implement it. Shareholder proposals to date differ on ownership requirements and other procedural terms. In addition, investors are divided on when and under what circumstances to support these resolutions.
    - Companies may choose to implement their own versions of proxy access.
  - **Majority voting/annual elections:** Electing directors by a majority of votes cast (versus plurality voting) and on an annual basis has become standard practice at large companies. In fact, 70% of S&P 500 companies have annual board elections and nearly 75% have implemented majority voting requirements.

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[1] Proxy access refers to the ability of shareholders to add their candidates to management's proxy materials. Effective 20 Sept 2011, the Securities and Exchange Commission amended its shareholder proposal rules to explicitly allow investors to submit shareholder proposals to establish proxy access on a company-by-company basis ("private ordering").

[2] All data is from Ernst & Young's Corporate Governance Database, unless otherwise noted. For a full review of the 2011 proxy season, please see Ernst & Young's 2011 Proxy Season Review.

[3] Proxy advisory firms ISS and Glass Lewis will closely scrutinize companies where the prior year's SOP proposals received significant opposition (greater than 30% and 25% of votes cast, respectively). See ISS' 2012 US Proxy Voting Summary Guidelines and Glass Lewis' 2012 Proxy Season: US Proxy Paper Policy Guidelines.

[4] This shareholder initiative is separate from any yet-to-be issued SEC rules on clawbacks mandated by the Dodd-Frank Act. The Act directs the SEC to require that exchange-listed companies have a policy to clawback certain compensation from executives in the event of a financial restatement.

In addition to targeting shareholder proposals at large companies that have not implemented these practices, investors are now pressing for the reforms at smaller issuers. Shareholder proposals on these topics garner average voting support levels well over 50%. This is a significant threshold because failure to implement a majority-supported shareholder proposal may lead to votes against incumbent director nominees in the following year.

- **Chair/CEO split:** Investors are likely to continue to push for independent board chairs as the number of companies with this leadership structure has risen from 1% of S&P 500 companies in 2000 to 22% in 2011.[6] Shareholder proposals calling for independent board chairs averaged support from 33% of votes cast in 2011.
- **Board diversity:** Shareholders are evaluating whether boards are actively renewing themselves and including directors with diverse backgrounds, skill sets and expertise that are connected to the company's strategic goals and market challenges. Boards that are not challenging their composition and effectively communicating board assessment and development strategies could become candidates for proxy access shareholder proposals or other targeted reforms.

- **Corporate political & lobbying activity**
  - A record number of shareholder resolutions focused on corporate political spending and lobbying activities is possible, with the 2012 elections underway and expanded avenues for corporate spending now available following the U.S. Supreme Court's *Citizens United* decision.[7]
  - While new variations of shareholder proposals on these topics continue to emerge (including proposals seeking to prohibit corporate political spending outright), most proposals call for board oversight and disclosure of these expenditures, including direct and indirect spending through trade associations and other intermediary groups. These proposals are widely supported, averaging nearly 30% support in 2011.
- **Corporate social and environmental responsibility**
  - Average support for social and environmental shareholder proposals crossed the 20% threshold for the first time last year.
  - Investors are increasingly concerned with company environmental resource management and sustainability practices across the global supply chain. Shareholder proposals now call for sustainability reports from company suppliers, and ask for more disclosure on how companies are managing specific environmental and safety risks.
  - Shareholders are seeking to integrate sustainability issues into core governance frameworks, including requesting that companies tie executive compensation to sustainability metrics.
- **Exclusive forum bylaw provisions**
  - New shareholder proposals calling for the repeal of Delaware exclusive forum bylaw provisions (which generally mandate Delaware courts as the exclusive forums to resolve intra-corporate disputes) are likely to draw strong support. Many investors are concerned that these provisions improperly take away shareholder rights to sue outside of Delaware.[8]
  - In addition to shareholder proposals on this issue, expect some investors to vote against incumbent directors of companies that adopted exclusive forum provisions without obtaining shareholder approval.

Board and management priorities

We believe it should be on every board's agenda to consider strategies for communicating with investors on corporate governance matters. This can serve to improve investors' understanding of a company's approach to addressing key governance issues, particularly important as investors increasingly work together to press for changes to

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5 Over a dozen proxy access shareholder proposals have been filed to date, with more expected to follow.
6 Year 2000 data from the Investor Responsibility Research Center's *Board Practices/Board Pay 2002: The Structure and Compensation of Boards of Directors at S&P Super 1500 Companies.*
7 In *Citizens United v. Federal Election Commission* (2010), the U.S. Supreme Court struck down restrictions on independent political spending by corporations and unions.
8 In 2010, the Delaware Chancery Court endorsed a corporation's right to mandate a chosen forum for resolving certain types of litigation brought against the issuer, its directors and officers. Since then, at least 80 companies have implemented such provisions — most without shareholder approval — and all naming Delaware as the sole jurisdiction.

governance practices. Boards should be prepared for requests to enter into substantive dialogue on a range of governance and sustainability issues and can take advantage of disclosure opportunities to highlight developments in board composition, executive compensation and investor engagement initiatives. Boards can distinguish themselves by:

- **Developing a communication plan regarding when and how directors will engage with shareholders:** Reaching out to top shareholders when considering a significant governance change and responding to shareholder requests for engagement — including having specific directors participate in the dialogue, as appropriate — can go a long way. Engagement provides the board with an opportunity to better understand investors' perspectives on governance issues and can strengthen shareholder relations. Company-shareholder engagement can also lead to successes as both sides reach agreement on how best to achieve corporate governance and corporate responsibility goals.
- **Using executive summaries in the proxy statement to showcase governance reforms and engagement efforts:** Summaries at the opening of the proxy statement and in the Compensation Discussion and Analysis section give boards an opportunity to address areas of investor concern, note developments and changes from the previous year and explain the board's thought process. Since time constraints during proxy voting season may impede shareholders' opportunity to review proxy statements in-depth, such summaries can be particularly effective for communicating the board's message.

> Maximizing proxy statement disclosures can demonstrate a depth of attention to shareholders. Shareholders derive value from executive summaries that directly and concisely communicate governance-related developments and make clear that the board is considering shareholders' perspectives as a factor in its decision-making process.

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