InSights
FOR AUDIT COMMITTEE MEMBERS

Issue 15: March 20, 2007

TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781-290-2270

Priorities for the 2007 proxy season

Introduction

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

- The shareholder community's key proxy-related priorities for 2007
- Important issues that the shareholder community expects will emerge over the longer term
- Shareholders' evolving relationships with important constituencies (e.g., boards, management, other shareholders)

In February 2007, Tapestry Networks spoke with nine senior leaders drawn from the shareholder community. We interviewed institutional investors, including representatives of pension funds and mutual funds, as well as representatives of proxy adviser and governance ratings firms whose analyses and opinions may influence them. The participants were:

- Glenn Booraem, Principal & Assistant Fund Controller, Vanguard
- Ed Durkin, Director, Corporate Affairs Department, United Brotherhood of Carpenters and Joiners of America (UBC)
- Jim Melican, Chairman, Proxy Governance
- Nell Minow, Editor and Co-founder, The Corporate Library
- Howard Sherman, Chief Executive Officer, GovernanceMetrics International (GMI)
- Damon Silvers, Associate General Counsel, AFL-CIO
- Lynn Turner, Managing Director of Research, Glass, Lewis & Company
- John Wilcox, Senior Vice President and Head of Corporate Governance, TIAA-CREF
- Ann Yerger, Executive Director, Council of Institutional Investors (CII)

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

Executive summary

Last year, *InSights* reported two key proxy season priorities for shareholders: executive compensation and majority voting for directors.[1] Although those two priorities will again attract the most attention in 2007, new compensation disclosure requirements and changes in Congress are likely to impact the dynamics of the 2007 proxy season. Despite perceptions that some shareholders are overly focused on social objectives, participants argued that they have a vested interest in ensuring a robust capital market. Many shareholders view improved corporate governance as a means to achieve that end. While shareholders are coordinating

[1] Ernst & Young and Tapestry Networks, "Priorities for the 2006 proxy season," *InSights*, February 17, 2006. Available at http://www.tapestrynetworks.com/documents/Tapestry_E&Y_ACLN_Feb06_InSights.pdf.

their efforts more effectively, there remain significant disagreements about tactics (e.g., binding vs. non-binding resolutions, targeting "problem" companies vs. building support for effective practices across a range of companies).

In the course of our interviews with leading institutional shareholders and their advisers, the following themes emerged:

- **Majority voting was an "enormous victory" in 2006, but the campaign goes on** *(page 3)*

  Last year, few corporate bylaws required that board directors receive a majority of shareholder votes to secure election. However, faced with shareholder pressure and unpersuasive arguments in favor of retaining plurality voting, many large corporations adopted majority voting during 2006. With majority voting practices still not yet universally applied, shareholders hope to sustain the momentum they achieved last year.

- **Directors who sit on compensation committees may be held personally accountable for aligning executive compensation with performance** *(page 4)*

  New compensation disclosure requirements will shine the spotlight on both the magnitude of executive compensation packages and the link between compensation and performance. Shareholders will hold some compensation committee members personally accountable for poorly designed plans that lead to excessive compensation. Many shareholders seek a "say on pay" by means of a non-binding advisory vote on executive compensation.

- **Climate change is emerging as one of several longer-term priorities** *(page 6)*

  Although it is still a lower priority, global warming is likely to become an important strategic issue for boards and shareholders in the future. Other longer-term issues that will impact audit committees directly include accounting for pension liabilities and enterprise risk management.

- **Shareholders report improved communication with management and directors** *(page 7)*

  Shareholders describe a new spirit of cooperative dialogue with companies around complex governance issues. Although logistical barriers often prevent directors from meeting directly with shareholders, some participants say this is changing.

Introduction: shareholders are more organized, but proxy tactics and objectives vary

Business leaders have sometimes argued that, for certain institutional investors, "social concerns are prioritized ahead of fiduciary duty."[2] The shareholders who participated in this research strongly reject that view. Ed Durkin of the United Brotherhood of Carpenters and Joiners stressed that point, saying, *"Our members need healthy, growing companies so that, after 30 years, they can kick back and retire. We're invested in the market, not a company's next quarter … The board is the entity that, as the representative of the investors, is central to making that long-term vision."* Mr. Durkin asserted that, with its portfolio that includes over 3,000 companies, *"[the UBC] buy[s] and hold[s] the market."*

---

[2] Securities and Exchange Commission, *Detailed Comments of Business Roundtable on the "Proposed Election Contest Rules" of the U.S. Securities and Exchange Commission* (Washington, DC: Securities and Exchange Commission, 2003), 41. Available at http://www.sec.gov/rules/proposed/s71903/brt122203.pdf.

Mr. Durkin and his colleagues agreed that shareholders are more active in pursuing their interests. Jim Melican of Proxy Governance said, *"I think around certain issues, we've seen the shareholder community galvanize and say, 'This is the way it needs to be.' Shareholder groups are more conscious of the power they wield. There's a good amount of communication among them."*

But despite investors' increased alignment on many issues, Mr. Durkin added, *"It's not as unified as some might think … In terms of activism, that's more disparate than coordinated and unified. We've been big advocates, along with other trade groups who pushed majority voting. Others were more focused on access to the proxy. We disagree with that and think majority voting is more important and less disruptive. Everyone agrees with the need for improvement and the need for accountability with directors, but the activism that flows from that is not always as coordinated as it might appear."*

In pursuing their objectives, some shareholders and their advocates target a limited number of high-profile companies whose practices they oppose.[3] Others prefer to propose resolutions to a larger number of companies that reflect a more representative cross section of the market. For one shareholder's perspective on the future of corporate governance, see John Wilcox's "ten landscape-altering trends" in the appendix on page 9.

Majority voting was an "enormous victory" in 2006, but the campaign goes on

Although changes in corporate governance often take many years, shareholders and their advisers expressed satisfaction with the widespread adoption of majority voting practices in 2006. Under the plurality voting standard, shareholders lacked the power to vote against directors, and a single positive vote ensured a director's election. Majority voting allows shareholders to oppose specific board candidates, which gives them direct influence on the composition of the board. At the start of 2005, fewer than 30 companies' bylaws required a majority vote.[4] By February 2007, as Mr. Durkin noted, majority voting had been adopted at 200 companies, representing two-thirds of the S&P market capitalization.

Ann Yerger of the Council of Institutional Investors observed that majority voting proposals received widespread support in 2006 because they were difficult to refute: *"What is happening is just a commonsense reform that quickly gained broad support in the institutional community. Mutual funds have tended to lag a bit when it comes to supporting many reforms, but that didn't happen in [the case of majority voting]."*

Nell Minow of The Corporate Library described majority voting as *"an enormous victory in 2006, with enormous momentum."* As a practical matter, Ms. Minow observed, *"It will be hard for D&O providers to insure directors who don't have a majority vote,"* and she predicted that *"virtually all companies will adopt majority voting within the next few years."* John Wilcox of TIAA-CREF agreed that the battle had been fought and won: *"In some respects, this is yesterday's issue. The arguments against it are unpersuasive. The only remaining questions are technical ones dealing with implementation under state law."* Glenn Booraem

[3] For example, see the CalPERS 2006 Corporate Governance Focus List at http://www.calpers.ca.gov/index.jsp?bc=/about/press/news/invest-corp/focuslist.xml.

[4] Tamara Loomis, "What Will Be the Corporate Concerns in the Coming Year?" *Corporate Counsel*, January 18, 2007. Available at http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1169028144777

of Vanguard reflected on the fact that *"we've seen this practice, implemented via by-laws or policies, go from leading edge a year ago to a baseline expectation of companies going forward."*

Howard Sherman of GovernanceMetrics International also expressed satisfaction with the progress to date, but was not yet ready to declare victory. He noted, *"Among large U.S. companies, we've tracked over 200 who have some majority vote standard, but that still leaves thousands of others who have not followed suit, and there is reluctance in letting shareholders into the tent too much."* Damon Silvers of the AFL-CIO also worried that not all majority voting provisions will deliver their intended benefits to shareholders. He pointed out that *"the mechanisms [some] companies are adopting aren't real. Most investors want to see genuine majority voting, and not various things that sound nice but might not work in a crunch … There's too much smoke and mirrors and not enough genuine binding change."*

Directors who sit on compensation committees may be held personally accountable for aligning executive compensation with performance

On July 26, 2006, the U.S. Securities and Exchange Commission (SEC) voted to require more extensive disclosure of executive and director compensation. The amendments to the rules are intended "to refine the currently required tabular disclosure and combine it with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors."[5] Public companies with a fiscal year ending after December 15, 2006, are required to include a compensation discussion and analysis (CD&A) disclosure as part of the compensation committee report in their next annual proxy.

Although shareholders were focused on executive compensation in 2006, increased disclosure requirements will almost certainly change the dynamics of the discussion. Ms. Yerger observed, *"Everybody is on pins and needles. The new pay disclosure rules are going to be of great interest to the press, the public, the investor community, and the individual investor. It's hard to predict responses, but boards need to spend a lot of time thinking about those numbers and the message [they're] sending to the marketplace."*

Lynn Turner of Glass Lewis is finding *"more divisiveness this year between investors and management over compensation."* After all, as Mr. Sherman noted, "*People will see a total compensation figure compiled for the first time. We're waiting to see what the new CD&A will say, if it will tell a story."* Many experts assume that shareholders will be unhappy with the story that emerges. Either way, Mr. Sherman said, "*The first year out probably won't have a huge impact."*

Focus on performance

Although media headlines often focus on the size of executives' compensation packages, savvy shareholders take a more practical view. According to Ms. Minow, *"It's never about the absolute magnitude of compensation. It's the pay-performance link."* Mr. Turner agreed: *"As people look at companies this year, compensation is something that they're focused on, and the first issue is did you perform or not? Then,*

[5] U.S. Securities and Exchange Commission, "SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters," press release, July 26, 2006. Available at http://www.sec.gov/news/press/2006/2006-123.htm.

given performance, how was the compensation in relation to that? If money managers are making money on a stock, they aren't going to vote against its management, no matter how much money [the executives are] making."

Mr. Wilcox said that rather than dwell on current-year compensation, many shareholders will focus their attention on the longer-term implications of executive compensation plans: *"In evaluating whether to vote for or against a compensation plan, we will analyze the quality of the disclosure to determine whether the following questions have been answered: Is the plan performance-based? Does it provide sufficient detail and explanation of metrics and goals for us to understand how it is incentivizing managers to deal with short and long-term business challenges? Is the plan integrated with the company's business strategy? Is it customized and tailored to fit the company's special characteristics, size, industry position, maturity, culture, performance, etc? Does it articulate how it serves the interests of shareholders and the achievement of long-term performance and growth?"*

Some compensation committee members may face proxy challenges

Mr. Melican predicted *"a substantial number of withheld votes from members of the compensation committee. I think it'll be compensation committee members mostly, but in some cases, you can't blame this all on them; the full board has to concur, so the full board is equally responsible. But the primary emphasis is on the compensation committee."* Mr. Turner agreed, stating, *"I expect we would be voting against a number of board members where there's been option backdating, and it appears the compensation committee wasn't fulfilling their obligation to investors."*

"Say on pay" advisory votes

Some shareholder groups are asking companies to submit their executive compensation packages to an advisory vote. Known informally as "say on pay," this practice has been widespread in the United Kingdom since 2002 and is also prevalent in Sweden, Australia, and the Netherlands. Mr. Sherman noted, *"Of all the new types of proxy initiatives, the one getting a lot of attention is the 'say for pay.' It's interesting that, like majority voting in director elections, this was developed outside the U.S. and is being imported as a best practice."*

Ahead of this year's annual meetings, shareholders have submitted proposals at roughly 60 companies seeking an advisory vote on executive pay, according to Institutional Shareholder Services.[6] The American Family Life Assurance Company (Aflac) recently agreed to allow a nonbinding shareholder vote on executive compensation in 2009, but widespread acceptance of say on pay proposals is far from guaranteed.

Mr. Melican suggested that *"unlike majority votes, which are being accepted, this will be resisted,"* with opponents arguing that it undermines the authority of the board and that the issues are too complex to be subjected to a simple up or down vote.

[6] Erin White and Aaron O. Patrick, "Shareholders push for vote on executive pay," *Wall Street Journal,* February 26, 2007. Available at http://money.aol.com/news/articles/_a/shareholders-push-for-vote-on-executive/n20070226122209990002.

Some directors may view say on pay as a convenient tool. According to Mr. Sherman, *"Many boards understand in their heart of hearts that the CEO compensation system has gotten out of hand, and an advisory vote can be an outside ally. If they're interested in making changes at the board level, it's more diplomatic to defer to the shareholder vote than confront the CEO."*

Furthermore, while many shareholders are undoubtedly concerned about the dollar value of compensation and the pay-performance link, others will focus on compensation philosophy. According to Mr. Wilcox, *"We like the idea of voting on whether the board has fulfilled [its] responsibility, and the [compensation] scheme is a good one. We're more inclined toward that approach, and we're not interested in voting on the specific dollars paid to the executives. That would be micromanagement."*

Shareholders expect the November 2006 election results to change the dynamics of the proxy season. As Mr. Silvers noted, *"It's hard not to conclude that a significant change in our government will have an impact … I think you'll see a lot more scrutiny and attention."*[7] Some participants felt the prospect of regulation may prompt companies to voluntarily adopt new practices. In Mr. Melican's view, companies have *"a desire to [prevent] Congress [from] substituting [its] judgment for the board's on compensation matters … There are some people in the business community who would say we have an opportunity to clean up our own house, so the government doesn't have to do it."*

Climate change is emerging as one of several longer-term priorities

Regardless of arguments about its causes and likely impact, climate change is likely to become a significant corporate issue in the coming years. Mr. Sherman said, *"The emergence of climate change is a new corporate risk for many industries."*

Action on climate change and other environmental initiatives is often considered under the rubric of broader socially responsible investing (SRI) principles. Mr. Melican said, *"The SRI proponents have done a good job ramping up support. With certain resolutions, like those on global warming, there are now higher levels of support than in the past. SRI proposals seldom received more than 10% … [Now] some are taking hold and getting substantial votes, and we'll see that continue."* Looking a few years out, Ms. Minow predicted, *"Climate change will be huge. Companies better develop board committees with an expertise for managing this issue. It's going to be a huge, huge issue."*

Two other shareholder issues that could impact audit committees directly include:

- **Accounting for pension liabilities.** Ms. Minow noted the recent accounting rule changes for pension liabilities, and observed that *"some [companies] are doing it right and making the required calculations, and others are monkeying around and trying to hide the bad news. The market is going to be very tough on those who are not forthcoming. Boards are focused on operations and not pension*

---

[7] Indeed, Rep. Barney Frank (D-MA), the new chairman of the House Financial Services Committee, has advocated regulations that give shareholders more power to vote on executive compensation, as he believes it is "unrealistic to expect boards of directors to serve as a check on CEOs, [because] the relationship is too close." See John D. McKinnon and Christopher Conkey, "Bush Gives Hope to Foes Of Sarbanes-Oxley Law," *Wall Street Journal,* February 1, 2007.

funds. If they don't [oversee pension liabilities] appropriately, they will find themselves very unhappy. That's the audit committee's problem."

- **Enterprise risk management (ERM)**. Mr. Sherman noted, *"We see [ERM] as an emerging board responsibility, and we are in the process of figuring out how to capture various approaches to ERM in our systems, so we can credit companies who are ahead of the curve and remind others that it is a governance responsibility, and there are different solutions out there."*

Shareholders report improved communication with management and directors

Shareholders report that the frequency and tenor of their discussions with management have dramatically improved. Ms. Yerger said, *"The concept of dialogue between boards and owners, or management and owners, has come a long way. I don't think any [dialogue] is mandated by regulation, so it's all by market forces. We're in a whole different environment post-Enron, and many companies understand that and understand that good dialogue is important."*

Mr. Booraem agreed: *"We've certainly seen, in our discussions with portfolio companies, much more collaboration and much more [desire] for input. They want to understand and be responsive to our perspective on issues. As they're crafting proposals – either on governance changes or compensation plans, for example – they want to understand where our concerns are going to lie."*

Despite hopes that directors will advocate more strongly for shareholders' interests in supporting effective governance practices, shareholders recognize that communication with directors poses special challenges. Mr. Wilcox commented, *"If you're talking about direct interaction [between directors and shareholders], it is still low, and that's for logistical reasons. If the board wants to communicate with shareholders, it has to decide how to do so in a fair way. Which shareholders should be contacted? What's the most effective way to handle communications? How to avoid duplication of effort or mismatched messages and so forth."*

However, there is evidence to suggest that these obstacles can be overcome. As Mr. Sherman noted, *"We talk with boards frequently these days. Because of the nature of our business, we're dealing with the corporate governance officer or secretary, but substantial discussions tend to have a director involved in the end. Dialogue is healthy. It's not like it was 20 years ago, which was, '[Go away], it's our company!'"*

Conclusion

Institutional shareholders are more actively seeking to influence corporate governance practices. While this could lead to greater conflict between shareholder and corporate interests, there is no reason to assume that confrontation is inevitable.

Leading institutional shareholders have a clear interest in supporting and enhancing the financial strength of the corporations in which they invest, and the 2007 proxy season is just one milestone along the road down which shareholders, management, and directors are traveling together. Intelligent people may disagree about important issues, but positions often converge following open dialogue in the pursuit of common objectives. Many shareholders understand that while the power to impose sanctions serves a purpose, their interests will be better served by constructive discussion than unconstructive dissent.

About this document

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

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

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

Appendix: John Wilcox's "ten landscape-altering trends"[8]

Here is an optimist's view of 10 trends that will shape boardrooms and the governance landscape in the years ahead:

1. Majority voting and the right of shareholders to vote against directors will become the norm, replacing the plurality vote standard in U.S. director elections.
2. Executive compensation will be brought into line by a combination of factors: enhanced SEC disclosure requirements, an advisory shareholder vote on compensation committee reports, and recognition of the need for internal pay equity.
3. Separating the roles of chairman and CEO will become more common at U.S. companies, encouraging boards to worry less about preserving power and more about developing and incentivizing the best executive talent.
4. The model of the imperial, celebrity CEO will be replaced by the stewardship model, with Reginald Jones unseating Jack Welch as the role model.
5. Sustainability and corporate social responsibility, formerly relegated to gadflies and special-interest groups, will be recognized as key corporate governance responsibilities for which directors should be held accountable.
6. Shareholder communications and proxy voting systems will be revamped by the SEC to make better use of technology, reduce costs, increase efficiency, and improve a board's ability to identify and communicate with shareholders.
7. Shareholder resolutions will be overtaken by other forms of constructive engagement, and shareholder activism will become less confrontational, more responsible – and more effective.
8. The definition of beneficial ownership will become more complicated and problematic as stock lending and derivative investment strategies enable investors to separate voting rights from any economic interest in the underlying stock.
9. The spotlight will shift from the governance of companies to the governance of institutional investors, with a focus on how institutions should best fulfill their conflicting duties to maximize returns while acting as responsible owners.
10. Companies will come to recognize that corporate governance is not just a matter of regulatory compliance and accountability but a strategic means to lower the cost of capital, reduce risk, create value, and strengthen the long-term performance of the corporate enterprise.

---

[8] John C. Wilcox is senior vice president and head of corporate governance at TIAA-CREF, one of America's largest institutional investors and a leading advocate for sound principles of corporate governance (www.tiaa-cref.org). Before joining TIAA-CREF, he spent 31 years with Georgeson Shareholder Communications, where he specialized in corporate governance, takeovers and control contests, and investor communications. This column is available at http://directorsandboards.com/DBEBRIEFING/November2006/ColumnNovember2006.html. Used with permission.