Get Ready For A Red-Hot Proxy Season

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If the 2006 proxy season felt dramatic, just wait until spring. The folks with their fingers on the pulse of big shareholder groups have already identified the top five areas of activity this year: majority voting, executive compensation, board declassification, poison pill elimination and activist hedge funds.

Many boards grappled with one or more of these issues last season, but that doesn't mean they've gone away. If anything, shareholders feel empowered by their progress. Proxy advisory firm Institutional Shareholder Services recently polled the largest of its 1,720 clients on the future of corporate governance. The 325 institutional investors surveyed control some $20 trillion worth of equities, or 62% of the total $32 trillion under management by ISS clients. "Ninety-seven percent of the respondents said that corporate governance was going to be more important than it is today," reported John Connolly, the firm's president and chief executive. Furthermore, he added, a large majority said that within their own organizations, corporate governance has moved from a compliance activity to a business imperative.

What does this mean for boards, and how should directors be spending their time in the runup to the 2007 voting season? The consensus of Directorship's Agenda 2007 panel on proxy issues was that communicating clearly and frequently with shareholders is more important than ever. Investors who don't hear about strategy, financial developments, transactions and major market changes from corporate leadership are going to draw their own conclusions. And with various stakeholders eager to spin events to fit their own agendas, those conclusions will often be negative. "As we well know, nature abhors a vacuum," said Nancy Humphries, president and CEO of the National Investor Relations Institute. "Either you control the situation, or one of your owners or the media is going to control it."

Directors aren't about to be asked to become instant investor relations experts--although some companies bring their IR leaders into the boardroom often. But arguably, in today's climate, part of their fiduciary duty is pressing management to engage early and often with shareholders on key issues. That is a year-round job. "The annual meeting process nowadays is kind of like being a professional athlete. Even in the off-season you have to train," says Warren de Wied, corporate partner at law firm Fried, Frank, Harris, Shriver & Jacobson. "And if you're not training in the off-season, you may not do very well in the regular season."

Clearly, shareholders have targeted the boardroom as the place where they want to see change begin. It's telling that two of the five hot issues for 2007 relate to board composition and structure. Connolly expects 450 resolutions on majority voting to come before U.S. companies this year, up from 140 in 2006, 89 in 2005 and just 12 in 2004. Corporate giants from Wal-Mart Stores to Intel

have already embedded majority voting in their bylaws, and many more large companies will likely follow.

Gavin Anderson, CEO of rating firm GovernanceMetrics International (GMI), called the majority voting movement an "unstoppable train." So far, only 150 out of 9,000 publicly traded companies have adopted it. But Anderson predicts that a majority will do so within three or four years. Starting this season and continuing indefinitely, more and more directors will be unseated because of shareholders' views of their performance or because they are associated with a problem within the company. And fewer board-appointed directors will be elected in the first place if there's dissatisfaction with the company's overall strategic direction or share price.

Meanwhile, the movement toward board declassification has gathered so much momentum that Connolly advised companies not to waste their resources fighting it. Already, 53% of publicly traded companies have declassified boards, and last year saw 94 proposals. Academic studies by Harvard's Lucian Bebchuk and others correlate staggered boards with lethargic stock performance, and shareholders have taken notice. Connolly thinks they have simply concluded that a classified board has no benefits for them as owners.

Of all the issues that motivate investors to call for a board shakeup, executive compensation is probably the most explosive, and new disclosure regulations on pay packages--for directors as well as managers--will make the topic even more prominent this year. A whole slew of formerly private information will henceforth be public, and the scandal over options backdating is ongoing. All the panelists agreed that the scandal could be a catalyst for action at a lot of companies.

Once again, clear communication with shareholders could go a long way toward defusing potential crises. Once the compensation committee makes its recommendations and the full board decides on executive pay, says Humphries, "the presses are going to run with hundreds of thousands if not millions of copies of your proxy statement. I would suggest to you that the board needs to know, if they don't already know, very clearly what the process of communication is going to be around those numbers. And that's got to be done beforehand and not after."

Executive compensation that is not closely tied to performance is one important issue that makes companies vulnerable to activist hedge funds. And because more and more companies are eliminating their poison pills, the kind of major proxy fights seen last year--Nelson Peltz's run on Heinz, for instance, and Carl Icahn's on Blockbuster--could become more common. "We have favorable market conditions for the type of investor who is seeking to make a short-term profit by trying to get a company to restructure or sell itself," says de Wied. "And what every director needs to understand is, unless you have a controlling stockholder or group, you are usually a target."

Connolly thinks even General Motors could come under intense attack from activist hedge funds or private equity investors this year. "So, how you as a board of directors communicate with those shareholders is, I think, going to be increasingly important," he says.

Directors may also have to pay more attention to governance ratings. Whether such ratings, including numbers like ISS's Corporate Governance Quotient (CGQ) and GovernanceMetrics' accountability score, correlate with financial performance remains a matter of fierce debate. The

important point for companies is that many powerful investors believe the correlation is real. Francis Coleman, executive vice president of Christian Brothers Investment Services (CBIS), which has more than $4 billion in assets under management and promotes socially responsible policies in the companies where it invests, says, "This is not something that we are doing just to do it. There is a fundamental belief that companies that address these issues are better plays and better investments in the long term than companies that aren't addressing them."

In fact, Coleman says, his organization's clout is growing precisely because its concerns address economic performance. (CBIS is a member of the Interfaith Center on Corporate Responsibility, which includes some 275 faith-based organizations with over $110 billion in assets. Talk about clout.) Whereas 10 years ago, companies in which CBIS held several million shares barely acknowledged him, he has a much easier time initiating dialog with management and board leaders now. "I think one thing that is contributing [to that influence] is our increased ability to make the business case on some critical social issues," Coleman says. "There are issues out there that are potential long-term hidden bombs for companies. Environmental liabilities, human rights issues--no one wants a headline, 'Company Is Employing Children in a Factory.' That just doesn't play well."

Of course, making a business case for good governance is what activists of every stripe try to do. That's why companies' CGQ and GovernanceMetrics ratings are so widely watched. GMI's Anderson says that unlike ISS, his organization produces governance ratings without advising investors on how to vote their shares. But he says that among the 3,800 companies his organization rates, the top 10% in terms of governance metrics had superior return on equity and return on investment than average "and way outperformed the bottom 10%."

He says that such numbers, which measure economic performance rather than stock activity, are watched on an ongoing basis--not just by hot-money hedge funds or long-term pension investors but by the vast universe of mutual-fund managers and shareholders. "Remember, the proxy is just dealing with two or three issues that happen to be the hot-buttons this year," Anderson says. "But your overall governance matters."

That huge, anonymous investor pool could get much more visible in the future if the Securities and Exchange Commission follows the New York Stock Exchange's recommendation and eliminates broker-dealer discretion. "The broker-dealer vote for the issuer community has been a management-favored vote for years," says Connolly. When individual investors vote their proxies, the balance could change dramatically. Connolly envisions teachers' organizations issuing voting policies that apply to all teachers who own shares or mutual funds, or AARP instituting guidelines of its own.

The central issues in the coming proxy season all point to large-scale and lasting "democratization" of corporate leadership. One result for companies will be a need to spend more time separating mere gadflies from well-intentioned shareholders. CBIS's Coleman says that when companies engage with their critics, "you will be able to discern who are the serious players in this arena and who are not. It behooves you to begin a conversation with those serious players."

Better investor relations, the panel concluded, will go a long way toward preventing disasters at this year's annual meetings. Directors need not be humiliated by hostile questions or irate lectures. They just have to make their message heard outside the boardroom. "You've got to be out there talking to

your investors," says de Wied. "And you have to talk to the proxy advisory firms, because they have tremendous clout."