

2004 PROXY SEASON: A TEST OF NEW RULES AND ATTITUDES

Attention, board chairs, independent directors, chief executive officers, chief financial officers, and other senior corporate managers: with the turning of the calendar pages in January, you have now "crossed over" into a new and potentially far more volatile and uncertain operating arena for publicly owned corporations. The 2004 proxy voting season and the usual (mandatory) annual shareholder meetings are likely to be much more contentious for some companies and will provide a peek at the uncertain future for many other issuers.

The rules of the road for those who manage and steward large public companies *really are* different now, and the forces at work in the marketplace will make proxy voting and board elections in 2004 an important testing ground for new proxy rules, new mutual fund disclosure rules, first-time or continuing shareholder pressure on a company on vexing issues, and expanding investor-company communications, including new types of direct board-holder dialogue.

Proxy election season 2004, particularly in the spring months and continuing out to November, will present a clear dividing line between the nature of proxy seasons past and electoral processes, and what is ahead for most issuers. Many observers see 2004 as a template for what could follow in 2005 and future years. Shareholder advocates are hailing some of the changes in the proxy environment, believing now that after several decades of increasing activism, and the mounting challenges to nonresponsive companies, the scales are tipping in their favor (issuer ability to ignore or reject shareholder proposals is diminishing, they argue).

The players to watch from the boardroom and corporate suite especially include public employee and labor union pension funds, and individual and faith-based investor coalitions. These types of institutions, often having rank and file trustees, are themselves proxies for other institutional

investors—think of them as canaries in the coal mine for proxy contests to come in 2004, 2005, and beyond.

The issues will be defined company-by-company, industry-by-industry,

and often according to the missions of the challenger (faith-based investors, for example, focus on corporate responsibility and social justice issues).

Finance officers will be closely watching the issuance of new rules (and proposed rules) by the Securities and Exchange Commission (SEC or Commission), as the Commission, under the leadership of new commissioners and Chair William Donaldson, continues to react to public criticism that it was "too slow to move" on corporate reforms in the past.

The oft-used metaphor "Perfect Storm" could well be applied to describe the various forces that will shape proxy-voting season 2004 in particular. (The best-selling book of that title described the once-in-a-century convergence of powerful meteorological disturbances that presented a "perfect storm," not in the positive sense but as in the horrific effects during and after the big blow. Not since the passage of 1933 and 1934 securities protection legislation has there been such a concentration of dramatic forces for change in board governance, corporate electoral processes, and financial disclosure practices and polices.)

Vigilant institutional investors

In looking at some of these forces, let us start with shareholder activism. Institutions of all types are emboldened and moved to action by the events of the past three years, beginning with corporate scandals in the U.S. and other major economies, huge corporate bankruptcies in the U.S. and abroad, passage of the comprehensive and bipartisan Sarbanes-Oxley legislation (quickly signed into law by President George W. Bush and rushed into rule-making by the SEC), state prosecutions of Wall Street firms and mutual funds, and many closely related events.

One of the largest pools of corporate equities investment is the mutual fund industry, which holds more than \$7 trillion in various portfolios for an estimated one hundred million Americans (through direct investment, 401(k) plans, self-directed IRAs, etc.). A good number of these mutual fund [management] companies now have troubles of

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their own. (The top eighty advisor firms, as mutual fund managers are known, have been queried by the SEC on various policies and practices related to trading and other issues). They don't need more headaches, such as proxy contests where they must choose sides, sometimes with penalties.

Investor confidence in funds has been seriously shaken by New York State Attorney General Eliot Spitzer's and the SEC's investigations of large fund families and revelations of unseemly insider self-dealing at formerly trusted advisor companies. In late 2003, at times it seemed that the last bastion of investor trust—the friendly, warm and fuzzy mutual fund—was also a place you could not put your money with any confidence.

Greater transparency has come to the mutual fund (investment company) industry. This year, under new rules, fund advisors must begin reporting to their shareholders on two key issues: First, advisors must explain their formal corporate governance voting policies, as in, "here is how we will vote the shares we hold for you as your fiduciary, in trust, and why we are voting this way."

Second, on an annual basis beginning with their 2003 corporate proxy votes, the advisor must then inform shareholders how the votes were cast for each company held in fund portfolios. For some large advisors, such as Fidelity, Vanguard, Morgan Stanley, and others, these portfolio investments collectively represent billions of shares to be voted as part of the advisor's fiduciary duty. Will a fund vote with corporate management on unpopular issues? And what if serious investor challenges are presented by other institutions, such as the activist California, New York State, New York City, Wisconsin, Connecticut, and other public employee pension funds; labor unions through AFL-CIO campaigns; or TIAA-CREF on behalf of educator beneficiaries? Will your mutual fund vote with these shareholder activists or with company management in a future proxy contest?

What if the specific fund family was one of the growing number of advisor companies targeted by the New York State Attorney General or another state official, or by the SEC? Would fund management take on additional headline risk by bucking the trend to support management or targeted directors standing for reelection in a hotly contested election? In the past, at many advisory firms the choice was simple: follow corporate management's recommendations (contained in the proxy) and pro forma vote the shares, no matter the public relations battles sur-

rounding contested issues. Beginning in 2004, proxy voting will not be that simple for mutual fund advisors.

The effect of holistic company-investor communication

John Wilcox, Vice Chairman, Georeson Shareholder Communications, is an investor communications professional with three decades of experience in literally thousands of proxy contests as well as ordinary voting campaigns. He has been involved in investor communications, friendly and unfriendly takeovers, contested control contests, expanding cross-border communications, introducing global proxy voting, and monitoring proxy voting patterns over the long term.

Addressing the lively proxy contests that will begin in spring 2004, Wilcox observes: "Corporate officers and directors will experience being in an entirely new place that shareholder meetings will occupy in their lives and in the lives of their companies. Financial managers and investor relations professionals will need to play a major role in determining how new types of disclosures are handled under new SEC rules, for example."

"Boards of directors will now have specific disclosure responsibilities, thanks to Sarbanes-Oxley, New York Stock Exchange, and NASDAQ Exchange rules, and direct communication with shareholders will begin and quickly expand. What will this mean? How will board-investor communications work? We will soon be seeing more of the traditional investor relations functions being instituted at the board level. Until now, we have had corporate secretaries at the center of board activities, with a more legalistic view of board affairs. As investor-company communication expands, a more holistic type of communication is needed. I see this as a major opportunity for the investor relations officer, and corporate financial officer, beginning this year."

Direct nominations of directors by investors

One of the major changes Wilcox refers to is the pending revision to SEC rules that *could* open the door to direct nomination of candidates for open board seats. At first, this will be a very complicated process (perhaps beginning this spring, *if* the Commission approves the rule in time), initially requiring contortions to include just one nomination on the company proxy in 2005 or



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beyond. But the door will begin to open for more direct participation in board elections, as in 1992, when the Commission made investor-to-investor communication less cumbersome and expensive. Since then, we have seen much greater cooperation among institutional investors and more public dialogue on proxy and electoral issues.

The SEC's pending rule would allow long-term security holders of 5 percent (or more) of a company for up to a certain period of time to offer one nominee as a board candidate on the company proxy, after a "triggering event" demonstrates widespread shareholder dissatisfaction (except where prohibited by state laws, which govern U.S. domestic corporations). (For details, as published in the *Federal Register*, see www.sec.gov/rules/proposed/34-48626.pdf.) These measures are also intended to improve disclosure surrounding board elections and proxy resolutions.

Introducing the proposed rule in October 2003, SEC Commissioner Harvey J. Goldschmid declared, "We are in the process of shifting the balance of power between corporate managements and shareholders. No longer will managements be able to ignore dissatisfied majorities of shareholders."

"If all goes well, independent directors will represent shareholder interests. But... when corporate senior managers are unimaginative, ineffective, or wrongheaded, and a compliant board allows them to remain on a painful or disastrous course . . . the proposed rules . . . will give dissatisfied majorities of shareholders a means of playing a meaningful role in the election process."

Corporate governance issues are now perennial

In conversations at recent financial analyst and corporate or board member [association] meetings, the writer has often heard the comment that corporate governance "may now be fading" as a front-of-the-mind issue for corporate leaders, especially with the major equities indices rising dramatically in 2003. Does that change proxy season 2004? And the mindset of institutional and individual investors? Don't bet against continuing corporate governance reforms, at least any time in the remaining years of this first decade of the new century. Because of forces already in motion, continuous tidal waves of reform will be swept against the rocks of the securities and mutual fund industries and corporations themselves.

For an example of what may be in store for companies in 2004 and 2005, watch the actions of the

coalition of four big public pension funds as they set out to sponsor a shareholder resolution to change the board of Marsh & McLennan Companies (parent of Putnam Investments, the large mutual fund advisor). The funds—the California Public Employees' Retirement System (CalPERS); the New York State Common Retirement Fund; the American Federation of State, County, and Municipal Employees (AFSCME) Pension Plan; and the California State Teachers' Retirement System—intend to seek direct (and immediate) access to Marsh & McLennan's proxy process to nominate and elect independent directors (providing, of course, that the SEC issues its new rules governing shareholder access to proxies in time for the 2004 contest).

Is this a peek at things to come at companies under challenge? "Marsh & McLennan deserves to be the first company in U.S. history to face a binding proxy access proposal because of its gross failure to have proper controls that could have prevented the Putnam [mutual funds] disaster," said Gerald McEntee, chairman of the AFSCME union pension fund.

William Rosoff, Senior Vice President and General Counsel, Marsh & McLennan, responded immediately, expressing surprise and disappointment that "major, experienced long-term investors would proceed in a manner that serves the interest of all shareholders . . . and would not communicate their opinions through a press release and not directly to the board and management." Welcome to the contentious new environment of the proxy season!

In the traditional "Wall Street Walk" method of voting, eleven major state employee pension funds—including those of Vermont and Massachusetts—did pull their investments out of Putnam, part of a \$30+ billion outflow of the Marsh & McLennan fund complex after New York State Attorney General Eliot Spitzer began his investigation of Putnam staff trading practices.

New public pension fund coalitions

At a January news conference, New York State Attorney General Eliot Spitzer, California State Treasurer Phil Angelides, North Carolina Treasurer Richard Moore, and New York State Comptroller Alan Hevesi announced the formation of the "Mutual Fund Protection Principles," a state-coordinated effort to force reforms on the \$7 trillion mutual fund industry (top issue: more complete disclosure of management fees and costs). These officials control \$400 billion in assets

and influence other state officers managing hundreds of billions more.

The National Coalition for Corporate Reform (NCCR) is also on the march. In December 2003, this group of public pension and labor union funds proposed an alternative for proxy access to the SEC. (The above leading funds plus those of Kentucky, Nevada, Iowa, Pennsylvania, and others are involved in the coalition.) NCCR doesn't believe that "triggers" are necessary to put direct nominations for directors on the corporate ballot.

If, however, the SEC proceeds with triggers (which now appears likely), NCCR wants an *additional trigger* to serious mismanagement. (SEC triggers as proposed all involve a two-year, two-step process, which state fund trustees feel is too lengthy when there is substantial mismanagement or worse.) The states and unions would like to see the SEC include such events as SEC enforcement actions, indictment of executives or directors on criminal charges, material restatements, delisting by an exchange, or significant share underperformance. *Any* of these events should trigger proxy access for the *next* shareholder meeting, they believe.

Watch for these and other public pension fund officials to focus on their investments in corporations in 2004 and beyond; continue to push for reforms, expanded proxy voting rules, and more disclosure on the part of corporations; and become more prominent players in expanding proxy contests for underperforming companies, as well as those with "errant managers" caught in the spotlight of state and federal prosecutions.

Shareholder issues raised for 2004

CEO compensation is shaping up to be the major issue for proxy contests and votes in 2004. Charles Elson, corporate governance expert and Edgar S. Woolard, Jr., Chair in Corporate Governance at the University of Delaware, is a veteran of proxy wars. (A law professor as well as a director of public companies, he was the board member at Sunbeam who led the charge to oust the controversial "Chainsaw Al" Dunlap.) Professor Elson is also the director of the university's influential Weinberg Center for Corporate Governance and is advising companies on corporate governance issues. What are the big proxy contest issues Elson sees for 2004?

"The Number One issue for many companies will be executive compensation," Elson explains. "We will see the issue of options fading with NYSE rules for shareholder approval of all plans, and a shift to the issuance of restricted stock for

senior officers. There will be many more independent committees of the board, and some committees could pose serious internal challenges to CEOs as they act more independently, and on behalf of stockholders. The critical issues of severance pay, parachutes and other compensation practices of the past will be addressed more and more by shareholder resolutions, both from within the companies themselves and especially as proposed from outside."

"As for the second major issue, we will see more focus on board candidates, and board independence, beginning in the 2004 elections. Investors are now posing serious questions about board elections. Who are the nominees? What are their qualifications? What will their mandates be if elected? What will their disclosure policies be if elected?"

With the tightened New York Stock Exchange-listed company rules now in place, Elson stresses, "there is going to be heightened investor focus on important issues, especially compensation plans, board qualification, and matters of independence. The place where all this plays out is in the annual meeting, board elections, and shareholder proxy voting."


California—where trends often start

One bellwether institutional investor to watch is CalPERS, the huge California employee pension fund. Since the 1987 proxy season, the fund has maintained an annual "Focus List," selecting the lowest [relatively] performing companies for attention. If after communication and meetings with the company, changes are not forthcoming, the list is made public and proxy resolutions are often filed. (The 2003 public list included Gemstar, JDS Uniphase, Xerox, and others. CalPERS visited the boards of dozens of other companies during the past year to discuss shortcomings.)

CalPERS looks at three important areas of performance: (1) shareholder returns, relative to peers; (2) Economic Value Added (EVA®); and (3) the firm's corporate governance practices. For more information on this important approach that, in turn, influences other institutional investors, visit www.calpers-governance.org/alert/selection/default.asp.

2004 season getting underway

As this column was being prepared, the various institutional shareholder interests and their consultants, corporate governance rating services, socially responsible investing associations, and



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other interests were jockeying for advantage. In 2003, more than 1,000 shareholder-sponsored resolutions were played out in contests.

Some resolutions received a significant share of votes, and a record number achieved majority status. While in 2003 and prior years such shareholder expressions could be ignored by management and boards, given the major changes taking place and the powerful forces

coming to bear on the corporate electoral process, 2004 is the year in which boards and managers have indeed stepped over the line into a new and more volatile operating environment.

The major indicators for the future—for year 2005 contests—will be evident in the voting results this year. The proxy season, therefore, will be important to watch whether your firm is challenged by shareholders or not. •