CORPORATE GOVERNANCE

PROXY SEASON 2003—A WINDOW INTO THE FUTURE

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Most U.S. public companies schedule shareholder proxy voting and annual meetings in the first half of the year (following the close of business on a calendar basis, December 31). In recent years, there has been a steady increase in the numbers of resolutions introduced by individual and institutional shareholders, comprising two primary types: demands for changes in the way the corporation is structured or governed (corporate governance), and pressures applied through the proxy to change corporate behavior (e.g., to have the target company exhibit social responsibility).

As examples of the governance type of shareholder resolution, there are shareholder demands for:

- More independent board members
- More controls over CEO compensation
- Board election issues (such as staggered terms versus entire board standing for election)
- Board member stock ownership and compensation (cash payments versus all stock)

And of the behavioral and social responsibility type of resolution, some recent filings include:

- No tobacco sales
- No sales of military weapons overseas
- Standards for offshore workers ("sweat shop" initiatives)
- Prohibitions on use of child labor in offshore factories
- Environmental protection and sustainable development issues

Some issues are perennial, and others reflect current trends in society. The financial debacles of 2002—the financial collapse of Enron, followed by WorldCom, Global Crossing, et al.—came too late in the year for the shareholder activist community to react fully to dramatic changes in the environment, and to bring aboard allies such as managers of large mutual fund families to support new measures in response to corporate scandals. There was enough time in autumn and winter 2002 to plan proxy campaigns carefully against the background of the equities markets entering the fourth year of falling values, major trading indexes declining by as much as 40 percent or more, and major media coverage of the misbehavior of corporate managers.

Individual and institutional investors are displeased with the financial under-performance of many large-cap U.S. companies, and with the falling values of their portfolios. Enron and then WorldCom became front-page news and demands for reform increased from all parts of America. Then Wall Street, Capitol Hill, and the White House joined the chorus for reform, supporting public sector focus on important issues—public company accounting, public company auditing practices, CEO and board misbehavior, and the demand for greater accountability on the part of all parties in the investment process.

The year 2002 will be remembered as the turning point in corporate accountability, when corporate governance became an everyday catchall phrase to embody the concept of companies

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"doing the right thing" for shareholders.

The major forces in American society driving important changes throughout 2002 and into the 2003 proxy season include:

- Executive orders by President Bush addressing corporate governance and management misbehavior, that in turn pressured the Securities and Exchange Commission (SEC) to issue new rules (President Bush suggested 10 points for reform, such as certification of financial reports by CEO and CFO)
- The comprehensive Sarbanes-Oxley legislation (S-O), which was signed into law by President Bush on July 31,2002 and strengthened 1933 and 1934 securities statutes, expanded SEC authority, provided significant financial support for the Agency, created a new Public Company Accounting Oversight Board, and other reform measures
- SEC rules flowing from S-O statutory authority, and other rules that followed the spirit of S-O, for which statutory authority already existed
- Greatly expanded New York Stock Exchange (NYSE) corporate governance rules (now pending before the SEC) for listed companies, to be phased in over the coming months
- Expanded NASDAQ exchange rules for listed companies (similar to those of the NYSE), with more disclosure and transparency rules promised by exchange officials
- Revelations about investment banking, brokerage, and corporate behavior in the 1990s as made public by New York State Attorney General Eliot Spitzer in his investigation of Merrill Lynch, Citigroup's Salomon Smith Barney, and other investment houses
- Corporate governance recommendations by The Conference Board,The Business Roundtable, and other business organizations, suggesting voluntary reforms to senior corporate management for adoption in their respective companies
- The campaign begun by Domini Social Investments LLC (Domini Social Equity Fund) to have mutual fund managers develop and publicize formal corporate governance guidelines for voting proxies, and the posting of actual votes on Web sites (approved by the SEC in 2003); investment companies own approximately 20 percent of publicly traded securities and vote on behalf of 90 million individual investors
- The anger and disappointment experienced by mutual fund and other institutional money managers because of the poor performance of public companies is being manifested through increased support for shareholder activist initiatives by institutional investors (with billions of dollars invested and millions of votes to cast at proxy time)
- And most important, under NYSE-listed company rules, shareholders must now approve corporate stock option programs

PROXY SEASON AND PROCESS

The majority of shareholder-sponsored resolutions are developed in autumn and winter months. Coordination of campaigns among active investors has been on the rise in recent years. These investors have set an ambitious 2003 proxy season agenda, and the companies in which they invest would be well advised to pay close attention to both the mechanics and spirit of the shareholder resolutions.

Boards and managers will have much to study: almost 900 resolutions had been filed at this journal's deadline, compared to 802 for all of the year 2002. This will be a record year for proxy filings; most will be voted on by shareholders in the April-June period, though the outcome for some will be decided in contests extending to November 2002.

According to the non-profit Investor Responsibility Research Center (IRRC):

- There are 653 resolutions related to corporate governance (versus 529 in 2002)
- Governance resolutions ranged from 400 to almost 700 in the 10 years since the 1992 proxy season, and many were passed by majorities of shareholders/voters
- "Behavioral" (social and environmental) issues were much fewer in number (less than 300 in all 10 years), and except for one contest in 2002, no majority votes resulted
- More than 40 percent of the resolutions filed for 2003 are focused on compensation issues
- The AFL-CIO (union funds) have filed almost 400 resolutions in 2003, roughly double the 2002 total (global labor standards account for 27 proposals)
- The faith-based investors of the Interfaith Center on Cor-

porate Responsibility (ICCR) have filed 140 resolutions with 92 companies
- There are 58 proposals filed on environmental issues
- New issues in 2003 include the global AIDS crisis, requiring "sustainability" reporting by companies and offshore tax havens as headquarters for U.S. companies
- Hedge fund managers are joining the chorus; it is reported that MacKenzie Partners has prepared 30 campaigns for this proxy season

Two types of issues are generating the most support among investors:
- Excessive CEO pay (a governance issue with considerable crossover support from social activists); this is the most important issue for many investors
- Global warming (a behavioral or social responsibility issue)

IRRC Director of Social Issues Services MegVorhees noted: "In what is a major trend, shareholder advocates concerned with their portfolio companies' social and environmental performance increasingly are reaching the conclusion that [these] policies cannot be considered in isolation from the companies' governance practices and structure. This is evident in the issues of CEO pay and global warming."

As the canary in the coal mine is said to be the first warning of trouble, the combination of the two types of shareholder resolutions, with crossover support for each by all types of investors, could reach a critical point in this proxy season and signal important changes in investor behavior that will shape future proxy voting seasons, in terms of resolutions likely to be on the ballot, level of shareholder support (many have not voted at all in prior seasons), and the outcome of the vote.

CONTINUOUS IMPROVEMENT PROXY PROCESS?

One important shift in the American corporate electoral process could be the evolution this year of a continuous improvement proxy process. The long-time activist investor and corporate governance expert Nell Minow ofThe Corporate Library sees the phenomenon this way: "Shareholders are going to ask a lot of questions at 2003 annual meetings. If they don't like the answers, they won't wait a year to propose the next year's resolutions." Ms. Minow, with partner Robert Monks, spearheaded early 1990s shareholder resolutions (through their Lens Fund investments) that brought about CEO changes at American Express, Westinghouse, and other blue chip companies where performance was seriously lagging behind peers and competitors.

THE PROXY PROCESS IS CLOSE TO CONTINUOUS NOW

The process is close to continuous already; consider these steps in the process that many companies experience:
- The resolution sponsor brings demands to management or board attention (for example, TIAA-CREF and CalPERS regularly write to and meet with companies)
- The company reacts, and in some cases negotiations result in no filing or withdrawal of the resolution
- There is public discussion of the initiative(s) while the process unfolds (company review, SEC review, etc.)
- If the initiative makes it to the ballot, a 5 percent vote in the first year is considered a beach head; a success rate of 8 to 10 percent in the second year voting usually determines if the issue is perennial or is dropped by the sponsor
- The issue receives shareholder-wide visibility if published in the proxy
- Many issues generate considerable media coverage, creating a different kind of pressure on companies (bringing issues to the attention of government, customers, etc.)
- Lawmakers and regulators will be drawn to issues by hotly contested proxy initiatives (if labor-sponsored, for example)

PROXY INTEREST STIMULATED BY 2002 REFORMS

President Bush in his 2002 State of the Union address suggested that corporate management should be "more accountable" and convened a senior-level task force, which called on the SEC to tighten corporate governance practices and improve corporate financial disclosure.

What was often overlooked in the debate following the collapse of once high-flying companies were the ambitious (10-point) recommendations issued by the White House, many of which became embodied in the landmark Sarbanes-Oxley legislation in July 2003, and which in turn triggered a comprehensive rule-making process at the SEC (continuing at this writing). The overall effect will be a major re-ordering of the public company financial reporting process not seen in decades.

Not all discussion is public:The largest pension fund, TIAA-CREF, which also offers its beneficiaries mutual funds, is active on the corporate governance front but conducts much of its negotiations in private. The fund managers prefer to discuss issues with corporate managers, and if all else fails, a resolution is then filed. This year the fund had been discussing issues with about 30 firms, which resulted in letters to each company's CEO; about a half-dozen will result in public proxy contents. The conversations continue on a constructive basis until the issue is resolved, or a proxy resolution results.

FAITH-BASED INVESTORS IN VANGUARD OF CHANGE

Faith-based investor activists have focused on corporate behavior and certain corporate marketing practices for three decades, and in recent years have been able to generate support for their initiatives from among labor unions, endowments, foundations, socially responsible mutual funds, public employee pension funds, and wealthy individual investors.

The leader in this category is the ICCR, now in its thirtieth year. Executive Director Sister Pat Wolf points to this year's proxy contests as a clear reflection of the low level of trust investors have in senior managers, boards, and the corporations they run. Issues such as escalating executive compensation are hot buttons for this coalition of more than 275 institutional investors (members include religious denominations, orders, foundations, publishers and health systems). Combined, they have approximately $100 billion under management—and their influence is multiplied through coordinated campaigns with AFL-CIO unions and others.

ICCR traditionally has focused on social issues and corporate behavior; the group's proxy campaigns are clustered in these issues:

- Environmental (global warming, adoption of Coalition for Environmentally Responsible Economics (CERES) Principles, PCBs, nuclear power)
- Equality issues (board diversity, glass ceilings)
- Global corporate accountability (supplier and vendor standards, human rights policies)
- Global finance (domestic U.S. finance and the world financial system)
- Militarism (space weapons, foreign military sales)
- International health and tobacco (pharma prices, tobacco)

Recent campaigns have focused on such companies as Abbott Labs (issues are increased access to Pharmaceuticals, affordable drugs to treat HIV/AIDS, and global availability of drugs to treat tuberculosis and malaria). Sponsors of these measures included the Board of Pensions, Evangelical Lutheran Church, Walden/BBT Domestic Social Index Fund, Catholic Health Initiatives, various religious orders, the Jesuits, Christian Brothers Investment Services, and United Methodist Church.

In 2003, there is a decided shift toward support of more traditional corporate governance issues, and a joining of forces (not always formal) to support corporate governance proxy initiatives. Sister "Wolf points out that greater transparency of corporate finance and operations is needed, as well as a societal focus on stock options and corporate tax treatments as well as the importance of the role of public auditors.

Corporate behavior is critical in these times, ICCR believes. Commercial banks, for example, are being asked by the coalition to examine their lending policies and to make certain that "they know their customers," which ICCR says should be a concern of the entire American public. Issues that were isolated over the years are moving to mainstream shareholder activism and should be more critical, says Sister Wolf:"We raise questions of management, and ask that they address the needs of people to have financing to further human development. Our voice will be there." (Note that ICCR's universe of like-minded investors—its new and traditional allies—represents as much as two trillion dollars in market investment.)

STATE AND CITY GOVERNMENTS WEIGH IN

The New York State Common Retirement Fund has long been active in generating proxy resolutions as a means of encouraging change in companies in its portfolio. Separate of the proxy ballot box, elected Comptroller Alan Hevesi recently forced HCA Inc., the nation's largest hospital chain, to adopt shareholder-friendly policies as part of a settlement in a class action lawsuit. (The pension fund was the lead plaintiff; the settlement included a cash sum and adoption of a number of corporate governance changes.)

New York City Comptroller William Thompson, Jr.—who succeeded Mr. Hevesi—is a trustee of the city's five large employee pension funds. In February he called on the Congress, SEC, and NYSE to enact rules that would require companies to act on any measure when investors win a majority of votes (in support of their own resolutions). His office has filed shareholder resolutions at Pacific Healthcare, Goodyear Rubber & Tire, Gillette, and Hasbro to require these firms to take action if shareholders vote in the majority.

The New York City financial office has long been an advocate for corporate governance reform. Acting on behalf of the city's police and fire funds, Comptroller Thompson asked GE, Halliburton, and ConocoPhillips to conduct board-level reviews of offshore operations to examine "potential financial and reputatonal risks" that could result from doing business with countries that support terrorists.

CORPORATE DEMOCRACY INITIATIVES

If 2003 represents a sea change for the proxy process, and demands for greater democracy in the corporate sector gain traction, what kinds of changes might be ahead for boards and senior managers? Speculation and predictions have included:

- Separation of the posts of board chairman and CEO
- Designation of the chair as head of the board, with "lead director" perhaps occurring as an interim step (many professional corporate governance observers are boldly predicting the end of the combined Chairman/CEO title by end of this decade)
- Boards with all independent members, with only one executive representative (the CEO)
- Financial executives (the CFO), the corporate secretary, the senior investor relations officer, and perhaps senior communications officer could report to the board at some point, perhaps with a dotted line responsibility (note that the Sarbanes Oxley legislation suggested creation of an internal "Disclosure Committee," made up of the comptroller, general counsel, CFO, internal auditor, and investor relations officer; this group would review filings, create and review the company's disclosure policy, and create and monitor the control process for corporate filings)
- Boards may demand to sign off on corporate disclosure and transparency policies as a normal part of doing business
- Activist shareholders will be invited to meet with the board, to discuss their demands for reform (especially for corporate governance matters, perhaps for corporate behavioral issues)
- Shareholders could gain more access to the proxy process by being allowed to nominate their own directors (such petitions have been filed with AOL Time Warner, Citigroup, and other firms)
- Boards may order the expensing of stock options as a standard industry policy versus waiting for government, self-regulated organizations, or standard setters to do so

Are these scenarios realistic? The GE Retirees Justice Fund filed a resolution this year to split the offices of board chairman and CEO; GE is often a bellwether for the large-cap companies. (GE this year did name a presiding director of the board, and appointed the former CEO of Champion International.) This is one of 25 such shareholder proposals on this issue this proxy season; perhaps half or more will make it to the ballot. When the AFL-CIO investment office was developing a resolution on this issue, Dow Chemical agreed to divide the Chairman/CEO jobs and the union withdrew its resolution.

As might be expected, some of the largest companies attract the most attention each year, and the media focus on the companies and their issues, which come to characterize the proxy season. *The New York Times* reporter Claudia Deutsch, a longtime corporate governance observer, recently reported on a number of large-cap companies facing lively proxy contests in 2003. These included General Electric (focus on severance packages), Citigroup (investors want to eliminate golden parachutes), Wal-Mart (investors seek to divide the chairman and CEO posts), and General Motors (a number of environmental protection issues). Eastman Kodak's proxy process will include six shareholder resolutions on the ballot (versus two in 2002); this year's include stock options, environmental reporting, and board elections, which reflect the combining of corporate governance and behavioral issues in many corporate contests. These may be a preview of proxy seasons to come.