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# CORPORATE Finance REVIEW

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# KEY ISSUES TO WATCH IN PROXY SEASON 2008

It's become an annual event that institutional investment managers, their consultants/advisors, and financial analysts eagerly look forward to: The RiskMetrics Group's annual proxy season review and preview: a review of the critical issues and events of 2007 and a look at what is on the table for proxy season 2008. The conference was entitled "2008 RiskMetrics Group US Governance Conference" and was held in New York City. What was set out for investors in the conference is of critical importance to financial executives.

The RiskMetrics Group is a global consulting services organization serving mostly institutional and some corporate clients and carefully looks at real or potential risk through three primary sets of resources.

What is now becoming clear, in terms of identifying the potential areas of agreement—or of *conflict and combat*—is this: Investors are demanding and expecting far greater board and director accountability. In 2008, "accountability factors" will directly affect the director nomination and election process, setting of executive compensation, supervision of the audit process, and response to greater investor and societal demands for corporate responsibility.

Consider the three important players in the capital market dynamics: Institutional investors (the owners of 75% or more of outstanding stock); boards of directors (elected by the shareholders); and the corporate managers the board hires to manage the enterprise. Serious differences of opinion between any of these players can spell trouble. Since the end of the 1990s, the relationship among key players in the investor-director-officer dynamic has been changing—sometimes quite dramatically for the better, and too often for the worse.

The battleground in the "worse off" category is the annual showdown over proxy voting. In the first years of the twenty-first century, the number of shareholder-sponsored resolutions has been growing and the number of owner votes cast in favor of these resolutions has been increasing. The number of "no" or "withheld" votes has also been increasing in director elections, and some companies have been responding to shareowner demands. Others have tended to ignore institutional demands for reform, even ignoring majority votes on shareholder-sponsored proxy resolutions (which, of course, are mostly nonbinding to the board).

After the *Sturm und Drang* of the proxy season, the key players in this triangular dynamic may end up as something like an *immovable object* meeting an *immutable force.* (Such as, in the board-investor relationship; or investor-corporate manager; or board-manager, or board and manager vs. investor.)

## The proxy season environment

In the view of the RiskMetrics proxy watchers, these are the top-line concerns for institutional investors that directly affect senior corporate executives and members of boards:

- Serious investor concerns cloud the 2008 proxy season horizons. These concerns can be grouped under a company's "ESG profile": i.e., its (1)

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environmental, governance, and social (ESG) issues and policies.

- For many companies, this is a key year for determining the future relationships between shareowners, the directors they elect to represent them, and the corporate executives selected by the board to manage the company on behalf of the owners (a triangular dynamic of great importance). Greater accountability is expected on the part of directors and corporate executives by investors. Accountability was at the heart of many 2007 proxy campaigns that resulted in higher votes of support by investors for both management- and shareholder-proposed resolutions.
- Investors are intensely focused on traditional governance issues, especially those concerning the director nomination and election process. These are combat zones for a growing number of institutions, including coalitions of activist investors who want reforms in direct elections and direct input in the nomination of directors.
- There was considerable investor anger after the Securities & Exchange Commission (SEC) in effect closed the door to expanded investor access to the director nomination and election process in late 2007. Investors had expected to see greater access to the corporate electoral process and were disappointed with the SEC's abandonment of reforms in this area.
- US and global accounting standards are beginning to converge and other standards are becoming more important to institutions in 2008. These factors will pose challenges to public companies—including carbon footprint disclosure, a greater emphasis on various aspects of environmental protection, and demonstrations of product stewardship. The UN-encouraged Global Reporting Initiative's (GRI) environmental and social disclosure standards are prime examples of new standards that are impacting corporations. US companies lag behind their foreign counterparts in GRI filings. Investors in the US and abroad are demanding far greater transparency and disclosure and are looking to into mechanisms such as GRI's models to accomplish this.
- In this election year for the US, the leading candidates will be advancing populist themes that may be contrary to corporate interests. CEO compensation may become an important flashpoint for the American electorate. Beginning in 2009 the Democrats could control the SEC and its mechanisms, with two board members and the possibility of a new chair appointed by a Democratic president.

"This proxy season may become a scary time for corporations," noted Jeremy Perler, co-head of RiskMetrics Group's CFRA Accounting Research product. As an example of the steadily expanding challenges, he cited the coming convergence of domestic and global accounting practices: What will the US company balance sheet look like? The answers are not clear yet. In 2008, he said, there are serious threats posed to US balance sheets—think of the effects of subprime lending—that will complicate this issue for many companies and may lead to calls for reforms by investors.

## Capital markets issues

The RiskMetrics staff identified these important issues that will affect the global capital markets for both issuers and investors as the proxy season campaigning gets underway:

- The spreading subprime mortgage lending crisis, with its fallout sweeping through the US and overseas capital markets. Financial institutions' balance sheets are being especially hit hard; bank reserves are affected, and there are issues emerging for homebuilding companies.
- The global convergence of critical ESG factors is now becoming interconnected to a much larger degree for non-US companies and

**A GROWING NUMBER OF COMPANIES NOW FACE THE SPECTER OF GROWING HEDGE-FUND SHAREHOLDER ACTIVISM.**

**THERE IS A GROWING CONCERN OVER BOARD STRUCTURE, THE PROXY VOTING PROCESS, AND THE OVERHANG OF RECENT SEC DECISIONS "AGAINST" INSTITUTIONS ON PROXY NOMINATIONS.**

investors.[1] There are rising concerns about real and headline risk in each of these areas.

- A growing number of companies now face the specter of growing hedge-fund shareholder activism—and that activism knows no borders now.

Patrick McGurn, head of US corporate governance trends for RiskMetrics, characterized 2007 as the year in which accountability issues were clearly front and center for investors and a major factor in shareowner-board relations. "Board engagement" will become more widespread and more productive for investors. (The SEC has been encouraging communication between boards and shareholders without specifying the how or when of such dialogue.)

Mr. McGurn identified a concern that is growing in importance—the market gap affecting many companies during proxy season. Most large cap issuers are getting things right, he commented, by discussing potential changes and responding to shareowner concerns. That large-cap capability to respond effectively is migrating down to mid-caps. The RiskMetrics Group's concern is that small-cap issuers have far less ability to deal with many of the issues. And because the large-caps are engaging on the issues, the number of potential targets for reform is shrinking. The small-cap universe represents a very rich target base for activist investors now.

**Louder cries for reform—more disclosure.** Watch for growing investor demand for more reform in corporate disclosure mandates. Investors are focusing on risk resulting from the subprime crisis, credit quality erosion, homebuilders' disclosures, and disclosures by banks on reserves for loan losses. Another area of risk resulting from the subprime crisis is succession planning, as high-profile CEOs depart large financial services firms.

**Greater focus on social and environmental issues.** Specific issues in focus include greater product safety stewardship. Institutions are demanding more transparency and disclosure in such areas as toxics in products and dealing with the aftermath of the 2007 holiday-season toy crisis. There is a growing investor focus on corporate healthcare principles, with universal coverage policies being a considered approach (these are typically continuous, affordable, and sustainable, according to RiskMetrics).

**Board independence.** There is a growing concern over board structure, the proxy voting process, and the overhang of recent SEC decisions "against" institutions on proxy nominations. The global practice is to separate CEO and chair positions; 13% of S&P 500 companies now separate the two posts. Most companies use the lead director method.

**Compensation disclosure.** The SEC-mandated"Compensation Discussion & Analysis" (CD&A) is now in the second year of expanded disclosure by companies; poor pay practices are very much in the light now. There is more intense investor focus on the "five Ps": pensions, parachutes, past pay (deferred compensation), perks, and "problematic paychecks."

The SEC report card on corporate year one CD&As was mostly negative—much improvement was needed.

Global influencers are putting this issue in the boardroom; there are a number of investor coalitions focused on reforms in executive pay transparency and disclosure. There are at least sixty shareholder proxy resolutions filed at press time for say-on-pay mandates. Pointing to the potential for expanded conflict between investors and boards, RiskMetrics points to the Conference Board survey of corporate directors on say-on-pay; 92% of corporate directors oppose these measures; in a Bigdough survey, 85% of investors say they support say-on-pay. Thus, the immovable force meets immovable object, noted Patrick McGurn.

**Key ESG issues gaining traction.** Investors'views on ESG issues were clearly presented through the 200 socially responsible investing proposals presented in proxy season 2007; these focused on almost 100 key issues for investors. About one-fourth was related to an issuer's "sustainability," involving such concerns as equal employment

opportunity policies, climate change (some of these won up to 40% of votes cast in 2007), and corporate political-contributions reporting. The ESG proposals are now becoming less descriptive and more philosophical.

Traditional corporate governance issues involved classified boards, poison pills, and the shareowners' right to call special meetings. Over the past decade these reforms have won ever-larger supporting votes. One result: Majority voting for board members is now a growing trend. RiskMetrics advises that companies should not ignore this trend. The issue of backdating options seems to be having less "significant impact" on board accountability as large-cap companies effectively address the issue. The best *accountability* practices are being instilled in large-cap companies, say RiskMetrics; there is troubling "market-cap gap" between large and small firms. Small firms are under increasing pressure from investors to adopt meaningful reforms in 2008 and beyond.

**Postelection landscape.** Corporate governance issues are being raised on the campaign trail by leading presidential candidates — depending on economic conditions, and the outcomes of 2008 proxy voting, there is the potential for dramatic postelection legislative change in executive compensation. Proposals for reform could be coming, no matter who is elected: Republicans have Sarbanes-Oxley in focus for potential reforms and watering down; Democrats have executive compensation and more transparency about pay in focus. Executive pay is now a major populist issue, which is complicated by the growing gap between executive *haves* and middle and lower income group *have-nots.* This could become a large nonpartisan issue. In 2009 we will likely see (in the first 100 days of the new administration) a focus on proxy-ballot access and shareholder say-on-pay voting.

Greater pay-for-performance demands. There is clear support growing for executive compensation reforms among institutions of all kinds. Gross-ups (a tax-related issue), buy-backs, executive employment contracts, pay disparities between executives and other employees, and the role of independent compensation consultants—these are now dominant themes for activist investors in proxy season 2008.

**Director elections.** A range of corporate governance issues are in focus for investors on the issue of corporate election processes: Majority voting (two thirds of S&P companies are adding accountability mechanisms to address voting outcomes); support for say-on-pay (large investor support was demonstrated in voting in 2007); a major shift seems to be underway as almost as many corporate-sponsored resolutions are put on the proxy as resolutions offered by shareholders; major bylaw changes are being offered; RiskMetrics staff that the market-cap gap is evident as it is difficult for small-caps to attract "the right directors" to their boards.

Finally, we should expect to see a "Shareholders Bill of Rights" on the agenda for congressional action if there is a Democrat sweep in November—e.g., White House, House of Representatives, and US Senate — and this could set up reforms of the type presented to companies in the Sarbanes-Oxley legislation of 2002.

**INVESTORS ARE LOOKING TO HOLD INDIVIDUAL DIRECTORS AND ENTIRE BOARDS MORE ACCOUNTABLE.**

## Conclusion

All these trends signal that major shifts are underway in 2008. Investors are looking to hold individual directors and entire boards more accountable. They expect positive responses when their demands are presented to boards and management through the proxy process. The outcomes of these trends could greatly complicate the life of the finance professional—the future will be a bit easier to divine when all the votes are counted in the 2008 proxy-voting season. •

**NOTE**

1 See H. Boerner, "Your Company's ESG: Environmental, Social and Governance Factors Are Mattering More Now to Institutional Investors," *Corporate Finance Review* (Vol. 12, No. 2, September/October 2007): 40-43.