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PROXY SEASONS: OBSERVATION POSTS FOR INSTITUTIONAL INVESTOR CONCERNS

Proxy seasons have become excellent observation posts for examining institutional shareholder concerns. In proxy matters, there are now more players and more power exerted (and exhibited) by a growing corps of shareholder-activists; more exposure of individual players (especially CEOs and directors) in public-opinion crosshairs; more media coverage of proxy campaigns, including votes for the previously invisible board-of-director candidates; and more involvement of high-profile public-policy figures in campaigns (such as New York City Comptroller William Thompson, California State Treasurer Bill Lockyer, Connecticut State Treasurer Denise Nappier, and others).

Issues and concerns that were once deemed to be in either the "corporate governance" or "social concerns" silo are merging or at least continuing to blend. Leading advocates for governance and social reform are frequently speaking out and acting on both types of issues. The silos are coming together more often than not. Close observation of recent corporate proxy-voting contests reveals that company management and boards may be listening to, but quite often not acting on, the expressed concerns of their shareholders. Most shareholder-sponsored resolutions are nonbinding, and it has not been unusual for companies mostly to ignore the voting outcome—even when a majority of votes carry the shareholders' resolution.

New institutional players have entered the proxy arena—hedge funds and private-equity funds stand out for corporate managers. Managers and directors of the corporate enterprise are busy trying to figure out who the investor behind the opaque screen is and what said investor or money manager really is after.

We explore current trends here in an attempt to divine what management, boards, and investors can expect in coming proxy seasons. Or actually, on a year-round basis, as activists are pounding on the door regardless of whether or not it is proxy season.

Coming your way: investor coalitions

Managers are paying closer attention to the word *coalition,* as in investor coalition; institutional players are probably paying closer attention to your company's operations, investments, conduct, commentary on critical societal issues, and relationship between management and board of directors. It is not just small groups of institutions agreeing on an issue and attempting to bring pressure on the issuer: Today there are coalitions and even coalitions of coalitions bringing more intense pressure on management and boards, year-round and in very public ways.

On issues related to corporate governance and social concern, there is often a "Main Street" vs. "Wall Street" showdown. As a result, powerful forces have emerged among activist shareholders to bring pressure on corporate management and boards of directors to force specific changes, generally summed up as follows:

- Campaign to make issuers more accountable to shareholders, stakeholders, communities, and society at large, in various ways;

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COMPANIES THAT ARE MORE RESPONSIVE TO INVESTOR CONCERNS ARE MORE ATTRACTIVE INVESTMENTS FOR INSTITUTIONS.

- Create better governance within the specific enterprise;
- Force the issuer to focus on important societal issues, and engage investors in dialogue; such issues include climate change, environmental protection, the treatment of workers in the US and abroad, and political contributions by companies.

What has this got to do with shareownership? Plenty, say institutional investor advocates; companies that are more responsive to investor concerns are more attractive investments for institutions. And given the importance of "indexing" among many institutions (such as public employee and labor funds), the "Wall Street Walk" is not practical anymore. Money managers or trustees can't sell because of index restrictions? Alternative: Engage with the company. Company won't engage? Create pressure for dialogue and response. Not working? Force changes in management and boards of directors.

2007 object lesson: Exxon Mobil takes heat

An object lesson for the spring 2007 proxy season is Exxon Mobil with the critical issue being global warming. Under former CEO Lee Raymond, Exxon and the then-merged Exxon Mobil was viewed as being publicly skeptical on the issue of fossil fuels and the impact on climate change. Global-warming issues were a distraction for its corporate leaders, it appeared. Under new CEO Rex Tillerson, things are a little better for investors, but still not good enough according to a growing number of institutional investors.

Two dozen large institutions united on Exxon Mobil issues and in May 2007 created public pressure on the company: They demanded removal of an Exxon Mobil board member because of the company's inaction on the issue of climate change. The activist institutions included large public employee pension funds, such as the California State Teachers' Retirement System, Illinois State Board of Investment, New York State Common Retirement Fund, and others. Labor funds (i.e., Service Employees International Union (SEIU) and the American Federation of State, County and Municipal Employees (AFSCME)) were instrumental in assembling the coalition. The treasurers of the states of California, Connecticut, Maine, Maryland, North Carolina, and Vermont were solidly on board. A comparatively new force in institutional advocacy has clearly emerged in recent months. In all, the coalition members represented $900 billion in equity holdings.

Why put a single board member in the crosshairs? Exxon Mobil Director Michael Boskin "repeatedly refused to meet with many of the largest shareholders on the climate issue," said the coalition leaders. Professor Boskin (of Stanford University) has been a director at Exxon since 1996 and chairs Exxon Mobil's Public Issue Committee. "By refusing to meet with shareholders, the firm and Boskin have disregarded their environmental responsibility and their financial obligation to shareholders," said California State Treasurer Bill Lockyer (formerly the state's proactive attorney general and the Democrat candidate for governor in 2006).[1]

The Exxon Mobil shareholder-sponsored resolutions demand in various ways that the company demonstrate its accountability on sustainability, global warming, climate change, energy conservation, and related issues. These are part of a sweeping movement that grows in intensity from proxy season to proxy season and all the months between. Activist shareholders filed global warming-resolutions at forty-two companies (a proxy season record) in 2007, with almost all having some focus on increased disclosure of the respective issuer's plans to reduce greenhouse gases and set out plans for dealing with climate change.

The coalition of investors focused on Exxon Mobil was organized by Ceres and the Interfaith Center on Corporate Responsibility (ICCR), which is a coalition of faith-based and allied investors. This is a grassroots movement; the greenhouse resolution at Exxon Mobil was spurred by the expert activism of the Sisters of St. Dominic (New Jersey). Sister Pat Daly was instrumental in the Exxon Mobil filing; of the growing coalition proxy ballot power she said, "This amazing support reflect investors growing understanding that companies now need to move beyond basic disclosure of green-

house gas emissions to a business plan to reduce emissions."[2]

Ceres is a national coalition of investors and environmental groups working with companies to address sustainability challenges. The group directs the Investor Network on Climate Risk, a network of more than fifty institutional investors in the US and Europe, managing $4 trillion in assets.

Exxon Mobil released its "2006 Corporate Citizenship Report" as the proxy balloting was under way, noting that its greenhouse gas emissions rose 5.4% from 2005 because of increased oil production in Africa and liquefied natural gas output in the Middle East. But the company claimed to be on track to improve energy efficiency by 10% at its global refining operations by 2012.

Also, the company said that Director Boskin had arranged for senior corporate management to meet with the institutional shareholders involved to discuss their concerns — but even with an acknowledged six-hour meeting with Exxon management (July 2006) to discuss concerns, Connecticut State Treasurer Denise Nappier told a May 2007 news conference that "this meeting is not a substitute for a meeting with Michael Boskin and other board members."[3] Ms. Nappier went on to say, "While Exxon Mobil's competitors are moving aggressively on climate change, this company—one of the world's largest refiners and marketers of oil products — continues to hide its head in the sand rather than acknowledge the business implications of climate change."[4]

Does this lead to a competitive disadvantage for Exxon Mobil? Consider points made by the investor coalition that competitors such as BP, ConocoPhillips, and Royal Dutch/Shell have joined with environmental activists urging the US Congress to require limits on greenhouse gases tied to global warming. While all this was going on, Exxon Mobil share prices rose slightly, to reach a fifty-two-week high.

The SEC focuses on the proxy process

In these pages in recent issues we've commented on the growing activism of institutional investors focused on senior management and board behaviors, strategies, responsiveness(or lack thereof)to public concerns and issues, and the increased public awareness of the once-arcane relationship between investor and issuer. The proxy ballot has become the ultimate weapon of choice for investors that want to raise issues and effect real change in the companies in which they invest.

As we indicated in these pages over two years ago, the once-seasonal aspect of ballot box advocacy is becoming year-round.[5] The proxy campaigns of 2007 are a clear demonstration of such phenomena; the activist investors (most often working in coalitions) are focused year-round on the issues that concern them. Dialogues between management and investors go on after the proxy votes are counted and as the participants move toward the next year's proxy voting.

The Securities and Exchange Commission (SEC) is at the center of the contests. Corporate law counts most at the state level; the Delaware laws are the models for the rest of the states. But federal law is important as well; the SEC has shareholder rights to enforce (or arbitrate) proxy-voting rules through congressional approval. And so in the midst of proxy season 2007 — with hundreds of proposed proxy resolutions presented by investors—SEC staff was challenged to keep up with rulings on whether such resolutions could be put forward. (Companies routinely challenge shareholder draft resolutions as interfering with "ordinary business" and ask SEC staff to keep such measures off the proxy ballot.)

The SEC thus scheduled three roundtables to hear from investors, issuers, and others. "When Congress charged the SEC with regulating the proxy process for public companies," explained SEC Chairman Christopher Cox, "it created a federal role for the vindication of shareholders' state law rights. This roundtable will explore the relationship between the federal proxy rules and state corporation law, and pose questions to the participants about whether this relationship can be improved."[6] We can expect new rules of the road for federal proxy rule application from the SEC in late 2007.

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Caught in the crossfire: mutual-fund managers

There's at least one group of major institutional investors who would like all the proxy stuff to go away: investment company advisors. The twenty-eight advisory firms that run the 100 largest mutual funds in the United States either abstained from voting or opposed shareholder resolutions seeking added disclosures about the effects of global warming on issuers, according to Institutional Shareholder Services (ISS).

ISS Director of Climate Change Research Doug Cogan told the Associated Press in April 2007 that the organization's review of voting data revealed that mutual-fund advisors "wall[ed] off" social and environmental resolutions as a separate category from governance resolutions and showed more deference to corporate management than to institutional investors.[7]

So while the major advisory firms—companies that run Fidelity-, American-,and Vanguard-branded funds — are not friends or allies of investor activists focused on "societal" issues (such as placing caps on greenhouse emissions),there maybe changes riding on the winds of investor activism.

Consider the case of Denver-based Newmont Mining, which prompted shareholders to support a shareholder resolution asking the firm to report on social and environmental issues. Again, it was an investor coalition (eleven institutions, primarily faith-based) that filed and supported the resolution, and Newmont said that it would agree to the demand that the company appoint a team of independent directors to prepare a report on the impact of its mining operations. (The investors focused on gold-mining operations in the US, Peru, Indonesia, and Ghana.)

The company considers itself to be complying with "high standards" of social and environmental responsibility, although critics say Newmont mining operations harm local communities, damage habitat, cause pollution, etc. Newmont threaded the needle by backing the resolution brought by Christian Brothers Investment Services; the company opposed another resolution, brought by New York City Pension System, that asked Newmont's corporate management to report on the environmental and health impacts of its operations.

Hedge funds

The unknown force in institutional investing: hedge funds. During the first quarter of 2007, more than $60 billion inflow was recorded in these dark pools that are mostly unregulated; this brought total assets under management to $1.57 trillion, said Hedge Fund Research, Inc.

"[T]he newest force in corporate governance" is how the not-for-profit Conference Board characterized hedge funds. "Hedge funds are the biggest and least understood force to enter corporate stock registers in decades," the Conference Board noted in its Research Working Group on Hedge Funds.[8] With $1.2 trillion in assets around the world managed by more than 8,800 hedge funds, these pools now represent as much as 30% of total US equity trading.

Among the points made by the Conference Board's working group were the following[9]:

- Hedge fund managers claim to have the financial muscle to overturn boards, oust managers, and essentially remake corporations.
- They've risen to power so swiftly that many companies have been caught unawares.
- Corporate executives need to understand hedge-fund managers — their economic motivations and strategies—and communicate effectively with them.
- Hedge funds are notoriously opaque and face little or no regulation.
- There has been an increase in shareholder activism related to hedge funds.

There are more than 100 hedge funds (some estimates range much higher) involved in "activism," says the working group, and they are becoming the most activist of investors with a much tougher playbook for corporations they target. Of critical importance for financial executives: The linkage of "ownership rights" and "economic interests" — long a standing assumption of good corporate governance—is being severed by hedge funds. Question posed rhetorically (but with very practical meaning): "Is this a fundamental threat to corporate governance; and if so, what can be done about it?"

Say on pay—shareholders have their say

One of the most important challenges in the proxy arena is focused on executive compensation. The issue of CEO compensation is in focus and has been for a decade for many institutions. But in some ways, the activities of proxy season 2007 may be a warm-up for seasons to come — and year-round focus of activist investors.

The new disclosure rules prescribed by the SEC came too late (December 2006) for large-scale activism on the issue for spring 2007 contests. To be sure, there were many "say-on-pay" resolutions filed at major companies for 2007 votes. But the extensive disclosures that flowed from corporations in the current proxy season were (fortunately for management teams and boards) too late for response by investors. Wait until 2008, advised more than one socially responsible investment manager. The volumes of text, data, and charts flowing from issuers is being absorbed in 2007; some companies take up to 75% of their annual 10-k report to discuss their compensation and reward systems for managers and directors. The reaction has been mixed or negative among investors.

Congress takes action

As the say-on-pay proxy campaigns rolled on in spring 2007, the US House of Representatives passed HR 1257, the "Shareholder Vote on Executive Compensation Act," by a vote of 269 to 134. There is still along way to go before the bill sponsored by Massachusetts Democrat Barney Frank (chairman of the Financial Services Committee) is signed into law. The congressional focus on CEO compensation is generating expanded media coverage of the issue as a public-policy concern, as it links corporate US's salary schemes to Main Street. Says Congressman Frank: "This is a bill to further the workings of the capitalist system of the United States. It has one very specific provision; it says that the shareholders, the owners of public corporations, will be allowed to vote every year in an advisory capacity on the compensation paid to their employees who run the companies."[10]

This clear statement of purpose also characterizes the changed nature of corporate proxy voting. The lines between "sides" are abundantly clear; watch for bold steps on all sides of the issues. •

NOTES

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3 J. Porretto, "Groups call for removal of Exxon Mobil director," AP business writer on Boston.com, May 23, 2007.

4 "Investors want Exxon director out," CNN-Money.com, May 23, 2007, available at http: //money.cnn.com/2007/05/2 3/news/newsmakers/bc.exxon.board.reut/index.htm.

5 H. Boerner, "2005: The Era of Corporate Reformation Continues," *Corporate Finance Review* (Vol. 9, No. 4, January/February, 2005): 41.

6 The Securities and Exchange Commission, "SEC Announces Roundtable Discussions Regarding Proxy Process," April 24, 2007; available at http://www.sec.gov/news/press/2007/2007-71.htm.

7 T. Paradis, "Funds Step Away on Climate Change Issues," Associated Press, April 24, 2007.

8 "Hedge Funds: Confronting the Newest Force in Corporate Governance," the Conference Board, June 27, 2006; http://www.conference-board.org/index.cfm.

9 Ibid. The Conference Board Working Group on Hedge Funds is cochaired by Stephen Davis, president of Davis Global Advisors and Jon Lukomnik, managing partner of Sinclair Capital.

10 L.R. Walton, "Pay Vote Bill Passes the House," Institutional Shareholder Services, April 20, 2007; available at http://blog.issproxy.com/2007/04/pay_vote_bill_passes_the_house.html.