

COMPLIANCE WEEK

Preparing To Enter The 2008 Perfect Storm

By Louis M. Thompson, Jr., *Compliance Week Columnist* — July 24, 2007

Corporations should heed early warnings that they may encounter a “perfect storm” during the 2008 proxy season. The lead elements in this storm are executive compensation, forthcoming proxy reforms, and the increasing power of shareholder democracy. The ultimate victims could be boards of directors that fail to pay sufficient attention to the potential impact of these factors.

Let’s examine each of these elements and evaluate what could happen should they come together to form the perfect storm. Then I’ll suggest what companies can do to avoid it.

The SEC’s new executive compensation disclosure rule brought greater transparency during the 2007 proxy season. It made it easy for national and metropolitan newspapers to focus on the executives who made the most in 2006 compared with the shareholder gain or loss in their companies during the same period. Not only did the magnitude of executives’ total compensation shock many shareholders, but the inconsistency, in some cases, between pay and performance was even more revealing. It is not lost on institutional and individual shareholders that the ultimate deciders in these cases were boards of directors.

Securities and Exchange Commission Chairman Christopher Cox has often said that most companies have a long way to go to make their compensation disclosure more transparent. Cox said the SEC staff would evaluate the Compensation Discussion and Analyses of S&P 500 companies and comment on them individually. Then the Commission will publish a synopsis of these comments as further guidance to companies in preparing their CD&As for 2008 proxies. Areas of deficiency included a lack of clarity in compensation philosophy and compensation goals as well as an avoidance of using plain English in preparing these disclosures.

Couple this with the strong “say on pay” movement where investors are given an opportunity to vote on executive compensation, even though it may be non-binding. Boards are going to be under considerable pressure to match pay with performance. Say on pay ranked number one as a proxy resolution for the 2007 season. The experts on my global proxy issues panel at the Compliance Week annual conference in June predicted that say on pay will gain even more momentum in 2008, with a strong possibility that Congress will mandate that companies give shareholders a nonbinding opportunity to vote on executive compensation. It will be increasingly difficult for boards to ignore majority votes opposing their executive compensation decisions, even though they are nonbinding.

Added to this confluence of issues is majority voting to elect boards of directors. This was the second most popular proxy resolution in 2007 and the lead issue in 2006. Its popularity is declining only because many companies have voluntarily adopted majority voting in some form, and the experts say corporations will continue to do so.

Putting even greater pressure on accountability of boards of directors is the New York Stock Exchange proxy reform proposal now before the SEC to eliminate Rule 452—commonly called the “10-day rule” or the “broker-vote rule.” Under the current rule, broker-dealers can vote the shares of their customers if those customers provide no voting instructions by 10 days before a company’s annual meeting. These votes typically go with management and in favor of board candidates. Elimination of this rule could mean fewer favorable votes for board members. Coupling this with directors requiring a majority of shareholder votes for election could place some in jeopardy of gaining or retaining their board seats.

What should companies and their boards of directors do to deal with these elements?

1. Follow the SEC’s guidance on creating the CD&A by stating it in plain English. I suggested in my September 2006 column that the investor relations officer should be brought into the process to help write the CD&A since most can communicate in plain English and in many instances, they have to deal with shareholder concerns and questions about executive compensation.
2. The compensation committee and board should ensure that the compensation philosophy and specific compensation goals for each executive are stated clearly. Avoiding specific goals under the ruse that doing so will give away vital competitive information is a dodge that shareholders won’t accept, even though the rule allows a limited dispensation from stating specific goals if the company can prove the competitive damage of such disclosure. There were companies that stated specific compensation goals and stretch goals this year with no untoward consequences. We should also recognize that companies had to back into their 2007 disclosure of goals that were created before the new rules went into effect. Going forward, however, boards have the opportunity to create goals that shareholders can understand and relate compensation to performance. And if for some reason there is a disparity between total compensation and corporate performance, this can be explained in the CD&A.
3. Companies that have not adopted majority voting for directors should consider doing so voluntarily instead of waiting for shareholder pressure to do so. The shareholder democracy movement has gone beyond accepting plurality voting for directors, where a single director’s vote can ensure a seat on the board.
4. Board members should lean on the company’s investor relations officer to provide them face-to-face feedback at board meetings concerning investor sentiment and perceptions that can affect the board, particularly when hedge funds or activist mutual funds want to meet with the board to express their concerns about corporate strategy. Directors should consider listening to concerned fund managers, even though they aren’t compelled to accept their demands or what they say. Suffice it to say that boards should want to minimize surprises from their shareholders.
5. The company’s investor relations and corporate communications officers should prepare an integrated communications strategy and implementation plan targeted to the company’s employee shareholders and institutional and individual investors (registered and beneficial owners). Those plans should support the corporate position on proxy issues, particularly shareholder proposals that the company may oppose.

In today’s shareholder relations and corporate governance environment, director accountability to investors has emerged as a preeminent requirement for board service. The days are over when we should hear shareholders say, “The board just doesn’t get it.” While directors should have an open mind to

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Prior to joining NIRI, Thompson was assistant White House press secretary to President Gerald Ford.

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board service. The days are over when we should hear shareholders say, "The board just doesn't get it." While directors should have an open mind to what shareholders are saying about the company, they should also stand up to those who are demanding short-term gains that may run counter to longer-term value creation for investors.

By being sensitive to the changes that are underway and taking steps to deal with them, perhaps companies can avoid a perfect storm in 2008.

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