COMPLIANCE WEEK

Shareholder Democracy To March On In '07

By Louis M. Thompson, Jr., *Compliance Week Columnist* — November 21, 2006

The 2007 proxy season for calendar-year companies is just around the corner. Given all the changes that have happened so far in 2006 and still loom between now and the proxy season next spring, it's worth taking a close look at what we are likely to see in 2007 and what companies need to do to prepare for that.

In 2006, the hottest issue was majority voting. There were approximately 130 proposals calling for companies to change from plurality to majority voting standards for directors; we didn't see more only because a number of companies preemptively adopted majority voting in one form or another. The so-called Pfizer model requires any director who receives a majority of "withheld" votes to submit his or her resignation to the board of directors within 90 days of the shareholder vote. Then the board issues a news release stating its decision to accept or reject the director's resignation. The other approach is the Intel model, which involves a by-law change saying a director must be formally elected by a majority vote of shareholders.

Clearly, shareholders increasingly view plurality voting as an anachronism, since a director who receives just one vote can be re-elected to the board. Consequently, one might expect to see a continued increase in the number of companies adopting some form majority voting as the 2007 proxy season comes upon us.

We also saw in 2006 the introduction of binding proposals that would require a company to pass a bylaw implementing a proposal if it receives a majority vote. This sort of measure was virtually unheard of until this year, because some states do not allow shareholders to encroach on a board's responsibilities by changing corporate bylaws. Two measures in 2006 received more than two-thirds average support from shareholders: those calling for repeal of classified or staggered boards in which only a few directors are up for election, and those calling for repeal of supermajority voting. In the latter, some corporate charters contain an amendment requiring a large majority of shareholders to approve significant changes in corporate bylaws.

ABOUT THE AUTHOR

Louis Thompson Jr. is an internationally recognized expert on corporate governance and disclosure, having served for more than two decades as president and chief executive officer of the National Investor Relations Institute until his retirement earlier this year. An adviser to the Securities and Exchange Commission and the New York Stock Exchange, Thompson is currently serving a second term on the NYSE Individual Investor Advisory Committee.

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

A veteran of the U.S. Command in Vietnam and the Office of the Secretary of Defense, Thompson has held executive communications positions for a number of organizations, including the American Enterprise Institute for Public Policy Research, and the National Association of Home Builders.

A former journalist and news anchor, Thompson remains chairman of the advisory council for the Greenlee School of Journalism and Communication at Iowa State University, where he was the 2001 recipient of the James W. Schwartz Award for Distinguished Service in Journalism and Communication conferred by the Greenlee School.

A former member of the Harvard University New Foundations Working Group on corporate governance,

We also saw a decline in 2006 in shareholder proposals calling for the repeal of shareholder rights proposals, often called "poison pills," compared with 2005, due in large part to companies that voluntarily rescinded these plans.

Thompson is a partner with business consultancy Genesis, based in Denver. He is also a managing director of Washington, D.C.-based Kalorama Partners, the advisory firm founded by former SEC Chairman and Compliance Week columnist Harvey Pitt.

Contact Information

Reach Lou Thompson At

lthompson@complianceweek.com Or 540-717-3292

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And shortly—on Dec. 13—the Securities and Exchange Commission will once again consider the issue of proxy access for director nominations. The previous attempt to craft a rule allowing shareholder access to the proxy for this purpose failed, with the Commission deadlocked on the issue. Consequently, this may have given rise to the trend toward majority voting as an alternative. Shareholders wanted some means to remove from boards those directors who, in their view, were not acting in the investors' best interests.

Giving investors greater access to the proxy for the purpose of nominating directors may sound like a positive move in the context of shareholder democracy. It's one thing to give shareholders the power to remove directors under the majority-voting concept; it's quite another to give investors the power to nominate directors to the board. Why? It was quite clear that those who were pressing the SEC several years ago to adopt greater proxy access were some large investors with an agenda. Labor and some of the public pension funds were among the strongest advocates.

Directors who come to the board with an agenda are more likely to behave in accord with their special interest as opposed to acting in the best interest of all shareholders. Truly independent nominating committees should be free to nominate directors who understand the business of the company, or who bring to the table special expertise such as financial acumen and who have the ability work cohesively in their oversight role and in setting and approving the long-term strategy for the company. The SEC should keep this central concept in mind as it deliberates the proxy access issue.

What Comes Next

What can we expect to see in the 2007 proxy season? More proposals calling for majority voting for companies that choose not to adopt such provisions voluntarily are likely. Another major factor that shareholders will experience this coming season will be much greater disclosure of and transparency into executive compensation, as a result of the SEC's recently adopted executive compensation disclosure rule.

Investors who read a company's new Compensation Discussion & Analysis should get a sense of the company's compensation philosophy and compensation goals for each of the company's top five executives. The CD&A should analyze whether these executives met their goals and compare their performance with the company's overall performance during the past year. There also will be detailed tables regarding other compensation forms beyond salary and bonus, such as stock options, stock awards, non-stock incentive plans, and other forms of non-cash compensation.

This will be a way for investors to hold directors accountable for ensuring pay-for-performance, and not rewarding senior executives with excessive compensation while shareholders experienced a declining return on their investment.

So, what can companies do to best prepare for the 2007 proxy season?

1. Thoroughly review the company's corporate governance with an eye toward implementing best practices that help ensure that the business is being run in the best interest of all shareholders. In addition, companies that look at the interests of their other stakeholders in the governance process are likely to be more successful in the long run than those who do not.

2. Consider, if you have not already, adopting majority voting for directors and eliminate classified or staggered boards.

3. When implementing senior executive compensation plans, try to keep them relatively simple. Investors—particularly individual investors—will probably be overwhelmed with the disclosure this coming year, especially anything involving what are now complex stock option plans that will appear even more complex as a result of the full disclosure requirement.

4. Be an activist when it comes to educating those who vote the proxies in the funds that own your stock. This is a job for the investor relations officer or the corporate secretary. In most cases, the people who vote the proxies are not the ones senior executives typically meet with (who are analysts and portfolio managers) when discussing corporate strategy and performance. The ones who vote the proxies will be following the fund's guidelines or the recommendations coming from the four proxy advisory services: Institutional Shareholder Services, Glass Lewis, Proxy Governance, and Egan-Jones. Touching base with your major institutional investors is most important, to help them understand your position on key proxy issues; you can also respond to their questions or concerns directly.

5. Don't forget your individual investors in this process. You can't communicate directly with most individual investors, who hold their stock in brokerage accounts and who are (knowingly or unknowingly) objecting beneficial owners with their identity shielded from the company. Instead, use your Web site's corporate governance section to lay out the company's position on issues that will be presented in the proxy. According to ISS, in 2005-06, the individual investors provided the "swing vote" in a number of the shareholder proposals that received a majority vote. To ignore them is risky at best.

As we look ahead, we will likely see even greater change in 2008. The SEC will be considering a New York Stock Exchange proposal to eliminate Rule 452 (the 10-day broker-voting rule) starting in 2008. Should the SEC approve this, it will have major implications for companies; no longer will brokers be able to vote proxies in the final 10 days absent voting instructions from their broker clients. Moreover, this could well have implications with respect to achieving an annual meeting quorum. The NYSE Proxy Working Group is considering other proposals to send to the SEC that would open the proxy-voting process, allowing greater shareholder participation in the process along and giving companies greater access

to their shareholders whose shares are held in “street name” accounts.

As the shareholder-democracy movement marches forward, we are seeing major changes in proxy process as well as in issues brought before shareholders for vote. To be good corporate citizens and operate their businesses in the best interests of their owners, companies must pay attention to these developments and know what is coming down the road.

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