IR magazine

GUIDE

May 2010

Will activists go wild in a proxy access world?

New regulations shift power

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The proxy landscape

This year, the proxy voting system is receiving significant scrutiny and might even wind up with its first real makeover in more than 30 years. Regulators are mulling sweeping change in everything from who gets to nominate director candidates and how votes are reconciled to whether issuers will be able to communicate directly with shareholders.

These changes alone might tip the balance of power between managements, boards and activists hoping to remake some key aspects of how publicly traded companies are run. But when they are viewed against a backdrop of other changes, such as the steadily rising popularity of an advisory vote on compensation (say on pay) and the elimination of the broker discretionary vote in director elections, some public companies are rightfully concerned. They wonder whether activists might use their newfound rights to dramatically refashion the boardroom.

A host of changes

Observers of the US proxy system find several aspects of it outdated, especially in light of recent corporate governance developments that have increased the need for more transparent communications between public companies and their investors.

Among the more dramatic changes to the proxy landscape is the increasing popularity of the majority voting standard for director elections, which is now the norm at many public companies. This standard can have the effect of making things more difficult – or at least more embarrassing – for director nominees seeking to gain board seats. Under the old and still widely used plurality voting standard, director nominees need only a single 'for' vote to be elected.

In addition, many companies have opted for notice and access, and have begun mailing a notice of the company's annual meeting, directing shareholders who have not explicitly requested paper to

an electronic version of the proxy. One unintended consequence of notice and access is that many companies have encountered a marked decline in retail voting; apparently, investors are not reviewing the information posted online or responding to it.

The trend for retail investors not to vote their proxies is particularly worrisome to many public companies given that support for shareholder proposals has increased in recent years. A decade ago, activists might have claimed a symbolic victory after launching a proposal that garnered a mere 5 percent or 10 percent of the vote. Today, the votes are high enough that some of these proposals are winning approval. Non-binding proposals and those that narrowly fall short of a majority can cause considerable discomfort to managements and boards.

Say on pay

Over the past few years, many companies have either voluntarily embraced say on pay or have decided to do so after having a shareholder proposal achieve a high percentage of votes. Say on pay is the catchy term for a non-binding vote on executive compensation, which gives shareholders the right to register a thumbs-up or thumbs-down opinion on a company's executive pay practices.

When the US government required the hundreds of public companies that owed Troubled Asset Relief Program money to hold say on pay votes, the concept got an enormous boost. This non-binding vote could someday be required of all public companies. In July 2009, the US Treasury indicated its support for say on pay legislation, handing over the issue to Congress, where the concept has many fans.

Changes to Rule 452

On January 1, 2010, the NYSE amended Rule 452 and eliminated the broker discretionary vote in director elections. This means brokers are no longer permitted to vote uninstructed shares for their clients.

The repeal of discretionary voting in director elections intensifies the focus on institutional voting. As retail investors are less likely to be part of the final vote count now that brokers are no longer weighing in for them, institutional investors – and the proxy advisory firms guiding many of them – have more influence than ever.

As with other proxy issues, the effects can best be measured when examined in the context of the full range of changes that are afoot. For instance, the risks to boards from the amendment of Rule 452 are much greater at companies with a majority voting standard because the bar for successful director elections is higher. At these companies, the possibility that a director would have to submit his or her resignation to the board because of a failed election no longer looks quite so remote. ●

The new regime

It's one of the most contentious issues the markets have ever faced - but what form will proxy access take?

Proxy access has polarized the marketplace like no other proxy reform issue. Activists and many public pension funds have long coveted the right to nominate directors. Doing so without creating their own materials and waging a full-scale proxy contest suddenly looks like a goal within reach. On the other hand, public companies are mounting a spirited opposition: corporations clearly view this as a move that would throw open the director slate to pressure groups and activists with an axe to grind.

The SEC proxy access proposal, released on June 10, 2009, consists of two parts. The first part would mandate a federal proxy access regime for all publicly traded companies under the proposed Rule 14a-11. The second part would amend the existing Rule 14a-8 to permit boards and shareholders to propose bylaws that permit proxy access.

The SEC received numerous comment letters demonstrating that much of corporate America supports a bylaw change to proxy access. Public companies seem to prefer this alternative because it's not a one-size-fits-all solution. Further clouding the issue is the question of whether the SEC can authorize proxy access. Senator Dodd's bill would reaffirm what many believe is the commission's authority to provide investors with access to the company's proxy. The bill does not, however, mandate any specific structure for proxy access.

Most majority voting regimes have carve-outs for contested elections, so in a proxy access world with more nominees than board seats, plurality voting would be the controlling standard.

Nomination thresholds

Perhaps the most hotly debated issue within the SEC's proxy access proposal is that of the 1 percent ownership threshold for shareholders wishing to nominate director candidates at large-cap companies (those with net assets

Close votes: the new norm

- **In 2002, the merger between Compaq Computer and Hewlett-Packard was approved by only 51.4 percent of the voting shares.**
- **In 2004, the merger between AXA Financial and the MONY Group was approved by 53.8 percent of the shares outstanding and entitled to vote. The approval margin was only 1.7 mn shares at a time when more than three times that amount of shareholdings (6.2 mn shares) were loaned out for short selling.**
- **In 2005, a bylaw amendment to approve a poison pill plan at Alaska Air Group's annual meeting fell 2.4 mn votes short of the required 75 percent approval, at a time when 4 mn shares had been sold short.**
- **In a 2006 proxy contest, activist Nelson Peltz succeeded in electing two of five candidates to the Heinz board with a margin of victory of just 3.2 percent (8 mn out of 250 mn shares voted).**

Source: SCC comment letter to the SEC on proxy access, August 17, 2009

of $700 mn or more). At medium-cap companies (net assets between $75 mn and $700 mn) and small caps (under $75 mn), the SEC's proposed ownership thresholds are 3 percent and 5 percent respectively. The SEC also included a feature allowing unaffiliated shareholders to aggregate their holdings to meet the minimum share ownership threshold. Public companies criticize the thresholds as being too low: a 2009 analysis by Georgeson and Latham & Watkins found that 84 percent of letters to the SEC during the initial comment period argued for a higher ownership threshold.

Corporate America is also railing against the one-year holding period for eligibility to nominate a director candidate as being too brief. And corporations weren't the only ones supporting longer holding periods: recommendations for a two-year holding period came from institutional investor activists, such as TIAA-CREF, the Ohio Public Employees Retirement System, and the Sheet Metal Workers' National Pension Fund.

Another issue is how to handle the competing interests of shareholders, each with their own director nominees. Although the SEC proposed accepting the nominees of whoever first submitted candidates, that might also change. Most commentators say it should be the largest shareholders that nominate directors.

Some believe the proxy access debate is overblown. Beyond the US, there are mechanisms for nominating directors to a company's proxy that are used sparingly. What's more, some observers suggest that large investors are unlikely to avail themselves of a public company's proxy statement even if that avenue opens to them. To sway sentiment and win a proxy contest, an investor typically has to spend large amounts of money mailing fight letters and hiring lawyers, proxy solicitors and PR firms. A brief write-up in the company's proxy statement alone isn't going to be enough to secure the votes necessary to win a board seat. ●

Ask the expert

David Drake, president of Georgeson, provides insights into how IROs and corporate secretaries can best prepare for proxy access

Given the uncertainty over the precise form proxy access will ultimately take, what do public firms really need to know?

A lot of companies fear proxy access will end up being a case of activists gone wild, with a substantial increase in the number of potential proxy contests. That remains to be seen, but what we hear from a number of pension funds, such as CalPERS, which has strongly supported proxy access, is that the intent is not to use this tool frequently. It's simply a point of leverage to spur companies to engage with the fund.

Some companies are rightfully skeptical of that position, in that proxy access *does* make it easier for shareholders to run a proxy contest and have their nominees appear on the company's ballot.

The question is: how often will mutual funds and pension funds make use of this proxy access tool? In spite of all the fear in the marketplace, I don't think it will be used by those groups a great deal.

Our view is that hedge funds aren't necessarily looking for a way to carry out an inexpensive proxy contest. The hedge funds can usually foot the bill for running a proxy fight campaign, and the potential cost savings from proxy access – if there really are any – won't be much of an incentive. Hedge funds can generally wage contests without having to worry too much about the overall price tag.

One fear is that hedge fund investors might use proxy access to prod a company into an action that benefits more short-term holders. How likely is this?

In the proposed rules, there is a limit on the ability of an investor to use proxy access for certain specific purposes. For example, if a hedge fund has a 'control intent' – such as if its true objective is to force the sale of the company – the

proposed rules state that proxy access cannot be used.

When the SEC comes out with its final rules, it will be interesting to see how the commission clarifies this particular aspect of proxy access. It's one thing to say that hedge funds can't run a proxy access contest on a platform to sell the company, but what about other types of short-term objectives, like a leveraged recap or a spin-off of a certain division, or the sale of assets within the company? Will those types of campaigns be considered acceptable within a proxy access regime?

Will you hazard a guess as to what final form proxy access might take?

It's hard to tell. One issue is this: what will be the share ownership threshold for an investor wanting to use proxy access? Will it be 2 percent, or 3 percent? Will an investor have to hold the stock for two or three years? We're really not sure at this point where the SEC is going to end up.

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How would changes to the mechanics of the proxy system affect proxy access?

Our view has consistently been that the SEC should look closely at the proxy mechanics to ensure companies have good visibility into their shareholder base. The advent of proxy access – if, in fact, activists *do* go wild – makes it incumbent upon companies to monitor and analyze their shareholder base so they can see what's going on, engage their shareholders and determine what level of risk there is for the company and board.

Are there any proactive steps a firm can take to avoid being targeted in a proxy access contest?

Having a program of institutional outreach and engagement with investors may be an important factor in whether or not you're targeted for proxy access. If you *are* communicating with the likely proponents of proxy access, it stands to reason that you'd be less likely to be the focus of an *actual* proxy access contest. ●

Proxy mechanics

SEC reforms may address the problem areas of over-voting and the NOBO/OBO distinction

SEC chairman Mary Schapiro has promised a concept release on proxy mechanics in June 2010. Many areas could be addressed, but two of the most critical are the overall integrity of the voting process and the issue of whether public firms should be able to communicate directly with their shareholders.

Over-voting occurs when one or more brokers cast a greater number of votes than they should. This problem stems from share lending. Short sellers typically borrow shares from a broker-dealer to settle an agreement they've made to deliver those shares. The broker-dealers are allowed to loan shares if they've secured a signed agreement from their clients permitting them to do so. Share-lending agreements grant the borrower the right to vote the loaned shares, but many brokers do not reduce the positions held within their clients' accounts when they loan shares out of these accounts. If these positions have not been reduced by the record date for a shareholders' meeting, the shares might easily be voted twice: once by the account holder, and once by the share borrower.

This problem is apparently widespread. In 2005, the Securities Transfer Association reviewed 341 shareholder votes in corporate contests for that year and found evidence of over-voting in all of them.

To solve the problem, the Shareholder Communications Coalition (SCC) recommends that all beneficial owners be given proxy cards to vote rather than simply completing voting instruction forms that are then voted by a broker. If every shareholder received his or her own proxy card, only one proxy card would be voted per investor. An added benefit is that a third party could easily audit the vote count.

NOBOs versus OBOs

The SEC has clearly indicated its intention to revisit the non-objecting beneficial owner (NOBO) versus objecting beneficial owner

(OBO) distinction. Over the years there has been an inconsistent process for coding holders as NOBOs versus OBOs, leading to many Street holders being coded as OBOs – that is, holders whose identity is not revealed to the companies in which they invest.

This coding may not reflect investors' preferences. In an April 2006 study conducted for the NYSE, only 20 percent of OBOs recall having been asked whether they wanted to provide their contact information to the companies whose stock they purchased.

For public companies, the NOBO/OBO distinction makes shareholder engagement very difficult and expensive. Specifically, companies must present proxy materials, annual reports and other shareholder materials to brokers, which then use Broadridge to distribute the materials to the investor, all at the company's expense.

The SCC recommends an end to the NOBO/OBO system. It believes public companies should have access to contact information for all of their beneficial owners and should be permitted to communicate with them directly. If a beneficial owner prefers to remain anonymous, he or she should have the right to register shares in a nominee account with a broker, bank or third-party intermediary.

Some industry experts are advocating for the creation of a data aggregator, selected by a special committee of the NYSE. This aggregator would obtain beneficial owner contact information from all brokers, banks and other intermediaries. It would not, however, be responsible for proxy distribution and communications, as Broadridge is today. This change would throw open proxy distribution and communications to market forces, allowing issuers to select their own proxy service providers on a competitive basis.

Should proxy mechanics be reformed along these lines, many firms maintain that they could communicate more freely with retail investors when they have a valid business reason for doing so. This, they believe, would reinstill the trust and confidence shareholders once had in the companies in which they invest. ●

The SCC's vision

- **Create a single data aggregator in order to obtain beneficial owner contact information from all brokers, banks and other intermediaries.**
- **Allow issuers to choose their own proxy distribution and communications providers, thus ending the current Broadridge monopoly.**
- **Send beneficial owners proxy cards, rather than voting instruction forms, to avoid over-voting.**
- **Require the beneficial owner list to be reconciled as of the record date and before any proxy materials are mailed to investors.**
- **End the NOBO/OBO distinction.**
- **Give public companies access to contact information for all beneficial owners unless the owners take the proactive step of registering shares in a nominee account with their broker, bank or another third party.**

Source: Recommendations of the SCC, February 2010

Taking care of the board

Shareholder communication remains key to avoiding unwanted director bids

Issuers contemplating follow-on offerings typically debate the timing of the offering. When is the best moment to raise additional capital? And to whom should they allocate shares?

Faced with a raft of changes to the proxy process, IROs and corporate secretaries are considering ways to make their firms as bullet-proof as possible. Institutions interested in using proxy access in the future will be looking for weaknesses in the skill sets of current directors. Now is an ideal moment to revisit the composition of the board, asking whether directors have the experience and backgrounds needed to ward off shareholder attempts to remake the boardroom.

But precisely what gaps will be perceived as red flags? Diversity is almost certainly an issue worth considering. Some public pension funds are said to be developing pools of potential nominees for public companies with a notable lack of women or non-white people in the boardroom.

This is also a good time to revisit director disclosures. Savvy corporate secretaries and IROs will be sure to emphasize the diverse skill sets of board members, showing how a background in, for example, marketing or risk analysis might prove critical. They will also explain how the board as a whole satisfies the company's current needs for expertise and experience.

Some industries will almost certainly fall under greater levels of scrutiny than others. Financial service firms, for instance, will want to make sure that at least some of their directors have a background in risk management. Should there be a perceived gap in the necessary skills in these boardrooms, investors are likely to bring this to a board's attention. If the problem is left unaddressed, they may step in and nominate their own candidates.

Finally, the independence of most – if not all – board members will continue to be of paramount importance.

Many institutional investors engage proxy advisory firms for advice on how to vote hot-button issues. Target's battle against a dissident slate of directors in 2009 illustrates how it's possible for a public company to prevail, even if RiskMetrics, the largest and most influential proxy advisory firm, recommends voting in favor of dissident nominees.

Last year, Pershing Square Capital Management launched a campaign to install four of its dissident nominees on Target's board. RiskMetrics supported two of Pershing's candidates; ultimately, however, none of Pershing's nominees won seats. Observers believe Target ultimately succeeded because of the strength of its directors and its active investor outreach program.

Private ordering

It's possible the SEC might give companies the opportunity to ask shareholders to approve management and the board's own version of proxy access. A company's version might, for instance, have higher ownership thresholds or might not even kick in unless one or more of the directors has received a majority vote against him/her. Shareholders could then vote on whether the form of proxy access proposed by the company should supersede the federal proxy access regime approved by the SEC.

If this so-called 'private ordering' is indeed an option, companies would be well advised to consult with proxy solicitors and other advisers, as well as directly with their shareholders, to assess their chances of getting their proxy access scheme approved through a shareholder vote.

Rather than getting out ahead of proxy access, most companies are assuming a wait-and-see stance. But if proxy access is to become the law of the land, private ordering could provide an attractive means for gaining more flexibility. Private ordering might also afford a board more time to focus on long-term issues rather than worrying about the prospect of facing an annual proxy access fight.

Avoiding trouble

Given the turmoil in the proxy landscape, it may not be possible to craft a strategy that will please all investors. No public company, not even one without a single shareholder that qualifies for proxy access under the SEC's current proposal, is immune from a shareholder group nominating a director candidate.

In the final analysis, however, activists have demonstrated little interest in using proxy reform to push radical agendas. Instead, most have asked simply to be heard and to have their concerns taken seriously. Those companies that engage shareholders in a dialogue, listening to complaints and responding appropriately, are likely to satisfy existing shareholders – and, just as importantly, to continue to attract future investors who are interested in soundly governed companies. ●

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