

A perfect proxy storm

- ✓ Majority voting, say on pay, proxy access and removal of the broker discretionary vote present serious communications challenges
- ✓ Understanding how activists solicit support and initiate proxy fights will help you prepare to deal with dissident's tactics
- ✓ Changes to notice and access rules will save companies money and alter the tactics used to communicate with investors
- ✓ Regardless of the message or the delivery mechanism, maintaining an open line of communication with long-term shareholders is vital

HEDGE FUND ID

Hedge funds try to attract as little attention to their trading as possible, and identifying accumulations is no mean feat.

On February 1, 2006, the SEC began requiring that hedge funds with more than \$30 million in assets and 15 clients register as investment advisers. Around 1,000 hedge funds did so before June 23, 2006, when a federal appeals court tossed out the SEC's rule.

Hedge funds are still required to file 13Fs to disclose their holdings at the end of each quarter. But with high turnover, these filings may be of little use. In addition, with hedge funds occasionally borrowing or acquiring shares right before a record date to secure voting rights – and selling or returning their position right after the record date – knowing who owns your shares is a challenge.

IROs and corporate secretaries should be alert to any changes in shareholder composition that could signal a potential activist confrontation.

Changes abound

Companies contemplating this year's proxy season are facing worrisome developments on all sides. Not only are shareholders irate over runaway executive pay, but they're also focusing on the way directors are elected and continuing to push more aggressively for governance reforms. Activist labor unions and hedge funds keep moving from the fringes into the mainstream. Several recent changes to the proxy process will also help shareholders promote their agendas – and make it harder for management to prevail.

The success rate of activists is alarming: Last year, dissidents prevailed in 60 percent of cases resolved either through a fight or settlement

As of January 2007, it was estimated that nearly 450 governance-related shareholder resolutions had been filed already. And support for shareholder-sponsored proposals on pay and majority voting has been climbing.

There are several factors creating this 'perfect storm' on the proxy horizon: the NYSE's move to end the broker discretionary vote for director elections; inroads in majority voting proposals; the SEC revisiting the 'proxy access' proposal; and changes to the rules for delivering proxy materials.

Why now?

Ever since the collapse of Enron, WorldCom and others, the thinking has been that well-governed, transparent companies are less likely to implode. Meanwhile, studies have shown that better-run companies tend to realize higher returns.

Unsurprisingly, then, shareholder activists, once considered nuisances, are gaining increasing influence, even at some of the largest US companies. For instance, Ralph Whitworth, a well-known shareholder activist and founder of Relational Investors, recently spearheaded a campaign to protest the generous compensation awarded to Home Depot's then CEO Robert Nardelli in light of the company's flagging performance. Soon after, Nardelli resigned.

Since the start of 2006, the Altman Group has tracked 104 cases of hedge fund activism, up sharply from 2005. The success rate is also alarming: last year, dissidents prevailed in 60 percent of cases resolved either through a fight or settlement.

Some hedge funds are compelled to act by circumstance. They may own only ten or 20 equities in their portfolios and if one of their positions heads south, it has a real impact on the portfolio. So hedge fund managers who see trouble brewing tend to engage a company much more aggressively and far earlier than a traditional institutional investor might.

Other hedge funds engage in a basic strategy of shaking up the status quo for their own gain. These have shown a particular affinity for certain business scenarios, often targeting well-run companies with excess cash sitting on the books, demanding special dividends or

Selected cases of activism

Hedge fund	Company	Outcome
Pembridge Management	Topps Company	Activism settled when Capital Pembridge got three board seats.
Trian Partners	HJ Heinz	Trian nominated five dissident nominees and won two seats in this proxy fight.
Pirate Capital	James River Coal	Activism settled when Pirate got three board seats.
Third Point	Massey Energy	Third Point won two board seats at Massey's annual meeting.
PL Capital Group	Synergy Financial Group	PL Capital won two board seats at Synergy's annual meeting.
Dolphin Limited Partnership I	InfoUSA	All of management's nominees were reelected to the board.
Highland Capital Management	Motient Corp	All of management's nominees were reelected to the board.
The Shamrock Group	Intrado	Intrado signed a merger agreement with West Corp and Shamrock dropped its fight.
Greenlight Capital	New Century Financial	Activism settled with Greenlight given a board seat.
Relational Investors	Home Depot	Fight settled with Relational getting a board seat.

Source: The Altman Group

share buybacks. Some gravitate toward poorly run companies where they might push for a sale or changes on the board. Others buy shares in firms announcing a friendly deal in order to block the merger or even start a bidding war.

Too often, companies are completely unaware an activist hedge fund is a shareholder until the fund sends a letter to the board announcing its intentions. From there, matters can quickly escalate as other hedge funds pile in to take advantage of the confrontation. Acting in concert, hedge funds can

represent a particularly powerful force for disruption.

IROs have to be prepared for these eventualities. First, develop an unassailable PR and IR strategy and keep track of your shareholder base. Companies also need to know which avenues hedge funds have available to them for persuading other investors to follow their lead. Understanding how activists – whether they're hedge funds or labor or pension funds – solicit support and initiate proxy fights will help you prepare to deal with a dissident's tactics.

EMPTY VOTING

- *Let's say Hedge Fund A owns a 5 percent stake in a company. If it buys another 2 percent and simultaneously shorts 2 percent, the hedge fund's economic interest hasn't changed – but its voting control now stands at 7 percent.*
- *Using sophisticated strategies, hedge fund activists can increase their voting power without increasing their economic stake. While this practice – known as empty voting – first came to light in a 2004 lawsuit by Carl Icahn, an academic study by the University of Texas has shone a new spotlight on it.*
- *Borrowing shares right before the record date and returning them soon after is another way to increase voting clout. UK hedge fund Laxey Partners tried to break up British Land but held only 1 percent of the shares. Laxey ultimately voted a 9 percent block by borrowing 8 percent of shares and returning them after the election. The campaign ultimately failed, but the strategy is striking fear into the hearts of companies facing tough elections.*

SAY ON PAY

Shareholder dismay over the generous compensation handed to departing Home Depot and Pfizer CEOs may be vented this proxy season in several proposals designed to discourage such largesse. The SEC-mandated disclosure requirements going into the 2007 proxy season will make it easier for activists to focus on the outliers. Yet curbing exit pay is only one of many ways shareholder activists are attempting to rein in astronomical pay.

Executive pay proposals take many forms. As of early 2007, labor funds had filed 50 'pay for superior performance' proposals. These sometimes stipulate that bonuses won't be paid if a company underperforms its peers.

Another popular proposal is the non-binding advisory vote on the compensation committee report.

Proponents feel these 'say on pay' proposals give shareholders greater control over excessive pay packages. They were popular in 2006, with many receiving well over 40 percent of the votes cast, and companies should expect that trend to continue in 2007.

Getting it right

Majority voting has been described as the hottest topic to hit the corporate governance arena in many years. At many US companies, directors are elected by a plurality system, needing just one vote to be elected to the board – unless there's a competing slate.

By contrast, majority voting requires that a majority of the votes cast must be 'for' a certain candidate, meaning substantial withheld votes might turn the tide against a prospective director.

According to Institutional Shareholder Services (ISS), the number of majority vote proposals and the support they're getting is rising (see Majority voting proposals, below).

Some companies facing a majority vote proposal have offered a compromise, such as the model first adopted by Pfizer. Under this model, a company's corporate governance guidelines are amended so any director who receives a majority of withheld votes must resign. The board then has 90 days to consider the resignation and make a recommendation.

Shareholder reaction to such director resignation rules has been mixed. Majority vote advocates prefer the Intel model, which is an actual bylaw amend-

ment and gives shareholders the ability to vote 'against' a director.

Majority vote proposals give investors greater say over how directors are elected, a development IROs need to monitor closely because of the possible effects on election outcomes.

Proxy reform proposals often have a tangled history. Majority voting was embraced by labor unions and institutions around two and a half years ago when it seemed as if the SEC wouldn't allow shareholders access to the proxy. The proxy access proposal states that if certain conditions are met (including the surpassing of a certain threshold of withhold votes on any nominee), a qualifying shareholder or group can put its own nominees on management's proxy without the cost and effort of waging a full-blown proxy contest.

Then, in September 2006 courts ruled that the SEC had improperly allowed AIG to exclude from its ballot the 2005 access proposal filed by American Federation of State County and Municipal Employees. The SEC then agreed to revisit the proxy access issue.

Although the commission has revived the issue, it is obviously still a thorny one. The SEC postponed discussing

Majority voting proposals

	2004	2005	2006
Total proposals	12	58	98
Passed	0	13	34
Average support	12%	44%	48%
Percentage that passed	–	22%	35%

Note: All figures are rounded to the nearest whole number

Source: The Altman Group with data from ISS

Pay for superior performance – 2006 voting analysis

Issuer	% of votes for	% of votes against	% of votes abstaining
Black & Decker	46%	53%	1%
Weyerhaeuser	5	93	1
Nationwide Financial*	2	99	–
Fortune Brands	25	63	2
DuPont	38	57	5
Abbott Laboratories	26	6	2
Weingarten Realty	19	72	1
Boston Properties	37	62	1
Avon Products	25	74	1
Colgate-Palmolive	26	63	1
EMC	32	51	1
3M	33	64	2
Mattel	37	52	1
JC Penney	11	84	2

* Insider ownership - 94 percent was held by a controlling shareholder and the outstanding includes multiple voting rights.

Note: All figures are rounded to the nearest whole number

Source: The Altman Group

proxy access at both its October 18 and December 13 meetings.

Barring the broker vote?

Under NYSE Rule 452, brokers may vote any of their clients' unvoted shares if the matter addressed is considered routine. The NYSE is, however, seeking SEC approval to amend this rule so that the election of directors will no longer be deemed a routine matter. This would affect all NYSE, Nasdaq and Amex companies, as well as closed-end mutual funds.

Historically, brokers could be counted on to follow management's recommendations in elections. If the broker discretionary vote is repealed, firms will no longer be able to count on such large margins of success, and withheld votes will

carry far greater weight. Companies with majority vote standards could well face the prospect of a director not being reelected in the face of serious opposition.

Investor apathy is another potential problem: the Altman Group estimates that no more than one third of individual investors vote their proxies.

Although the loss of the broker discretionary vote will most likely occur in 2008, companies need to prepare now. That said, the effects of this rule will vary according to a company's shareholder makeup. Companies with a high percentage of retail investors will be most seriously affected. Consequently, even though the NYSE introduced the rule change, the greatest impact will be felt by companies listed on other markets and exchanges.

IT'S NOT JUST US INVESTORS

Europe, Latin America and Asia are clearly watching what the US does in terms of corporate governance – and making changes of their own.

France established a record-date system and greater access to shareholder proposals. And the UK has allowed advisory, non-binding votes on compensation reports since the end of 2002.

Japan has dealt with an avalanche of poison pill proposals in the past couple of years and observers now expect a wave of M&A activity, hedge-fund activism and calls for greater transparency. In Brazil, the proliferation of IPOs on Bovespa's Novo Mercado, which has strict governance requirements, is providing a lot of liquidity to companies with a single share capital structure.

Meanwhile, investors outside the US are exerting a pull on corporate activities inside the US. In January 2007, a group of international investors – including the Netherlands' ABP, Europe's biggest pension fund – wrote to regulators, the stock exchanges and politicians to ask for stronger measures to curb executive pay.

TALK TO THE DECISION MAKERS

Given the growing clout of the proxy advisories, what's an IRO to do?

Communicate. Although investors and proxy advisory firms rely on publicly available materials, many also welcome a dialogue with company management.

In contested elections, ISS is known for meeting with both management and dissidents and spending a great deal of time discussing the issues. While this is only one meeting a management team will have, it is not one to be taken lightly.

In many contests, ISS' recommendation has proven to be the decisive factor. Companies, however, need to be aware of the firm's influence on its clients – who also happen to be your shareholders.

Although ISS is considered the 800-pound gorilla in the proxy advisory ring, it's important to know the other contenders. Glass Lewis, with clients managing over \$8 trillion, and Proxy Governance, the new kid on the block, also wield some real influence. Ideally, you should know whose guidance your shareholders are heeding.

Getting ready

In the welter of voices influencing how companies are managed, the role of the proxy advisory firms – of which ISS is the largest – is growing. According to the Altman Group, it's not uncommon to see ISS' analysis influence 20 percent-25 percent of the vote at a meeting, and can often be the deciding factor in a contested election.

Glass Lewis and Proxy Governance, two of ISS' competitors, are increasingly playing a role in institutional decision making too.

Some are concerned about the increasing power of proxy advisers, fretting that ISS' verdict, for example, might be 'the make or break' factor in a multi-billion dollar transaction.

In the 2005 season, the SEC found that 56 percent of beneficial shareholder accounts didn't vote, but still received costly printed materials

Although you may feel like simply overlooking criticisms from proxy advisors or shareholder dissidents, ignoring the problem won't make it go away. Just the opposite. Pension and labor funds have shown themselves amenable to withdrawing proposals when they feel management has made a good-faith effort to address their concerns. Ignoring hedge funds or dissidents just increases the chance they

will ratchet up the pressure and you'll end up in an ugly fight.

Shareholder ID

The old exhortation to 'know your shareholder' has an even greater significance in this new proxy landscape.

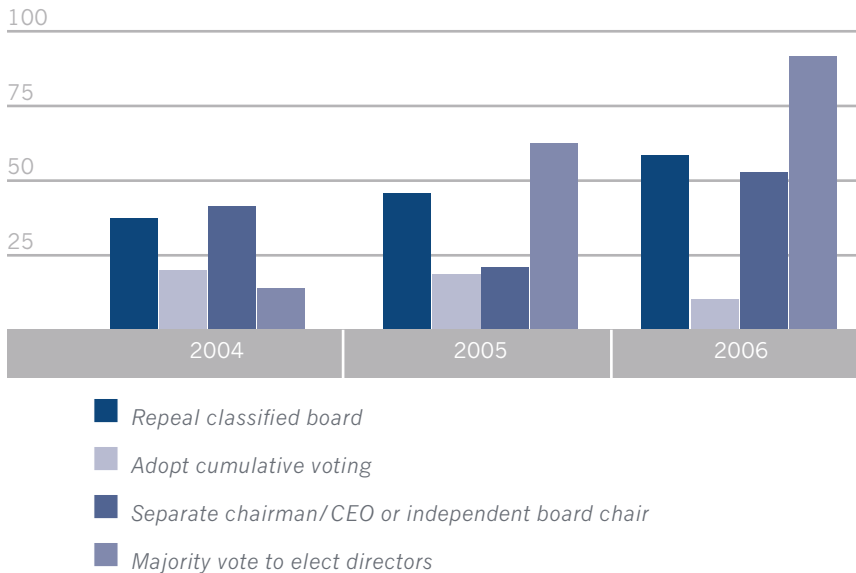
While shareholder identification programs are a good idea because they update you about who your largest holders are, you also need to know the extent of each beneficial investor's votable position, as well as some information about that investor's voting record. Does a holder manage shares it does not have voting control over? Does it automatically vote along with the recommendations of ISS or its competitor, Glass Lewis?

Companies with a sizable retail base also need to closely watch developments like the electronic delivery of proxies because e-delivery could further affect proxy results.

E-delivery

Beginning July 2007, companies will be able to offer proxy statements on the internet. This represents a departure from the current SEC rule, which permits electronic delivery of proxy statements only to shareholders who affirmatively consent to such delivery. The number of shareholders opting in for internet proxies has been low. The SEC is now moving in the direction of changing the default from paper delivery of proxies to electronic delivery. By doing so, the SEC anticipates US companies might save more than \$500 million a year in total. The commission notes that in the 2005 proxy season, 56 percent of beneficial shareholder

Growing proposals



Source: The Altman Group with data from ISS

accounts didn't vote – but still received costly printed materials.

Under the new rule, within 40 days prior to the annual meeting, firms must mail shareholders a notice with an internet address where they can access the proxy statement, the financial statement and voting information.

E-delivery doesn't mean your investors who lack an internet connection or simply prefer paper delivery will be denied a say. SEC chairman Christopher Cox emphasized at an open meeting in December 2006 that the 'SEC will always guarantee your right to printed document delivery.' In fact, a company's initial notice sent by mail must provide instructions for any investors who want to request paper copies of their voting documents.

Even though paper delivery will remain an option, some proxy experts are concerned voter turnout will decline. They're convinced people are less likely to either request a printed proxy or read a written notice and log

onto the internet to access a company's proxy materials before voting online than they are to fill out and return a paper ballot that is automatically mailed to them.

What's more, companies realize that while they will save large sums in shareholder communications, hedge funds and shareholder activists will also be able to reduce their solicitation expenses. SEC commissioner Roel Campos has suggested one benefit of the 'internet proxy' rule is that shareholders can play a greater role in the governance of companies.

When measuring the impact e-delivery might have on your company, begin by assessing your entire shareholder profile. How many shares are controlled by retail investors? As institutions have a fiduciary responsibility to vote and can largely be counted on to do so, it's the retail votes that might potentially be lost if e-proxies prove bothersome and are ignored – and these are generally the most management-friendly voters out there.

SHAREHOLDER ID

IROs want a glimpse into their investors' psyches, but in reality, many don't even know their shareholders' names. 13F filings are generally stale, 45 days old at best, so while they're a good starting point, you should also obtain an updated shareholder ID report when facing a contentious vote.

For many companies, particularly large ones, it's also not uncommon to have more than 75 percent of shares held in Street name with a majority owned by objecting beneficial owners (Obos). NYSE president Catherine Kinney has said the Big Board would like brokers to change the default from Obos to Nobos (non-objecting beneficial owners) in the near future, which would make direct communication easier, at least with retail investors.

However, a future in which more shareholder information and less expensive proxy solicitation procedures are the new reality will be a double-edged sword. Remember: these changes mean hedge funds and other activists may also be able to communicate more easily and inexpensively with your shareholders.

Communicate regularly

In proxy battles, shareholders have been known to complain that aside from SEC-mandated reports, they don't know what a company's doing. Avoid giving your shareholders the opportunity to say, 'You never put pen to paper.' Communicate regularly.

Understand the strengths and weaknesses of your IR message. Try to imagine how your message will be received by various audiences, from mom and pop investors to shareholder activists. Are you setting expectations (not necessarily about earnings but about business strategies) that might be exploited by a dissident?

Regardless of the message, maintaining an open line of communication with your long-term shareholders is important. Should any challenges to management arise, the loyalty of large, long-term investors may determine the outcome of a proxy contest.

That said, lobbying shareholders is getting more difficult. After a recent

change by the SEC, mutual funds must now disclose how they vote their proxies. Since the rule change, activists, reporters and other interested parties have begun carefully scrutinizing mutual fund votes, taking exception when they detect inconsistencies.


Because of this increased scrutiny, it is arguably tougher to lobby institutions to deviate from their established voting policies, even if the situation warrants it. More and more, institutions are voting on straight proxy governance principles rather than examining the proposals in the context of the individual issuer.

Above all, be prepared

For a company that finds itself in a tight proxy contest, it's essential to know where you stand as the voting progresses. Your proxy solicitor can help track how the vote is progressing, telling you how close the contest is on a daily basis and predicting the likely

result. When the outcome is uncertain, you should communicate more frequently with your shareholder base. And if your message isn't being embraced, you may choose to highlight different points going forward.

No question, today's IROs face some daunting issues. But excellent preparation will almost certainly pay off. Hedge funds and other activists have proven themselves worthy adversaries who are very skilled at their PR efforts. The best way to preempt trouble is to reinforce your IR message by communicating clearly and regularly and involving senior management in the process.

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