

Dodd-Frank requires a thicker-skinned board

Opposition can't be avoided, so stop being so sensitive to voting outcomes and make sure you are not lowering the bar to curry shareholder favor. **BY JOSEPH MILLS**

EARLY IN MY 26 YEARS as a proxy consultant I learned that it was important to have a sense of each issuer's tolerance for opposition votes on proxy issues. In the early years of the governance reform movement many companies could be quite resolute and were willing to resist shareholder activists, oftentimes for years. Of course there were also some companies that never wanted to be seen as the "bad guy" and generally gave in to activists. But at the time of the corporate accounting scandals (i.e. Enron, Tyco etc.) some 10 years ago the balance shifted, and I now find that the majority of issuers are much more sensitive to shareholder pressure and much more willing to accede to shareholder demands.

Thus over the last decade or so most companies have given up their takeover defenses and agreed to various governance and compensation reforms. Some of this was high minded — "we want to have best-in-class governance." Some of it was arrogance — "we don't need takeover defenses, we would never resist a legitimate offer." Still others were out of resignation — "takeover defenses are going away." I must confess I never really knew whether this was coming from the board or from management seeking to insulate the board. Either way, many companies barely put up a fight as governance advocates pushed through their reform items.

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In fairness, it is also true that the rise of ISS and the other proxy advisors along with majority voting and the increased use of withhold voting in director elections has made resisting reform initiatives very difficult and sometimes pointless. Advisory votes are no longer really advisory.

Looking back, what did companies get for being so accommodating? More and more demands for reform, to the point where activists are seriously encroaching in areas that have traditionally been under the discretion of management and the board. Now, with the Dodd-Frank legislation in place, shareholders have the ability to challenge management's compensation via say on pay. And pending a legal challenge, shareholders will soon have proxy access. All of this has the potential to have a material impact on companies. At the very least it will occupy more of management resources and directors' time.

You may ask what's wrong with any of this? Shareholders are the owners of the company and they should have the ability to curb executive compensation, and they should have the ultimate discretion in a takeover situation. No disagreement there.

Looking closely at what really goes on, it seems that the motivation on the activist side is far from pure. These reforms are very often being pushed by labor groups, who are arguably doing it for social/political purposes, small individual gadflies, who are involved primarily for self aggrandizement, and activist hedge funds, who more often than not are looking to monetize their trades.

These activists are enabled by institutional investors who tend to vote more like portfolio holders than as shareholders, meaning portfolio considerations very often outweigh individual stockholding considerations when deciding proxy votes.

Moreover, these institutions which are support-

ing governance reforms may be in your stock one quarter and out the next. Others routinely lend away their shares and their voting rights. Those that follow proxy advisors often do so because they are passive or quantitative and don't know the issuer, or because their holding is too small to justify the time involved in making a thoughtful decision, or because they are too afraid to be second-guessed in the media and by regulators. And proxy advisor policies are suspected to be heavily influenced by the activists themselves.

With this in mind I have been urging clients to stop being so sensitive to voting outcomes. Develop thicker skin. Nowadays, opposition can't be avoided. It is unrealistic to expect the board to be elected with 95% support; 40% of votes cast in support for a shareholder proposal means that the proposal did *not* carry. Don't implement the proposal just because it *almost* won. And certainly don't lower the bar so that you feel compelled to act (as many companies do) if one-third or less of your shareholders oppose your position.

It is also critical to understand the detail behind

the vote. A large visible client of our firm just received a sizable "against" vote on say on pay. But looking at the results we saw that the largest shareholders voted overwhelmingly for the company, while the opposition vote was driven almost exclusively by the ISS recommendation. Should this company take a scalpel to its compensation programs after a result like this? Many companies will be faced with this very question.

There are some institutional shareholders that can be counted on to be responsible proxy voters. They are not policy driven. They are not politicized and not bureaucratic. Their voting decisions are an integral part of their investment decisions. They do take stands, and they do push back sometimes, but they always vote as investors trying to earn a return on their investment, which is the way it should be. I urge my clients to identify these investors and to use them as a "moral compass" if you will. When you have the endorsement of shareholders like these you can trust that you are probably in a good place. ■

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The shareholder proposal — the little resolution that could

By Charles M. Elson

It has been almost 70 years since the Securities and Exchange Commission dramatically altered the face of corporate governance by mandating the inclusion of shareholder-sponsored resolutions in company proxies.

Shareholder proposals, despite the fact that they are precatory and therefore not legally binding on boards, nonetheless have had huge impact on board decision making and the general direction of board-shareholder relations. And, they form the basis for the contemporary discussion and debate on topics ranging from proxy access to the general advisability of shareholder participation in the corporate decision-making process.

It wasn't always this way. Originally the SEC conceived the inclusion rule as a way to stimulate capital investment and economic revival by giving all shareholders the sense of some influence over the affairs of the companies in which they invested. Shareholder democracy, or at least the appearance thereof, was considered important to the success of our system of capital formation.

Unfortunately, after a lively start involving

the now famous Gilbert brothers, who were the original shareholder activists of the 1930s through 1990s and who used the resolution to call for independent company auditors, the resolution was rarely availed of by shareholders seeking influence over corporate policy and direction. Instead, it became the refuge of social and political activists who used the mechanism to call attention to corporate involvement in various societal and political woes. They rarely commanded many votes in support of their agenda.

Things began to change dramatically in this area with the advent of institutional shareholder activism and the dawn of the modern corporate governance revolution sparked by this activism in the early 1990s. The topics of the shareholder-sponsored proposal broadened considerably to include not only issues of social concern but of fundamental company governance. Resolutions dealing with de-staggering corporate board terms, director independence and equity-based compensation, elimination of the poison pill, and many other similar issues involving fundamental board structure, were proposed by a variety of investors, including large institutions and smaller shareholder rights advocates.

These resolutions, unlike the earlier socially motivated proposals, did remarkably well at the corporate ballot box, garnering high double-digit and in many circumstances overwhelming majority support. Boards, to their credit, recognized the strong shareholder sentiment these votes represented, and, in most cases, voluntarily made significant changes in board structure. The shareholder proposal became an important signaling mechanism to communicate shareholder desire to their elected board representatives.

The notion of greater shareholder participation in and influence on corporate affairs began with creation by the SEC of the corporate-sponsored shareholder proposal. The idea, unfortunately, took about 70 years to reach its potential. Out of this concept grew much of the framework and direction of the modern corporate governance movement.

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