

MORROW & CO., LLC

Proxy Update

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Institutional Investors: An Issuer's Guide to Constructive Engagement

The 2010 proxy season has ended, and in years past the summer would be a time to put away all things proxy. Today, that could be a lost opportunity. Because NOW is the time to begin preparing for next year's meeting.

The Annual Meeting process is rapidly moving from a two to three month project to an almost year-round exercise that requires insight on many different topics. Knowledge of your institutional investors is one such topic. These shareholders constitute a significant portion of the holdings of most companies. Issuers should know who they are, how they view key governance practices, and what factors influence their voting decisions. Moreover, companies should know how their largest institutional investors voted in the past and how they are likely to vote in the future.

Morrow & Co. is well-positioned to assist companies in their efforts to gain this knowledge as part of an ongoing governance strategy. We are prepared to analyze historical voting returns, project the outcomes on future proposals, identify key voting contacts, and prepare clients to dialogue with institutions.

What factors drive the vote of your institutional holders?

We often hear from issuers that their institutional holders (portfolio managers and analysts) love the company and, as a result, they expect that they will receive their support in almost any voting situation. The reality, however, is quite different. At many firms, the voting and investment decisions are separated, with the voting being handled by a separate governance group or proxy voting committee.

For many institutions, voting is influenced by one or more of the proxy advisory services - ISS, Glass Lewis, and/or Proxy Governance, among others. The degree of influence can vary widely depending on the policies and practices of each institution; with some following the recommendation blindly (and even having the proxy advisor vote the proxies), and others merely considering the recommendation as part of their overall decision-making process. The extent of influence can also be impacted by the size of an institution's investment in an issuer (with an inverse relationship between the degree of influence and the size of the investment). And, of course, the nature of the proposal itself can have a great bearing on the proxy advisor's influence.

However, it is important not to overstate the influence of the proxy advisory firms. One trend that has accelerated in recent years is the willingness of some major institutions to take voting stances that diverge from the recommendations of the major proxy advisory firms; relying instead on internal guidelines and policies when making voting decisions. Therefore, an adverse recommendation from one (or more) of the advisory services does not automatically mean that a proposal will fail. Conversely, a positive recommendation does not insulate you from an against or withhold vote from one or more of your major institutional holders. The final outcome will depend on many factors, including the composition of your shareholder profile and the extent to which an issuer can engage in discussions with investors to present the company's point of view.

Engaging your investors

During the height of annual meeting season in the US (mid March through late May) most of the major institutional investors are inundated with solicitation calls from companies in their portfolios. How, then, do you make your company stand out from the rest of the crowd, and have some assurance that your request will be heard?

The best approach is a coordinated outreach program to your investors, outside of the annual meeting cycle. Fall is often a good time for this outreach, since many institutions will have more time to respond, and you will have had the chance to digest the voting results from the last meeting. You may also have the outlines of what you will be asking shareholders to vote on at the next meeting. While you cannot ask for a vote without a proxy statement on file, you can certainly ask questions about the investors' stance on governance issues and your company.

Before undertaking an outreach program, certain issues should be addressed:

- Identify who your largest shareholders are, from a voting control perspective
- Know what factors influence a particular institution's voting decisions
- Learn what advisory services the institutions subscribes to, and how the recommendations are used
- Read publicly available information about the institutions' proxy guidelines
- Identify the appropriate contacts at the institutions

Who should be involved in the outreach program will vary from company to company, but generally it should be those who are most familiar with the company's governance profile and related issues. Often, this means that people from the corporate secretary's office, legal, and/or investor relations are involved. If compensation issues are a concern, it may be appropriate to have someone from HR involved as well.

Engagement is a two-way street

Most institutional investors are reticent about publicly engaging issuers whose stocks they own (there are notable exceptions, but this is generally the case). They are not shy, however, about probing into governance and compensation practices that they are unhappy with in one-on-one sessions with issuers. Part of the preparation for this process should be a review of your corporate governance practices, viewed through the lens of what institutions would like to see.

Among the questions you may expect to hear are:

- Why haven't you adopted majority voting for the election of directors?
- Why do you still have a classified board of directors?
- Why can't your shareholders act by written consent or call a Special Meeting? Alternatively: Why is the level needed to call a Special Meeting so high? We think it should be lowered to XX%.
- Have you committed to not institute a poison pill without shareholder approval? Alternatively (if you have a pill): Will you redeem your pill or put it to a shareholder vote?
- What steps have you taken (or will you take) to ensure that executive compensation is aligned with performance?

Use of the information

Although this information gathering will not include soliciting a proxy for a specific meeting, important insight can be gained that will help in the Annual Meeting process. Institutions will often provide information on what they think is good or bad about the company and its governance structure, and they will certainly not be shy about critiquing executive compensation practices if they think they are out of line. You may also get a sense of what their level of support is for management; this could be crucial when it comes time to solicit a particular vote and you potentially face an adverse recommendation from one of the advisory firms.

The information gleaned should certainly be shared with senior management, and can also be used in making decisions about proxy ballot items for the next Annual Meeting. If you use a proxy solicitor to assist with your meeting, share the information with them as well to help track votes from institutions to ensure that actual voting matches expectations.

Conclusion

The Dodd-Frank bill was signed into law last week, and the SEC has issued a concept release on "proxy plumbing." While there are many issues to be settled regarding the implementation of the recently enacted legislation, it is clear that these developments will have a profound and significant impact on future Annual Meetings.

The overarching goal of an institutional outreach program should be to establish an *ongoing* relationship with your key shareholders. Developing contacts during the off season will allow you to more easily reach the right people at meeting time, if necessary. It will also portray the company in a positive light, and show that you are open to investor questions and responsive to their needs.

We would be pleased to structure a strategic governance program that would include setting up an outreach program to your institutional investors and helping you make productive use of the information learned from this exercise. In addition to providing the appropriate voting contacts at institutions, we can provide historical voting information.

If you would like more information or have any questions, please contact your representative at Morrow & Co., or you can call Fred Marquardt, Tom Ball or John Ferguson at 203-658-9400.

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