Director Notes

The 2010 Proxy Season

From Compliance Governance to Strategic Governance

by John C. Wilcox

The financial crisis demonstrated that corporate governance should be more than just a compliance exercise. In the next proxy season, corporate boards will come under increasing pressure to explain how they integrate governance with performance and long-term strategic business goals. As directors open a window into the boardroom, they will in turn have the right to demand that shareholders view each company on the merits and exercise their rights in an informed and responsible manner.

The year 2010—the start of a new decade—finds companies and investors at a transformational moment. The global financial crisis and economic downturn have undermined public confidence in the financial markets and engendered widespread mistrust of both listed companies and financial intermediaries. In the wake of the crisis, the business community is on the defensive. In addition to steering their companies through difficult times, business leaders must work to restore public trust in private enterprise and reaffirm their commitment to good corporate governance and long-term value creation.[1]

Institutional investors and other financial intermediaries are also on the defensive. The banks, financial service companies, hedge funds, and investment firms at the center of the crisis are under intense scrutiny by governments, regulators, and angry clients. Huge portfolio losses during the crisis have led to claims that investors operated with a casino mentality, encouraged bubble market practices, tolerated conflicts of interest, took excessive risks, profiteered from short-term strategies, and jeopardized their clients' long-term financial security.[2]

1 Several leading experts contributed to the effort led by The Conference Board to identify the major challenges facing business corporations during the financial crises. See Frederick H. Alexander, et al., *The Role of the Board in Turbulent Times: Leading the Public Company to Full Recovery*, The Conference Board, Research Report 1452, 2009.

2 On the impact of the financial crisis on the institutional investment landscape, see Matteo Tonello and Stephan Rabimov, *The 2009 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition*, The Conference Board, Research Report 1455, 2009.

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With both companies and investors under pressure and looking for redemption, the 2010 annual meeting season will be a shadow referendum on the financial crisis and an inflection point in the evolution of corporate governance.

Companies Companies will have greater difficulty attracting support from shareholders. For CEOs and boards of directors, the 2010 annual general meeting (AGM) will be a report card on their stewardship of the business during the financial crisis and its aftermath. Voting results will be interpreted not only in terms of specific agenda items but also as an indicator of shareholders' confidence in the company's leadership and business strategy.

Shareholders Shareholders will be eager to demonstrate that they are diligently fulfilling their ownership duties and holding companies accountable for governance failures and poor performance. At 2010 AGMs, shareholders will be more conspicuous in their efforts to probe the implications of agenda items, exercise greater skepticism about non-routine proposals, give more credence to activist initiatives at underperforming companies, and use their voting rights both to send a message to corporate boards and to create a public record in support of good corporate governance and shareholder rights.

Media The media and the investing public will look at 2010 AGMs collectively as a referendum on the causes of the economic crisis, the lessons learned, and the path back to economic stability. From the public perspective, AGMs are not just about the conduct of business and approval of agenda items. AGMs provide a once-a-year opportunity for executives to be personally accessible to their shareholders and stakeholders and publicly answerable for their decisions. In good times, AGMs can be a celebration of business accomplishments. In bad times, they can resemble the proceedings of a trial by ordeal.

Regulators Politicians and regulators will monitor the results of 2010 AGMs as a guide for public policy initiatives and legislation in response to the crisis.

In countries where taxpayers have bailed out financial institutions and shored up struggling businesses, companies will face political pressure for stricter regulation and increased oversight of business.[3]

The 2010 AGM season will test whether companies and shareholders are allies or opponents in the effort to restore the integrity of capital markets elsewhere. The threat of burdensome new rules and government controls can be minimized if companies and shareholders have the will to work together in support of private sector reform and voluntarily deal with the excesses and abuses that caused the collapse of securities and credit markets. Brazil, with the creation of the governance-based Novo Mercado, is an outstanding example of collaboration among investors, companies, and the stock exchange—Bovespa—to implement private sector reform on a voluntary basis without the need for legislation.[4] Unfortunately, Brazil's progressive approach has been ignored in most markets.

New governance principles

It is no accident that in response to the financial crisis, the International Corporate Governance Network (ICGN) has announced an important revision to its *Global Corporate Governance Principles*.[5] In the words of Paul Lee, who chaired the effort, the ICGN's new focus will be on governance "culture and behaviours" rather than just "structures and independence." The ICGN statement asserts that this shift in focus is "entirely new in any governance code,

3 The recourse to regulation as a means to restore confidence in the financial system has been outlined, for example, in the white paper on financial reform published by the Obama administration in mid-2009. "See A New Foundation: Rebuilding Financial Supervision and Regulation," U.S. Department of Treasury, June 17, 2009, available at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. For a description of other legislative and regulatory proposals submitted during the last twelve months, see Matteo Tonello, *Corporate Governance Handbook: Legal Standards and Board Practices* (Third Edition), The Conference Board, 2009.

4 The positive influence on Brazilian companies of optional governance standards set by Bovespa's New Market is discussed, for example, by Bernard Black, Antonio Gledson de Cavalho, and Erica Gorga, "Corporate Governance in Brasil," ECGI Finance Working Paper Series, June 2009, available at www.ssrn.com/abstract=1152454.

5 Membership Consultation: ICGN Global Corporate Governance Principles Revised, International Corporate Governance Network (ICGN), June 3, 2009, available at http://www.icgn.org/best-practice/icgn-global-corporate-governance-principles/.

but vital because the behaviours are what the structures are aiming to promote—the structures are not ends in themselves. The behaviours are what will help boards take better decisions and so create most value."[6]

If this shift can be accomplished, its repercussions—moving from the old agenda of structures and process to a new agenda of culture, behavior, implementation, measurement, and the strategic rationale of boards' governance decisions—could change the dynamics of corporate governance activity in markets around the world.

A dynamic change in corporate governance As the ICGN recognizes, the financial crisis revealed the limitations of the external, box-ticking approach to corporate governance from both company and shareholder perspectives. In fact, the crisis brought to a close the definitional and theoretical work of corporate governance and mandated a transition from external to internal governance monitoring. The change has clear implications for both companies and shareholders.

Companies Corporate boards will be required to demonstrate that they are integrating governance decisions with business strategy, sustainable economic performance, and long-term value creation. Companies should be able to rely on a "comply-or-explain" approach in lieu of compliance with standardized best practices, depending of course on boards' willingness to articulate performance measures and business goals with sufficient detail and specificity. To do so, board members themselves will have to work harder to understand the business fundamentals of the companies they oversee and to articulate the strategic rationale for their governance policies and decisions.

Shareholders The good news for companies is that, as a result of this evolution, shareholders will also have to work harder and pay more attention to customized governance arrangements. As they will no longer be able to evaluate governance solely on the basis of process and external standards, voting decisions will have to be made on the merits rather than relying on benchmarks, box-ticking, and black-box recommendations. Shareholders will have to devote more resources to their governance analysis and share voting. In many cases, institutional investors will have to reorganize their governance operations and overcome internal resistance to the inclusion of governance criteria in investment decision-making.

Issues in strategic governance The 2010 proxy season will likely inaugurate this new stage of strategic governance. Although there will continue to be skirmishes on governance compliance, structure, process, and shareholder rights, particularly in markets where standards are lagging, the focus of corporate governance is likely to undergo a transformational expansion to embrace the following issues:

- Integration of governance decisions with business strategy and performance goals
- Board oversight of risk management and internal controls
- Corporate culture, ethics, internal equity, and leadership style set by the CEO and the board
- Environmental practices, social policy, and the measurement of intangibles
- The board's strategic competence in executive remuneration, CEO succession planning, and board self-assessment
- Quality of disclosure and communication between boards and shareholders

As these issues fall outside the narrow framework of checklists and external measures, they will require customized disclosure by companies, customized decision-making by shareholders, and customized analysis by proxy advisory firms and other intermediaries. The challenges to all these groups will be substantial and unavoidable. Governance practices must evolve in response to new demands and new market conditions in the post-crisis environment.

6 ICGN News, October 2009, at www.icgn.org.

On some issues, such as executive remuneration, this evolution is well under way. For example, in markets that mandate shareholder votes on executive remuneration (either binding or advisory), shareholders already look beyond benchmarks and seek detailed explanations of the performance measures and strategic rationale for boards' remuneration decisions.[7]

A benefit of this strategic focus has been to increase dialogue and improve communication between companies and shareholders on pay practices. Not surprisingly, when both directors and shareholders are well informed and operating at the same level of detail, they are more likely to reach agreement on the best means to achieve the common goal of value creation.

Planning for 2010 AGMs

Years ago, Ira Millstein famously stated that "corporate governance is not rocket science."[8] Even with today's challenges, most companies already are well equipped to deal with shareholders and governance concerns. Drawing on the resources and skills they have developed in public relations, market research, customer satisfaction, and investor relations, companies should be capable of conducting effective outreach programs and managing the expectations of their shareholders. A change of attitude may be necessary for some companies to understand that it is in their interest to treat shareholders as customers rather than as opponents. CEOs must be enlisted to provide leadership and tone at the top. Boards must be capable of articulating a convincing strategic rationale for their governance-related decisions. Most important, corporate management must initiate communication and engage with shareholders on governance matters, rather than wait for activists to put them on the defensive.

7 See, for example, *10 Questions for Evaluating CD&As*, Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF), available at www.tiaa-cref.org. Also see the recommendations issued on executive compensation disclosure by *The Conference Board Task Force on Executive Compensation*, The Conference Board, September 2009, available at www.conference-board.org/ectf.

8 Ira M. Millstein, *Opening Remarks of Honorary Chairman*, International Corporate Governance Network Annual Meeting, New York, July 13, 2000, available at http://icf.som.yale.edu/ConferencePapers/backup_old_iicg/members/millstein.htm.

In 2010, activist shareholders are likely to continue to employ the generic strategy—used successfully in 2009—of withholding votes for the discharge of directors and voting against the ratification of annual financial statements. This is an especially prevalent practice at companies in continental Europe and other markets. To avoid being targeted by activist campaigns, companies will have to be proactive and commence dialogue with shareholders in advance of their formal AGM preparations.[9]

A basic framework for companies to prepare and conduct successful annual meetings in 2010 should include the following initiatives:

- Analyze the company's ownership base and shareholder communications.
- Review governance anomalies and red flag issues—comply or explain.
- Identify top institutional decision-makers and conduct an outreach campaign well in advance of the AGM.
- Prepare persuasive and transparent disclosure documents that align governance, strategic, and performance goals.
- Organize an effective vote-gathering campaign and eliminate technical impediments to shareholder participation and voting.
- Make use of electronic communications, email, and web sites.
- Provide opportunities for shareholder dialogue during the campaign and at the AGM.
- Conduct a postmortem and analyze AGM voting results.
- Implement reasonable and useful suggestions received from shareholders.

9 See Damien Park and Matteo Tonello, *The Shareholder Activism Report 2010*, The Conference Board, forthcoming, 2010. Also Id., *Avoiding Shareholder Activism*, The Conference Board, Executive Action 300, April 2009, available at www.ssrn.com/abstract=1390340.

The future

During the past 25 years, corporate governance reforms have clarified the duties and responsibilities of corporate directors, increased board accountability, strengthened minority shareholder rights, and established global best practice standards. This work is largely complete. The year 2010 will mark the beginning of a new chapter in corporate governance, requiring companies to deal with an expanded agenda linking governance to business strategy.

At the same time, the governance spotlight will enlarge to include critical market issues that are urgently in need of attention: improving the governance of institutional investors, creating clear standards for responsible investment, and overcoming short-termism in the financial markets.

This report is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

About the Author

John C. Wilcox is chairman of Sodali Ltd., a firm providing consulting and transactional services to listed companies in Europe, Asia, and developing markets. He served as head of corporate governance at TIAA-CREF from 2005 through 2008. Prior to joining TIAA-CREF, he was chairman of Georgeson & Company Inc. During his career, he has specialized in corporate governance, investor relations, proxy voting, corporate control transactions, capital markets regulation, and director education. Recently, Wilcox served as a member of the Technical Advisory Group to The Conference Board Task Force on Executive Compensation.

About the Series Director

Matteo Tonello, LL.M., S.J.D., is director, corporate governance, at The Conference Board in New York. For The Conference Board, Tonello has conducted governance and risk management analyses and research in collaboration with leading corporations, institutional investors, and professional firms. Also, he has participated as a speaker and moderator in educational programs on governance best practices. Recently, Tonello served as a member of the Technical Advisory Group to The Conference Board Task Force on Executive Compensation. Before joining The Conference Board, he practiced corporate law at Davis Polk & Wardwell. Tonello is a graduate of Harvard Law School.

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For more information on this report, please contact:

Matteo Tonello, LL.M., S.J.D., director, corporate governance, at 212 339 0335 or matteo.tonello@conference-board.org

The Conference Board, Inc., 845 Third Avenue, New York, NY 10022-6600
Tel 212 759 0900 Fax 212 980 7014 www.conference-board.org