The 2011 AGM Season

A Governance Shift from Sunlight to Electric Light - *Predictions and recommendations for the 2011 annual meeting season and beyond.*

By John C. Wilcox, Chairman, Sodali

Companies around the globe are anxiously preparing for the 2011 annual meeting season. A crisis atmosphere surrounds these preparations in the aftermath of all the new legislation, governance rules and expanded shareholder rights enacted globally during 2010.

End of an Era

In the U.S., corporations and their advisors are concentrating on the implications of the Dodd-Frank Act, majority voting in director elections, proxy access and say-on-pay. In Europe, the focus is on revisions to the UK Corporate Governance Code, the New EU Market Standards for General Meetings and the Basel Committee on Banking Supervision consultative document on principles for enhancing corporate governance. In key developing markets, such as Brazil, there are new regulations designed to improve disclosure, electronic communications and share voting as well as new governance listing standards. In Japan, the Ministry of Justice and the Ministry of Economy, Trade and Industry continue to send conflicting signals that impede efforts to improve basic shareholder rights and board accountability.

This flurry of new laws and regulations has generated a flood of information, guidelines, high-level expertise and advice on compliance with the new standards.

At the same time, the emphasis on regulatory, legal and compliance issues has obscured a major shift that is taking place in the focus of corporate governance. Events in 2010 should be recognized as both the culmination and the conclusion of an era of governance standard-setting that has lasted more than two decades. This year's legislation and rule-making dealt with virtually all the issues that remained on the governance reform agenda. The slate is now clean. In 2011, for the first time in two decades, corporations will face no surprises – no new governance policies, shareholder rights or legislative initiatives. In effect, the corporate governance formulary is now complete in most of the major financial markets (except Japan and China).

Illuminate the Boardroom

With the era of governance standard-setting drawing to a close in 2010, a new set of governance objectives will take center stage beginning in 2011. Shareholders will be pressing companies – and boards in particular – for more detailed and substantive explanations of how governance is being

implemented and how it relates to business strategy and economic performance. The shareholder agenda will shift from governance theory to governance implementation, from external metrics to internal conduct, from compliance to practice. Speaking metaphorically, and borrowing from Louis Brandeis' famous pronouncement, the governance shift will be from "sunlight" to "electric light."[1] Instead of seeking additional ways to make corporate activities transparent through disclosure and regulation, the new push will be to illuminate hidden spaces inside the boardroom and reveal how board conduct and business judgment serve strategic goals and long-term value creation. Turning on the lights and opening boardroom windows will pose significant challenges for corporations, particularly in the United States.

A proviso: it is important to recognize that during 2011 regulators around the globe will still be fully engaged in implementing the legislation enacted in 2010. They will continue writing rules, filling in regulatory gaps and issuing interpretive bulletins. The SEC's recent decision to suspend its shareholder access rule pending resolution of a legal challenge will prolong the battle over this contentious issue. Shareholders will continue to submit resolutions and conduct engagement campaigns, particularly at companies that are perceived as governance delinquents. Nevertheless, companies and boards should be aware that over the long term their governance responsibilities and their relations with shareholders will penetrate deep into the executive suite and the boardroom.

Predictions for 2011

Based on this governance shift, the 2011 annual meeting season is likely to have the following characteristics:

- Activist shareholders will select engagement targets based on poor economic performance, conflicts of interest, failed risk oversight and questionable business practices, rather than just non-compliance with governance norms or the dictates of proxy advisory firms.
- There will be a decline in generic activism. A few policy issues – say on pay, separating the chair and CEO, majority voting in director elections – will remain on the activist agenda in the U.S. and will continue to receive high levels of support. In Europe and developing markets, continuing issues will include unequal treatment of minority shareholders and abusive anti-takeover provisions. Aside from these perennial concerns, the primary goal of activists will be to influence behavior inside the boardroom.
- There will be more campaigns by hedge funds and strategic investors seeking to change business practices and improve economic returns at targeted companies. Efforts to challenge the motives of these investors or brand them as short-termers will be ineffective in most cases.
- Shareholders will demand more information about internal board matters, including the director nomination process, director qualifications, diversity, ethics, conflicts of interest, risk oversight, the board evaluation process and succession planning. Traditions of boardroom confidentiality and deference to business judgment will be increasingly subject to challenge.

[1] "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." Louis D. Brandeis, Other People's Money, Chapter V.

- Executive compensation will remain the defining corporate governance issue at most companies. Shareholders will continue to focus on compensation as a gauge of board independence, competence, fairness and commitment to shareholder interests. Say-on-pay will compel boards (as distinct from management) to articulate a convincing rationale for controversial practices such as tax gross-ups, high bonus payments and severance packages.

- Risk oversight, environmental practices, social policy and political accountability will join corporate governance on the roster of issues for which shareholders hold corporate boards primarily accountable. Boards will need to explain in detail how they are managing these responsibilities.

- Proxy advisory firms will be under increasing pressure to provide more customized analyses of individual companies and to base their vote recommendations on business fundamentals and economic performance in addition to governance norms. In effect, proxy advisors will face a growing demand for the deeper levels of financial and strategic analysis that in the past have been limited to their recommendations on mergers and contested elections.

- Companies will increase their efforts to engage in dialogue with institutional investors on governance matters. In contrast to well-established Investor Relations programs, governance initiatives face significant obstacles. Many major institutional investors are not fully organized to engage with companies on governance policies and share voting. Although the financial crisis highlighted the need for investors to address their long-term ownership responsibilities, few countries other than UK have adopted a Stewardship Code or made a meaningful effort to regulate the duties and responsibilities of institutional investors.

- Web sites and electronic technology will play a greater role in annual meetings, although the impact in 2011 will be limited to a few innovative companies. In Europe, the U.S. and Latin America, regulators and private sector groups are still at an early stage in analyzing the logistics of shareholder meetings and cross-border information flow. Over the long term new rules will undoubtedly increase efficiency, lower costs and improve cross-border procedures, but the process will take time.

Some of these predictions contain good news for companies. Their longstanding objections to proxy advisory firms, check-the-box governance analytics and formulaic share voting are no longer being ignored. Regulators, governance professionals and shareholder organizations are beginning to pay attention to two important goals long sought the corporate community: (1) establishing clear standards of conduct and accountability for institutional investors; (2) increasing the transparency of share ownership and voting practices. In the wake of the financial meltdown, it is clear that higher standards of governance and deeper levels of transparency for corporations should be matched by comparable standards for institutional investors and proxy advisory firms as well.

The other good news for U.S. companies is that elements of the principles-based, "comply-or-explain" governance model pioneered in the UK will begin to migrate to U.S. companies. The comply-or-explain system gives greater discretion to corporate boards. It promotes flexibility and contextual governance rather than standardization and box-ticking. It is based on a presumption that the board's expertise and

business judgment merit a high degree of deference. It encourages dialogue rather than confrontation between boards and shareholders. It recognizes that business strategy, governance, compensation and other policy decisions must be made by the directors based on their knowledge of the business, not dictated by disclosure or governance rules. Most important – and still questionable in the U.S. – the comply-or-explain approach to governance assumes that institutional investors will uphold their governance responsibilities by committing time and resources to their oversight role as responsible, long-term owners.

Recommendations for Corporate Boards

The shift from sunlight to electric light is occurring in part because governance experts have been compelled to acknowledge that there is a limit to the effectiveness of prescriptive governance rules and external metrics. The financial crisis revealed that textbook compliance with governance rules did not guarantee good governance in practice. In some high-profile corporate failures, governance that looked good on paper did nothing more than provide cover for weak board oversight, incompetence and fraud. Compliance does not guarantee diligence. Legal rules are no substitute for sound corporate values and "tone at the top." The clear lesson is that responsibility for good corporate governance begins and ends in the boardroom.

Here are recommendations to help boards take charge of corporate governance, improve communications and manage relations with shareholders.

- *Develop techniques and opportunities for the board to communicate with shareholders.* Separately from its disclosure duties, the board should be able to communicate with shareholders in multiple ways whenever the need arises. Formal, structured communication programs are not the goal. Standing board committees should periodically report on their activities. An annual Directors' Discussion and Analysis should link board policies with business strategy and explain how the board is serving shareholder interests. All directors should attend the annual meeting, but the only other prescription for good board communication is that it should be well-informed and proactive, not formulated defensively in reaction to shareholder pressure.

- *Increase the board's access to information and resources.* The board cannot do its job effectively without information about share ownership and access to resources. In addition to market data and investor relations reports, the board should receive regular briefings about investors' engagement profiles and policies relating to governance, environmental practices and social policy. The company's investor relations, market research and public relations resources should be available to help the board manage their relations with shareholders. The board should promote a corporate culture that treats investors as customers.

- *Conduct an annual review of corporate governance and compensation policies.* The board should conduct an annual corporate governance benchmarking and should review any policies - particularly relating to executive compensation – that may be perceived as falling short of best practice. The board should get in front of the issues, prepare convincing arguments in support of its decisions and communicate with shareholders rather than waiting for a crisis to develop.

- *Conduct an annual board evaluation.* The board's annual self- evaluation, like executive sessions at board meetings, requires discretion and strict confidentiality. Nevertheless, shareholders need to know that the board is in fact conducting a rigorous and objective review of the performance of individual directors, board committees and the board as a whole. Details of the process and the topics covered in the evaluation, rather than the findings, should be disclosed to shareholders in a report from the board chairman.

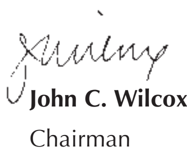
- *Engage with shareholders on environmental practices, social policy and risk oversight as well as governance.* Shareholders regard all these ESG issues as integral to business risk and performance. The board should support executive management in the development of "strategic governance," which includes intangibles and non-financial goals in the company's performance metrics.

Conclusion – The Corporate Governance Agenda in 2011 and After

Many companies have made the mistake of thinking that corporate governance is a zero sum game, where "wins" for shareholders mean "losses" for company executives and boards. Rhetoric that treats governance and shareholder relations as warfare has perpetuated this misguided thinking for decades. Establishing good corporate governance is not a power struggle. The task of defining roles and allocating responsibilities and benefits among the shareholders, the board and the managers of a business enterprise is comparable to family counseling. The goal of corporate governance is to stabilize relationships among members of a large and unruly family and to align their interests around the common goal of business success and long-term value creation. Twenty years of governance evolution have made clear that the board of directors must assume primary responsibility for overseeing the wellbeing of the corporate family. 2010 is bringing to a close the difficult process of governance standard-setting. 2011 should mark the beginning of the next stage of governance evolution – board conduct and communication with shareholders. At the same time, governance reformers will turn their attention to four additional issues of great importance to both companies and shareholders:

- The duties, responsibilities and governance of institutional investors.
- Proxy voting logistics and cross-border harmonization.
- The education and engagement of retail investors.
- Academic research on the big question: Is governance linked to performance?

When these issues have finally been resolved, corporate governance will no longer be a source of conflict but an integral and essential part of corporate culture.



John C. Wilcox
Chairman