Outlook 2006

Proxy Season

Executive Pay, Disclosure Top Investor Agendas for 2006

The top corporate governance issues in 2006 as proxy season starts up continue to be executive compensation as well as disclosure, institutional investor representatives and executive compensation attorneys told BNA in recent interviews.

"We are going to see executive compensation move even higher up the rung in terms of public focus this proxy season. Basically, [investor] groups are still frustrated that, even with all of the public focus in the past few years, compensation continues to increase," attorney Laura Thatcher told BNA Jan. 6.

The SEC has started to wade into the discussion more openly in recent weeks. SEC Chairman Christopher Cox has been vocal about reviewing executive pay disclosure, and the SEC has scheduled a Jan. 17 meeting to consider whether to propose amendments to beef up the disclosure requirements for executive and director compensation.

Congress also has entered the ring with a bill introduced last year by Rep. Barney Frank (D-Mass.) (H.R. 4291) that would require public companies to disclose the pay policies and compensation for their top executives, but investor representatives said legislation is not the answer.

Several institutional investors have started off the 2006 proxy season by filing at companies numerous shareholder proposals that target what the investors say is egregious executive pay coming out of corporate boardrooms.

In a recent survey conducted by consulting firm Watson Wyatt Worldwide, 90 percent of institutional investors said corporate executives are overpaid, and 64 percent said executive compensation is not disclosed properly, according to the firm's Dec. 13 press release.

AFSCME Targets Comp Committee Reports. The American Federation of State, County, and Municipal Employees Pension Plan's 2006 shareholder proposals, released Dec. 7, target executive compensation at 26 companies. Richard Ferlauto, AFSCME's director of pension investment policy, said the two key issues for the season are executive pay and director elections. AFSCME's strategy is to link them together, he told BNA Jan. 9.

"We wanted to be able to put mechanisms in place that would hold boards and compensation committees accountable for executive pay that is not based on performance," Ferlauto said. He highlighted one of the proposals in particular, which calls on companies to have an annual shareholder advisory vote on compensation committee reports at five companies: Bank of America Corp., Home Depot Inc., U.S. Bancorp, Countrywide Financial Corp., and Merrill Lynch & Co.

The proposal has two purposes for shareholders: to send a message against executive pay that, in their minds, was not totally aligned with their interests; and to make comments on the report itself, such as whether the disclosure was detailed and comprehensive enough, he said. "The companies that we targeted for this have significant questions for the pay-for-performance connection historically," he said.

According to AFSCME's Dec. 7 press release, the AFSCME pension fund's other proposals include:

- requiring companies to have programs that align executive pay with shareholder interests;
- calls for procedures for recouping solicitation costs for proxy contests that do not seek board control;
- binding bylaw amendments for a majority vote standard for director elections;
- annual elections of directors;
- performance-based vesting measures for restricted stock; and
- limits on executive severance in the event of changes in control or involuntary termination.

AFSCME Also Submits Binding Amendments. Ferlauto said the AFSCME pension fund also is focused on director elections. "We've submitted binding amendments as opposed to precatory proposals to make clear that the director resignation policies that a few dozen companies have put into effect do not respond to the shareholder's view that we need to take the election system," Ferlauto said.

For example, Ferlauto said, what will be "interesting" is what happens with Honeywell International Inc., which submitted a no-action letter request to the SEC staff for staff concurrence in the company's plan to omit the AFSCME-proposed amendments from proxy materials for Honeywell's upcoming annual meeting, claiming it had substantially implemented AFSCME's proposal. However, "their director resignation response was not where shareholders want to go in terms of reform," he said.

Ferlauto said another AFSCME pension plan proposal he "is fond of" is the proposal for a number of companies to reimburse solicitation expenses for proxy contests that do not seek board control, so shareholders can replace bad directors. Some institutional shareholders had been pinning hopes in 2003 and 2004 on Securities and Exchange Commission rule proposals to allow shareholders greater access to corporate proxies to nominate a board candidate directly, if certain conditions were met. Ferlauto said the response investors who supported the rule proposals got at the SEC regarding the stalled proxy access rulemaking was that the real problem was not necessarily that shareholders needed access to the proxy, but that institutional shareholders could not afford the costs of a proxy contest. He said this proposal responds to that problem.

Ferlauto said it is a little early for feedback on the proposals, but he has received a lot of phone calls with

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questions. "I'll be talking with most companies over the next few weeks," he said.

ICCR Files 299 Resolutions. The Interfaith Center on Corporate Responsibility, with 275 faith-based institutional investor members and a portfolio of about $110 billion, so far has filed 299 shareholder resolutions at 147 companies for 2006. ICCR sponsors have withdrawn 11 of these filings, and the SEC has challenged seven, according to ICCR's Jan. 11 news release.

Seven of these resolutions are aimed at reforming Wal-Mart's policies, it said.

Dan Rosan, ICCR's program director for public health, said in a recent interview that ICCR has "a wide range of concerns" about Wal-Mart Stores Inc. Rosan told BNA Jan. 4 that ICCR is "trying to represent a group of resolutions that addresses the real range that people are interested in, and also get at some of the core problems."

He said focusing on executive pay will do this: "Executive compensation at American corporations in general has been going very much in the wrong direction for a very long time."

He said Wal-Mart's business model is very labor-intensive, and its workers "are not paid particularly well" at $9.50 per hour. According to the company's filings, its CEO received $17 million, he said. "Each of those million-plus employees should be valued," he said. "For people of faith, it is particularly difficult to see one person valued one thousand times more than everyone else, whose shoulders he is standing on."

He said the rest of ICCR's resolutions share "the common theme that we want to be investors in a company that values everybody in that company, not only people at the very top."

If Wal-Mart wants to succeed in its multi-year business strategy of expanding in new markets, it will need to change its core behaviors, in particular, behaviors related to what ICCR sees as excesses in executive compensation, he said. The Wal-Mart business model is based on growth in new markets. This means the East and West coasts, which are precisely the markets where consumers, employees, city councils, and a myriad of local officials care about these issues, and will get to determine where Wal-Mart will build stores, he explained.

TIAA-CREF Looks at Executive Performance. Linda Scott, director of corporate governance for institutional investor Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), agreed that the focus for many investors during proxy season in 2006 is going to be on executive compensation. "Executive compensation is still a source of frustration to shareholders," she told BNA Jan. 5. "Our perspective is that there really are two reasons for concern. First, as investors, it is our money. We are concerned with money that goes anywhere other than directly to shareholders."

"The other reason is that we see executive compensation as almost a window into the boardroom," she said. "One of the clearest ways to judge" what is going on in the boardroom "is to look at compensation policies and practices." She said she wants to know whether directors' top priority is their shareholders, as well as whether they are independent and competent.

While TIAA-CREF at the end of 2004 targeted more specific parts of executive pay plans, such as eliminating automatic evergreen clauses, Scott said this year the funds are looking at compensation more broadly. When analyzing compensation plans and determining how they will vote, TIAA-CREF is "looking at companies where compensation plans are, in and of themselves, egregious, and those plans where we cannot see any kind of a direct connection to performance." TIAA-CREF has not yet sponsored any shareholder proposals, she said.

How Far Should Disclosure Reforms Go? The other big issue for 2006 is how much more companies should be required to disclose about executive compensation.

TIAA-CREF's Scott said, "We are anxiously awaiting whatever the SEC will put out," which is expected this month. "Hopefully, there will be companies that will decide that, this year, they need to strengthen their disclosure, even before any new SEC rules are in effect."

She went on to say better disclosure would help investors understand policies, such as how they are related to performance and strategic planning.

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BARBARA ROPER
CONSUMER FEDERATION OF AMERICA

In an interview with BNA Dec. 29, Cynthia Richson, corporate governance officer for the Ohio Public Employees Retirement System, said, "More disclosure is definitely warranted, but the question is: then what? It will embarrass some people, but so far, the embarrassment has not done much." There must be some enforcement actions around this, she said. "It is almost a form of legalized theft; you have executives extracting millions of dollars in some form, regardless of performance," she said.

"Disclosure is often proposed as a way to address problems that we are not going to do anything serious about," Barbara Roper, director of investor protection for the Consumer Federation of America, told BNA in an interview Jan. 3. She said she is all for disclosure, but it is not always clear that people act on it. However, she said, "There can be an indirect effect that is beneficial. It is a step in the right direction, but it is not clear that it is really a robust solution."

Speaking with BNA shortly before the SEC announced it was going to meet on executive compensation disclosure, Laura G. Thatcher, a partner and head of the executive compensation practice in Alston & Bird LLP's Atlanta office, said she fully expects the SEC to address the issue. "The executive compensation disclosure rules were last overhauled in 1993, so it is long overdue and has been outpaced by the types of compensation that have evolved over the last 10 or 15 years," she said.

"Clearly, we will see requirements for more tabular and transparent disclosure of what many people think of as compensation that is too hard to ferret out of proxy disclosure," Thatcher said, adding examples of this include senior executive retirement plans (SERPS), retirement benefits, and change-in-control benefits.

ISS Encourages Tally Sheets. Proxy advisors Institutional Shareholder Services Inc. in November 2005 released changes to its proxy voting policies that it will apply for companies with annual meetings on or after Feb. 1, 2006, according to its Nov. 21 news release. ISS also will recommend to its clients performance tests for corporate directors and withhold votes for compensation committee members at companies with poor pay practices. According to the release, ISS is working on majority vote director election policies.

The focus of some observers, however, is ISS's announcement of its view that companies should be more transparent in 2006 with "tally sheets" of things to disclose about the chief executive officer's pay package. Addressing these disclosure policies, Beverly W. Aisenbrey, managing director of executive compensation consultants Frederic W. Cook & Co.'s New York office, told BNA Jan. 4 her concern "is always to balance good corporate governance with being sure we are not simply looking at one or two items."

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> Beverly W. Aisenbrey
> Frederic W. Cook & Co.

Aisenbrey said she is very concerned about having tally sheets with such detail. "It is very important for boards to have this information, and for companies to give better disclosure than they have in the past, but I would not recommend that clients disclose all of the information" in the ISS tally sheets, she said. "What will happen is, every time we increase disclosure, we end up with higher pay. So they might be working against themselves."

Thatcher said tally sheets "can get to be rote and lose meaning" when committees merely "check the box." However, they "have a laudatory function in that the board does need to make itself aware of all of the elements" of executive pay. She went on to say, "They can be useful if they are interactive." For example, when making a decision in one area of pay, the board could see how it would affect other elements. However, she said, making them interactive would be complicated.

Aisenbrey Cites Examples of Good Practices. Aisenbrey advocated disclosure of total target compensation. She said she is seeing better disclosure of executive perquisites, severance, and change-in-control payments. Some examples of companies that have improved their disclosure practices include Wachovia Corp., Marriott Corp., Alcoa Inc., Eli Lilly & Co., and MBNA Corp., she said.

Wachovia has added a total compensation column to its summary compensation table that adds up all of the pieces. Taking this one more step, she said she would prefer a separate table that clearly distinguishes the potential value of stock options, for example. She said Wachovia has done a nice job of breaking out all footnotes, such as descriptions of expense allowances and life insurance.

Marriott did a nice job of breaking out different elements of restricted stock grants, Aisenbrey said. Total values of restricted stock should be shown that include what vested during the year, the value, and what is left to vest, she said.

She commended MBNA's disclosure of deferred compensation plans, which showed what the executives put in and what the company contributed. For example, she said, the disclosures show they have someone at the company with a $16 million balance, but the company only contributed $313,000. This shows that "if the person leaves the company and there is a monster payout, it is mostly money that person put in," she said.

She also said she is seeing a lot more focus on internal equity and company performance, as opposed to competitive data. For example, she applauded a director who recently called her and said that instead of looking at what everyone else is paying, the directors looked at how the company performed this year versus last year, and how bonuses for this year compared to what was received last year.

She said companies are now struggling with long-term performance plan measures. It is an extensive operation with the move away from stock options to long-term performance plans, setting goals, setting performance, determining the performance cycle, and determining who should participate in the plan, she said.

Aisenbrey said she has a chart that lays out the "risk/reward relationship" for plans. She said, for example, those who have a performance-share plan with short performance cycles will have less potential leverage. This could mean, for example, they can only earn 125 percent if they have a one-year goal, but they could earn 175 percent with a three-year performance goal, she said. "You don't just get the same value for less risk."

Defined Benefit Pension Plans Decline. OPERS' Richson said she also is seeing gross-ups being abused. Media reports say one specific issue targeted in compensation plans is the existence of "tax gross-ups," or reimbursements given to executives for personal income tax payments on their compensation.

Richson also highlighted the erosion of defined benefit pension plans. She said the Council of Institutional Investors, of which she is a board member, plans to discuss at its board meeting in January the extent the council should have educational activities on why defined benefit plans are better for employees than defined contribution plans. Richson said the defined benefit plan allows pension funds to protect shareholder interests and speak up when something is egregious, like executive pay or Sarbanes-Oxley Act Section 404 rollbacks. If everything shifts to defined contribution plans, which are self-directed, the whole governance relationship changes, she explained.

She pointed out an example of this trend can be seen at IBM, which according to media reports said it would move away from defined benefit plans and only offer its employees tax code section 401(k) retirement plans in 2008.

Richson went on to say, "the thing that really kills me is that since Enron and WorldCom, the pension fund became underfunded and we took an enormous hit in investor losses. Everyone seems to have forgotten about the real impact of those scandals. Public pension funds on average are 86 percent-funded and used to be 100 percent-funded." She said the funds have not been irresponsible, but are in a low-return environment. Pension

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funds generally are trying to take on more risk to make up for the low-return environment, she said.

"There are so many wild cards out there," she continued. "You want to think we have learned lessons from Enron, but have we really? It doesn't sounds like it."

Compensation Consultants Continue to Play Role. While many want compensation committees to do more, some say they are doing just fine managing all of the new requirements of the last few years.

"Companies are so overwhelmed at this point, trying to deal with a panoply of new laws and regulations. They are doing the best they can to keep up with what is going on in a very fast-developing landscape," Thatcher said. Some of these new requirements include the Jan. 1, 2006, deadline for most companies complying with Financial Accounting Standard 123(R) on expensing of stock options, and new deferred compensation legislation under tax code section 409(a). She said this is "a really far reaching act that covers a lot of things people did not traditionally think of as deferred compensation," such as equity awards, separation pay, and severance pay.

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LAURA G. THATCHER
ALSTON & BIRD LLP

Thatcher, who serves as a director and compensation committee chair for Batson-Cook Co., said compensation committees that she deals with are taking their jobs seriously and trying to avoid liability by tripping over inadvertent violations of new laws and regulations, but are also giving new thought to redesigning their compensation programs and aligning compensation with performance.

Compensation committees "don't dream up these programs themselves; they hire consultants," she said. "We will continue to see, in large part, that compensation consultants have more influence over where compensation goes than anyone else."

She went on to say everyone "can overreact to all of this negative attention" and "there is a fine line in making appropriate adjustments without going too far." She said she has been encouraged by the messages that consulting firms are giving.

"National consulting firms have stepped up to the plate and taken some of the blame," she said. "Now, they are making a concerted effort to get the word out. A lot of consultants are speaking strongly about the need to come up with programs that compensate executives fairly but also focus on performance. They are really taking a good look at things that have become sacrosanct, like annual grants of equity awards, and thinking: what is their purpose? Should it be annual or just enough to get enough stock into the hands of management so they think like shareholders?"

Mentioning the executive compensation legislation introduced by Frank, she said, "Obviously, that will not sail through unopposed, but what is interesting to me is that Congress will not be shy about stepping in where the private sector fails to apply self-discipline." She went on to say, however, that "Congress is singularly ill-equipped to get into that."

BY ALISON CARPENTER

AFSCME's shareholder proposals for 2006 are available on its Web site at http://www.afscme.org/press/2005/pr051207.htm.

More information on ICCR's shareholder resolutions is available at http://www.iccr.org/.

ISS policy updates for 2006 are available for purchase on its Web site at http://www.issproxy.com/2006policy/index.jsp. The news release is on its Web site at http://www.issproxy.com/pressroom/index.jsp.

Auditor Oversight

PCAOB Leadership in Transition; Scope of Internal Control Audits Uncertain

The Public Company Accounting Oversight Board begins 2006 at a transition point, with an interim chairman and the imminent departure of its top auditing standard-setter. While the board that was created to oversee the accounting profession began 2005 with an aggressive standard-setting agenda, the PCAOB begins its third year on less certain ground.

In addition to choosing new leadership at both the PCAOB and some key posts at the Securities and Exchange Commission, SEC Chairman Christopher Cox has the task of deciding what to do about Sarbanes-Oxley Act Section 404 for smaller public companies.

Investor representatives are hopeful Cox will define himself by protecting investors, but the future is uncertain. "Thus far, I think Cox has been true to his word and the confirmation process, but nonetheless, he is confronted with a whole series of challenges that will force him to define himself," Damon Silvers, associate general counsel for the AFL-CIO, told BNA Jan. 6.

Top Pending Issues.
The PCAOB's top pending issues include:

- who will be appointed as a new PCAOB chairman,
- possible SEC action on SOX Section 404 and related changes to Auditing Standard No. 2 on audits of internal controls over financial reporting,
- standards on fraud detection by auditors,
- standards on communication between auditors and their clients,
- standards on quality control at audit firms, and
- final adoption of the proposed auditor independence rules on limiting tax services auditors can provide to audit clients.

"Christopher Cox is still an open question as SEC chair," Barbara Roper, director of investor protection for the Consumer Federation of America, said in a recent interview. "He has insisted he is not whom every-