

# CGQR



## QUARTERLY SUMMARY

**A**s the New Year dawned, newly elected President Obama and his advisors initiated policies that would provide financial support and restore confidence in a shaky U.S. economic system. Furthermore, investors anxiously awaited news of legislative action or regulatory reform to address corporate mismanagement

that resulted in excessive executive compensation, risk management lapses, and generally poor governance. Given these expectations, the new administration enacted executive compensation limits on financial institutions that received government funds. The SEC, also under new leadership, announced an investor-

friendly agenda and promised to act quickly on the following key initiatives: uninstructed broker voting and proxy access. However, it was other institutions, such as the NYSE and Delaware State Bar Association, which ratcheted up the intensity of the debate on these issues.

## NYSE PROPOSED RULES TO ELIMINATE UNINSTRUCTED BROKER VOTES

**O**n February 26, 2009, The New York Stock Exchange (NYSE) presented an important proposal to the SEC that would modify NYSE Rule 452 to eliminate broker discretionary voting for the election of directors.<sup>1</sup> The amended rule strengthens the original proposal that was filed with the SEC on October 24, 2006. The proposed rule change was submitted at the recommendation of NYSE Proxy Working Group, which was established to review the NYSE

rules regulating the proxy voting process.

Currently, brokers are allowed to vote on “routine” proposals if the beneficial owner of the stock has not provided specific voting instructions to the broker at least 10 days before a scheduled meeting.<sup>2</sup> However, in the case of “non-routine” matters, such as *contested* director elections, brokers are prohibited from voting without receiving instructions from the beneficial owners.

Importantly, the rule change will no longer classify the *uncontested* election of directors as “routine.”

As trivial as this change may seem, if approved, it would provide an opportunity for investors to encourage corporate boards to change poor governance behaviors or decide which directors will be voted against. It is estimated that approximately 80% of investors’ stocks are held in brokerage accounts<sup>3</sup> where brokers have the right

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### Corporate Governance Committee

Herman B. Santos  
Robert L. Spare  
William Pryor  
Paul C. Hudson  
Simon S. Russin (Alternate Member)  
Lisa Mazzocco  
Chief Investment Officer

<sup>1</sup> Securities and Exchange Commission (Release No. 34-59464; File No. SR-NYSE-2006-92)

<sup>2</sup> Routine is defined generally by the NYSE as matters which may not affect substantially the rights or privileges of stockholders.

<sup>3</sup> Source: Kara Scannell and Dan Fitzpatrick, “SEC Plans to End Broker Vote Rule, in Win for Activists,” *The Wall Street Journal*, April 24, 2009

## DELAWARE ADOPTS STATE LAW ENCOURAGING PROXY ACCESS

**T**he Delaware State Bar Association recently drafted several proposed amendments of Delaware General Corporation Law, which were adopted in April 2009, that encourage shareowner proxy access for Delaware incorporated companies.<sup>4</sup> The revised law would generally provide for:

- Corporations to adopt bylaws that allow shareowners to nominate directors for proxy solicitation. However, certain conditions could be included, such as minimum ownership requirements, limitation on the number of directors nominated, or to exclude a nominee from a shareowner that has acquired, or is attempting to acquire, a percentage of the firm's stock within a specified period before the election of directors.
- Corporations to adopt bylaws wherein they provide reimbursement of expenses incurred by a shareowner when soliciting proxies in connection with an election of directors. However, corporations can condition eligibility for reimbursement upon the number or proportion of persons nominated. They may also limit the amount of reimbursement based upon the proportion of votes cast in favor of a nominee or the amount the company spent soliciting proxies.
- Allowing boards to set a record date for notifying shareowners of meetings, separate from the record date for voting at the annual meeting. The amendment also addresses the issue of "empty voting" and how voting results would be more representative of shareowners that actually own the stock and who have a vested interest in the long-term performance of the company.<sup>5</sup>
- The Delaware Court of Chancery to remove a director, at the request of a company or a shareowner, who has been convicted of a felony or found by a court to have committed a breach of the duty of loyalty to the corporation.

The proposed amendments were submitted to the Delaware State House of Representatives and unanimously approved on March 18, 2009. The amendments were subsequently approved by the state's Senate on April 10, 2009 and signed into law by the governor on April 10, 2009. The law takes effect on August 1, 2009.

The revised law provides a dramatic advancement for shareowners in promoting good corporate governance. Although the enhanced laws do not require corporations to amend their bylaws to include these provisions, it certainly applies pressure to corporations to rethink their stance with investors. In addition, the SEC will be compelled to readdress proxy access and Chairman Mary Shapiro subsequently declared in a speech in May that a proposal should be released very soon.

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<sup>4</sup> House Bill No. 19, House of Representatives, State of Delaware

<sup>5</sup> Generally, empty voting is when an investor sells stock after the record date, but before the annual meeting, they are still entitled to vote shares even though they are no longer the owner.

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## TRENDS IN EXECUTIVE COMPENSATION PROGRAMS

**A** survey published by Watson Wyatt in March 2009 shows that executive compensation programs are being revisited by large U.S. based companies.<sup>6</sup> In most cases, the economic downturn has forced companies to change their programs, but it may not be enough to satisfy investors and/or the congressional financial services committees. The survey compares changes to programs of 149 companies from December 2008 to March 2009.

The survey reports the following results: Approximately 55% of the companies have frozen the base salaries of executives, which is up from 34% in December 2008. Regarding annual incentives, 9% of companies have reduced target bonus opportunities, while another 7% have decreased the maximum award opportunity. Long-term incentives

have also been cut with 12% reducing plan eligibility or participation and another 11% reducing the maximum award opportunity for performance-based awards. Additionally, 23% of companies have added clawback provisions or recoupment policies.<sup>7</sup> Other findings suggest that companies are changing their long-term incentive programs to incorporate a greater focus on time-based restricted stock and performance-based share awards rather than cash and stock options.

Although various measures of CEO pay were down in 2008 from 2007, it may be too early to tell if this is a trend or just a reflection of the economic downturn. Clearly, other measures show the expansion of CEO pay is clearly out of alignment with average worker pay. "In 1980, CEO compensation was approximately 50 times average worker pay. As recently as 2008, the

pay disparity grew to 350 times and now accounts for approximately 9% of company profits".<sup>8</sup>

The skyward trajectory of executive compensation has outraged investors and is consistently targeted as a key contributor to the mismanagement of companies. Corporate compensation programs are, without exception, too focused on short-term goals and not aligned with the long-term interests of corporate boards and shareowners. Directors are responsible for management behavior and should be held accountable for incentivizing poor management decisions and actions. While shareowners currently don't have an effective mechanism to hold corporate boards and individual directors responsible for misalignment of interests, they view this as an opportune time to obtain more rights from government and regulatory agencies.

<sup>6</sup> Source: "Companies Making Extensive Changes to Executive Pay," Watson Wyatt, March 17, 2009

<sup>7</sup> Clawback provisions and recoupment policies allow for recovery or cancellation, to the extent that it is feasible and practical to do so, of any unearned bonus and incentive payments that were awarded to executive officers owing to fraud, financial results that require restatement or some other cause.

<sup>8</sup> Source: Kathy M. Kristoff, "Limiting executive pay could be the only way to save capitalism," *Los Angeles Times*, March 29, 2009



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to vote those shares if not instructed by the beneficial owner. In fact, a very small percentage of retail investors actually provide voting instructions. Therefore, the broker will typically vote the retail shares in favor of management. As a result, the huge block of broker votes supporting management provides a very high hurdle for investors to surpass in

order to effect change at a poor performing, mismanaged company. This obstruction thwarts the will of shareholders who attempt to hold the directors accountable for a corporation's actions.

As expected, the majority of comment letters from corporations to the SEC have recommended against the rule revision without considering a broader overhaul of the proxy voting system and process. In spite of the strong corporate resistance, SEC Chairman Mary Shapiro has made the amended rules a priority and plans to issue a proposal sometime this summer.

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