

IR **GUIDE** NUMBER 3

magazine



Arming yourself against activists

Performing
a governance
checkup

Talking
with activists

Monitoring
the hot issues

Preparing for
a proxy contest

AN EDUCATIONAL SUPPLEMENT TO IR MAGAZINE



Getting prepared

Know your shareholders

The better you understand your investor base, the better equipped you are to anticipate shareholder resolutions. One sign of trouble is the appearance in your stock of a well-known activist hedge fund. A proxy solicitor can keep you abreast of hedge funds moving in and out of your stock.

Trading patterns also bear watching. Greater volatility and turnover can signal dissident activity. Before a shareholder campaign, hedge funds tend to swarm into the stock sensing a shake-up, while long-term investors begin taking profits and trimming positions.

That said, it's difficult to predict the source of a shareholder proposal. In some cases, proponents may be large public pension or labor funds, but often they're small shareholders that don't necessarily raise eyebrows.

There's no magic bullet for determining whether you'll be targeted by activists based on your shareholder roster. But shareholder identification *can* help you project their reaction to a prospective proposal, and even extrapolate the outcome of a hotly contested proxy battle.

As activist investors, hedge funds and even some sophisticated retail shareholders raise their voices to ask companies to increase returns, they often demand sweeping changes in governance. What can IROs and other executives do to head off unwelcome shareholder resolutions before they're filed?

Entering into a frank dialogue with investors is one answer. Although the number of activist proposals has soared in the past few years, so has the number of settlements. In 2007, for instance, 665 shareholder proposals were submitted but only 375 reached a shareholder vote, according to Georgeson's 2007 annual corporate governance review.

An issue like majority voting epitomizes how this process works. Last year activists submitted almost 130 majority voting resolutions but just 37 wound up on final proxies. Most firms agreed to adopt some form of majority voting rather than having the proposal put to a show of hands.

Beginning a dialogue

The rise in shareholder activism presents yet another excellent reason to maintain regular contact with key institutional investors. Shareholder conversations need not focus on specific issues; they can be friendly meetings or phone calls to invite feedback on a company's practices.

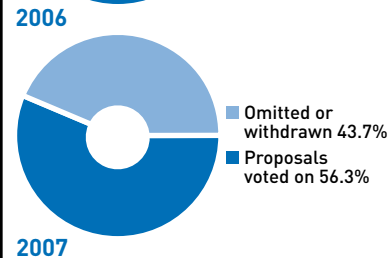
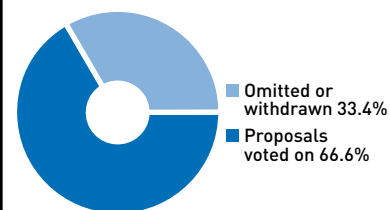
Outside of direct conversation, IROs

can turn to perception and investor attitude studies or even the annual meeting to discover what investors are honestly feeling. Did they express dissatisfaction with your company? What aspects of your governance practices elicit the most questions? Research analysts are another trove of information. What are sell-side analysts publishing in their reports? And how has their outlook changed in the past months, or years?

Gone are the days when IROs could confine their conversations to large institutions and activists and hope to ward off shareholder proposals. Retail investors are also expressing their displeasure through the proxy.

Corporate governance proposals

A growing number of proposals are being omitted or withdrawn before the actual proxy vote.

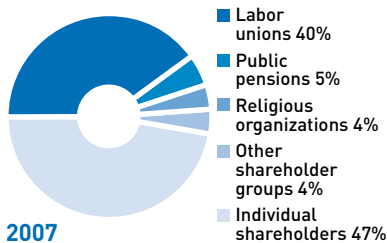


Source: Georgeson 2007 annual corporate governance review



Sponsors of governance proposals, 2007

The lion's share of proposals was sponsored by labor funds and individual investors.



Source: Georgeson, 2007 annual corporate governance review

While communicating with individual retail holders is a daunting task, you *can* ensure they know what's afoot. By maintaining your corporate governance website, writing periodic updates in plain English and addressing any changes in governance in the annual report, you can bolster your relationship with all shareholders.

A governance checkup

Forward-looking firms have begun creating teams to discuss criticism they've received and strategize about possible activist campaigns. Typically, these teams meet every two weeks by telephone to swap insights and suggest responses to hypothetical shareholder initiatives. Sometimes the call lasts a few minutes; at other times, the team should be prepared for a long conversation.

This team should include a proxy solicitor, legal adviser, PR expert and

perhaps your investment banker. Internally, the key players are the IRO, treasury department, corporate secretary and in-house counsel.

The team's function is to examine the company through an activist's eyes. To this end, the proxy solicitor can perform periodic strategic reviews, pointing out potential vulnerabilities. Plurality voting, a classified board, poison pills and a lack of mechanisms for shareholders to call special meetings might all raise red flags. Of course, knowing that a given provision could irritate shareholders doesn't mean you're necessarily going to make any changes.

A key part of the assessment is role playing: what would happen if a shareholder introduces a 'say on pay' resolution, for example? How well have such proposals fared at peer companies? Is there a modification that might appease investors without putting your pay practices to an advisory vote? This is also a good forum for discussing any forthcoming regulatory changes.

By setting aside time to plan, firms put themselves in a stronger position when shareholder proposals *do* hit. At the very least, when something happens, your response team will already be in place and you won't be scrambling to recruit members under pressure. Rather than reacting to what shareholders do, you'll have sketched out some responses and will be able to act with greater confidence.

Weighing the trade-offs

Modifying your company's corporate governance practices to be completely shareholder-friendly isn't always a winning strategy. Companies face several complicated trade-offs. For instance, management's desire for adequate defenses in case the company is targeted by activists is perfectly understandable. But poison pills, a classified board, super-majority voting and other such defenses also increase the likelihood activists will take aim in the first place.

In fact, in recent years, anti-takeover provisions have become the exception rather than the rule. From 2002 until 2006, the number of companies with poison pills dropped from 60 percent to 29 percent by year-end 2007, according to Georgeson.

Whenever possible, look at your governance initiatives against the backdrop of current practice and the examples set by your peer companies. Context matters: your governance practices will be viewed far differently if your financials are iffy than if performance is exemplary.



Following the hot issues

Say on pay

In 2007 and 2008 many companies faced a resolution calling for an advisory vote on pay, also known as say on pay. Among those targeted were Abbott Laboratories, Capital One, Lexmark, Wells Fargo and General Electric.

Say on pay is a non-binding referendum, significant because it gives investors an official outlet for voicing their opinions on pay practices. Although it's advisory, say on pay has generated considerable emotion. Anger is rampant over large payouts to ousted CEOs like Citigroup's Charles Prince (*Forbes* reports a \$10 mn bonus, \$28 mn in unvested stock options and \$1.5 mn in yearly perks).

The issue has become political and may even be decided by Congress. In 2007 Barney Frank (D-MA), chairman of the House Financial Services Committee, introduced a say-on-pay bill in the House; it passed by a 269-134 margin but has yet to be introduced in the Senate.

As US capital markets waver and talk of a lengthy recession intensifies, activists will almost certainly redouble their efforts to reform executive compensation. And the measures are likely to resonate with shareholders.

In 2007 over three dozen proposals requesting a link between pay and performance received average shareholder support of almost 30 percent. At companies where compensation is viewed as egregiously high relative to shareholder returns, resolutions like 'say on pay' (see *Shareholders tackle social ills*, opposite) and even 'vote no' campaigns aimed at compensation committee members garnered success.

With regard to executive compensation, the best way to keep shareholder activists at bay is to improve the quality of your compensation disclosure and analysis (CD&A). The more disclosure you can provide without divulging proprietary information, the less likely you are to be slapped with an executive compensation resolution.

Many companies could do better in this area. In 2007 the SEC sent 350 companies comment letters, detailing weaknesses in their mandatory compensation disclosure, the most common of which was insufficient explanation of how pay is calculated.

Proper pay benchmarking is central to linking pay to performance, as are clear formulas for calculating com-

pensation. Not only must you choose the proper peer groups to measure yourself against, but you should also include sufficient information to demonstrate that your pay is in line with your compensation principles. When your pay practices depart from the norm, offer plain-English explanations of what you do, and why.

Saying on pay

Within the CD&A, some aspects of pay are attracting particular scrutiny. Supplemental executive retirement plans (SERPs) and change in control or severance agreements have become lightning rods for shareholder discontent. Your best defense is to ensure your policies are well justified, clearly stated and consistently applied.

If your company has performance issues, expect pay to come under the microscope. Increasingly, shareholders are paying close attention to the financial deals executives receive in buyout situations. Some shareholders have even attempted to block mergers when they believed the company sweetened the change-in-control agreements for executives around the time of an offer, or that management wasn't holding out for the best financial offer it could negotiate.

In early March, Washington Mutual's board voted to exclude some mortgage and foreclosure losses from the metrics for calculating executive bonuses. This didn't sit well with WaMu shareholders who suffered



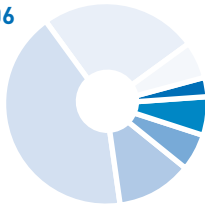
painful losses stemming from the subprime crisis.

Activists continue to push to remake boards and corporate bylaws to give shareholders greater voice.

Corporate governance shareholder proposals

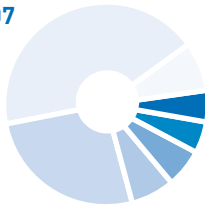
The number of executive compensation proposals grew dramatically in 2007.

2006



- Poison pills (12) 3%
- Supermajority provision (24) 6%
- Cumulative voting (23) 6%
- Repeal classified board (46) 12%
- Board-related (162) 42%
- Executive compensation (96) 25%
- Other (22) 6%

2007



- Poison pills (17) 5%
- Supermajority provision (19) 5%
- Cumulative voting (22) 6%
- Repeal classified board (26) 7%
- Board-related (99) 26%
- Executive compensation (161) 43%
- Other (31) 8%

Source: Georgeson 2007 annual corporate governance review

They have also reformed the ways in which votes are counted in corporate America. Under the old plurality voting standard, a director who received the most 'for' votes won because 'against' and 'withheld' votes were excluded from the tally. With a majority voting standard, a director must receive more votes in favor than withheld/against votes to secure or retain a seat.

Majority rules

Shareholders have scored numerous successes in spurring companies to move to majority voting. Research by Claudia Allen of Chicago law firm Neal Gerber & Eisenberg indicates that 66 percent of the S&P 500 had adopted some form of majority voting as of November 2007. IROs facing a majority voting proposal need to gauge the general proxy climate. Opposing the proposal may make you look retrograde, or even out of touch.

What's more, even though majority voting means more directors will get a higher percentage of withheld or against votes, few board members are being unseated for this reason. Only 15 directors at 11 S&P 1500 companies that held annual meetings in the first six months of 2007 had a director win less than a majority of the votes cast, according to Georgeson. Only one of these firms had adopted the majority voting standard and the director stayed on after she agreed to improve her meeting attendance (the primary reason given for withheld votes).

Shareholders tackle social ills

With climate change and labor issues seizing headlines, companies are beginning to pay closer attention to how their CSR practices are perceived.

Proxy solicitation firms say activists have demonstrated a willingness to engage with management on social and environmental issues. In this arena, simply coming to the table can sometimes be enough to quash a proposal.

At the same time, stonewalling can anger shareholders, leading to grave consequences. Activists recently waged a withhold vote campaign against Michael Boskin, chair of ExxonMobil's public issues committee, for refusing to meet with shareholders to discuss climate change strategy.

Often, opening the lines of communication makes a critical difference because shareholder proponents may not know about all of a company's programs in a given area. What's more, shareholders sometimes act as the proverbial canary in the coal mine, calling attention to a problem that's gone undetected.



Preparing for a proxy contest

A governance roadshow?

When facing a tough shareholder resolution, companies need to share their strategic objectives with investors in order to win votes. One way of doing this is an investor roadshow. You may consider going out on a series of meetings in key cities, allowing management to communicate with shareholders face-to-face in advance of a shareholder vote.

Investor roadshows require both time and true management commitment, but they can sometimes swing crucial proxy votes. A company's shareholder makeup will determine how feasible the idea is. For instance, if you have large holdings by international shareholders, this idea might be too difficult to execute. Proxy solicitation firms can help arrange the itinerary, pointing out key shareholders to visit and even scheduling meeting times.

Recently, some leading companies – including Nexen, based in Calgary, Canada – have launched corporate governance roadshows to engage investors and discuss pressing issues before trouble hits.

Almost everyone agrees: strong performance and an admirable governance record are your best defenses against an ugly shareholder campaign. If you're doing well relative to your peers, it's likely you'll be left alone.

Appraising your vulnerabilities isn't always easy and – ultimately – might not matter. Often, shareholder proponents decide they will file a fixed number of proposals on a particular issue; no matter how solidly you've performed, your company may still be selected as poster child for some general corporate ill.

It's therefore wise to consider how you'd handle shareholder resolutions on a variety of issues, even if there's no inkling of trouble.

Faced with a proposal, companies might decide acquiescence is the better part of valor. Typically, management receives far more credit for adopting a governance change proactively than for doing so under duress. When Aflac voluntarily agreed to hold a say-on-pay vote, the insurer generated enormous positive press. (The vote takes place at the company's annual meeting on May 5.) Par Pharmaceutical and Verizon Communications will also have say-on-pay votes in the near future.

At other times, management feels it has little choice but to fight a shareholder resolution. In these cases, it pays to know the array of

options for maximizing your chances of a positive outcome.

First steps

Even if the initial rounds of conversation didn't succeed, it's worthwhile trying to engage proponents on resolutions that have been officially filed. Whenever you're speaking with the proponent, try to listen carefully for common ground. In the best cases, the discussions could lead to the withdrawal of the proposal. Failing that, there may be a compromise less drastic than the action proposed that will satisfy both sides.

Deciding who should speak with the shareholder activists may affect your chances of success. If someone within the organization – the IRO, the corporate secretary, or even the CFO or CEO – has an existing and friendly relationship with the proponent, that individual might be the right person to lead the discussion.

Often, shareholder activists appreciate the opportunity to speak to the board. A company's lead director or an independent board member might be the right representative for broaching areas of controversy.

When confronted with a shareholder resolution, almost all companies approach the SEC asking for a 'no action' determination. Because companies routinely ask the government to have shareholder proposals removed, this tactic is not viewed terribly negatively.



Sometimes relatively minor corporate decisions – like the record date for the season’s proxy – can prove decisive. The record date freezes the shareholder roster for voting purposes so that only shareholders who own stock as of that specific date can vote a proxy. Sometimes, by setting the record date a little earlier or later, a company can ensure that arbs and/or other short-term players are either in or out of the stock for voting purposes.

Monitoring the vote

Once it’s evident that a proposal will appear in the proxy, companies need to get a sharper picture of where shareholders stand. A knowledgeable proxy solicitation firm can tell you the most likely outcome were the vote to be held immediately. The solicitor can

then design and execute calling campaigns and media initiatives, and even create internet sites designed to generate interest and support for management’s position.

If a proxy contest is extremely important, management can take many steps to improve its odds of success. IROs can ask institutions to borrow back shares on loan for voting purposes. Management can also try to engage with major investors individually to discuss the central issues and try to sway shareholders’ opinions.

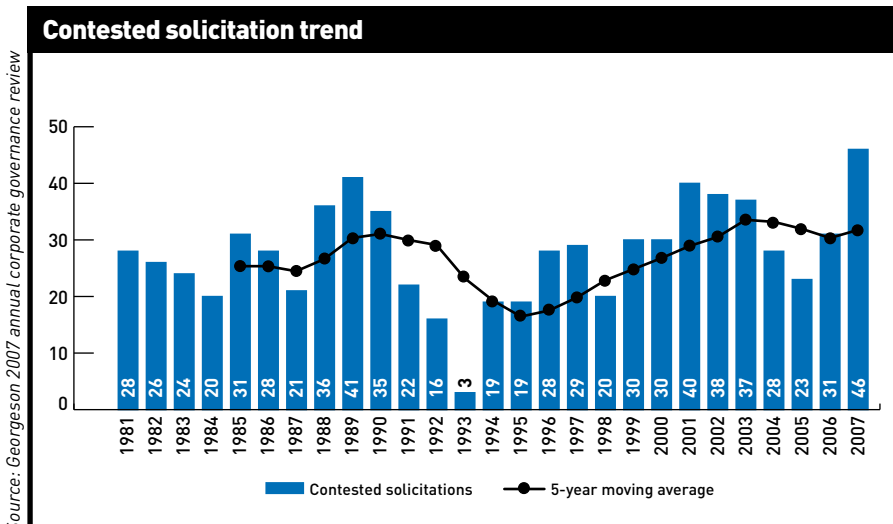
All of these efforts take time, though. The earlier a company can form a clear picture of where specific shareholders stand in an upcoming proxy contest, the better able it is to take the steps necessary for garnering a majority of the vote.

Talk to opinion-makers

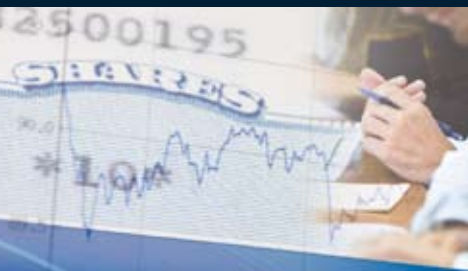
Increasingly, shareholders are taking their voting lead from proxy advisory firms like RiskMetrics, Proxy Governance and Egan-Jones. The analysis by RiskMetrics – the dominant player – can influence as much as or more than a quarter of the shares in a given stock. When a contentious issue is aired, it’s important to engage proxy advisories early and to try to persuade them of your position.

In practice, establishing a relationship with RiskMetrics and the other proxy advisers should begin well before the hectic proxy season. Often, these firms will meet with ‘clean’ companies that have no discernible issues just to familiarize themselves with a company’s governance practices and key players.

However, these meetings are usually initiated by the companies, not the advisory firm. Meetings like this can also help you better understand the types of issues looming on the proxy landscape and prepare for the future.



Source: Georgeson 2007 annual corporate governance review



A new kind of conversation

Sponsor's statement

Georgeson is one of the world's leading providers of strategic proxy and corporate governance consulting services to corporations and shareholder groups working to influence corporate strategy. Georgeson was ranked the top proxy solicitor for US M&A transactions in 2007 by *Corporate Control Alert*.

Since 1935 Georgeson has specialized in complex solicitations such as hostile and friendly acquisitions, proxy contests and takeover defenses. This expertise is enhanced with strategic consulting services, including shareholder identification and corporate governance analysis.

Georgeson also provides issuers with expertise in corporate event solutions such as post-merger unexchanged holder programs. The firm's global capabilities enable it to solicit responses from investors anywhere in the world.

Within the past several months a new sort of dialogue has begun taking place between companies and shareholders. On October 24, 2007, Pfizer spent a full day discussing its executive compensation and other governance practices with its largest shareholders. Members of the board were present, and all agreed it had been a very worthwhile exercise.

Not all companies can take this route. If too many firms adopted the Pfizer style of public forum, institutions, which have a limited bandwidth of time and attention, simply wouldn't have time to participate in all the meetings vying for attention.

At the same time, it is increasingly recognized that activist shareholders bring considerable expertise to a variety of challenges that public companies face, such as global warming, human rights challenges and safety issues. By sitting down and conversing with shareholders, companies can tap into alternative viewpoints and gain new ideas.

Engagement options

One possibility for generating future dialogue is electronic shareowner forums. These forums, which have yet to be fully tested, would allow shareholders and management an opportunity to exchange ideas.

Companies are waiting to see how these forums might develop. Will they become hotbeds of shareholder activism? Or will they evolve into useful tools for management and shareholders to exchange information on an ongoing basis?

Ironically, companies that have taken the most heat on controversial issues are emerging as leaders on how to deal with these problems. The Gap, which was vilified in the past for its child labor practices abroad, has developed a solid history of reporting and acting on labor issues in its supply chain. When a report recently uncovered children employed at one of its overseas factories, the company could point to numerous policies in place to prevent this situation, as well as the steps it routinely takes when a problem comes to light. What might have mushroomed into a major embarrassment was nothing more than a passing news story.

The bottom line? No company will ever be 100 percent perfect. For this reason, learning how to respond to criticism – and to act on well-meaning suggestions for change – can make you a far stronger and more resilient organization over time.

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