Corporate Governance BULLETIN

— Covering Shareholder Issues Worldwide —

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Proxy Season 2004: Union funds Lead the Charge on Executive Compensation

The same corporate governance issues that took hold in proxy season 2003 continue to grab shareholders' attention in 2004 because activists believe that despite major governance reforms implemented by Congress, the stock exchanges and the SEC, some issues still have not been addressed adequately. For instance, new stock exchange listing requirements mandating that compensation committees be comprised of independent directors evidently did not come close to satisfying shareholders' concerns about executive compensation—as the graph on page 3 indicates, more than one-third of the more than 650 shareholder proposals submitted so far for proxy season 2004 address executive compensation issues.

Of these more than 200 executive compensation proposals, most either call for a more "commonsense approach" to awarding executive compensation or urge companies to utilize performance- and time-based restricted share programs in lieu of stock options when they are developing future equity compensation plans—both essentially new proposals. Numerous others call for companies to begin expensing their stock options or to begin requiring shareholder approval of certain golden parachutes for executives. Although the Financial Accounting Standards Board (FASB) is expected to put in place a rule calling for the expensing of options effective for 2005, the other executive compensation issues have not been addressed specifically in the recent governance reforms. In addition, some investors want to be sure that FASB—and the U.S. Congress—get a clear message that they do not want option expensing derailed.

The prevalence of two other types of proposals provides further evidence of shareholders' dissatisfaction with the scope of the current reform efforts. More than 120 shareholder proposals submitted for 2004 ask companies either to require shareholder approval of a company's auditor or to limit the consulting that an auditor will be permitted to perform for its audit clients. The Sarbanes-Oxley Act required many companies to stop hiring auditors for some services, but activists are not entirely satisfied with these restrictions.

The proponents leading the charge on most of these issues are union funds. After breaking the record for the most shareholder proposals submitted by an institutional investor group in a proxy season last year, labor union pension funds appear to be headed toward setting a new record in 2004, already having submitted approximately 330 proposals. In 2003, union funds submitted 45 percent of the more than 700 governance proposals tracked by IRRC as the graph on page 4 shows. So far for 2004, the union funds are in the lead, submitting about 54 percent of all of the proposals tracked at this time.

Although the union funds are using similar approaches to tackling some of the standard

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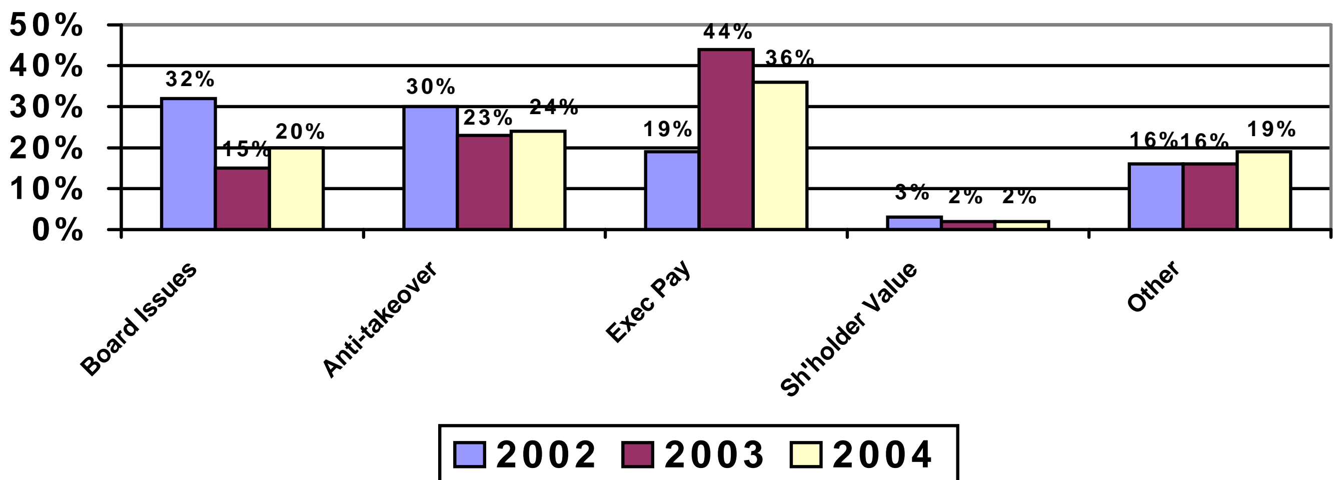


governance concerns that they have in the past, they also have drafted new proposals addressing these same issues in a new way.

Shareholder Access

While the SEC is considering a proposed rule that would allow shareholder-nominated candidates to appear on corporate proxy statements, four big public pension funds are testing the waters by collectively submitting a shareholder proposal seeking access to Marsh & McLennan's proxy statement. Specifically, the proposal asks that Marsh & McLennan "become subject to the shareholder right of access to the company proxy statement set out in the proposed SEC's Rule 14a-11, which would (a) allow a shareholder or group of shareholders that has held over 5 percent of the company's outstanding shares of common stock for over two years to nominate up to a specified number of candidates who are independent from both the nominating shareholder and the company for election to the company's board of directors and (b) require the company to allow shareholders to vote for the nominees on the company proxy card and to make certain disclosures regarding the nominees on the company proxy statement."

Marsh & McLennan is the parent company of Putnam Mutual Funds. In November, the SEC punished Putnam for failing to disclose self-dealing securities trading by several of its employees. The commission also found that Putnam failed to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment management professionals. Putnam agreed to reform its corporate governance and ethics practices and to pay restitution for losses caused by excessive short-term and market timing trading by its employees.

The American Federation of State, County and Municipal Employees' (AFSCME) pension plan, the New York State Common Fund, Calpers and the California State Teachers' Retirement System (Calstrs) said in a press release that they are submitting the proposal because Marsh & McLennan failed to properly control its money management business and to place enough independent directors on its board.

The company's senior vice president and general counsel, William Rosoff, responded to the pension funds with a letter saying that the company was "disappointed that serious investors concerned with corporate governance would communicate their opinions through press releases and not directly to our management and board." In the letter, Rosoff also invited the representatives of the pension funds to

meet with him to discuss corporate governance at the company, and welcomed any suggestions that they have for qualified individuals to serve as directors on Marsh & McLennan's board.

Under the proposed rule to increase shareholders' access to the proxy, which is being considered by the SEC, if a shareholder proposal such as the one submitted to Marsh & McLennan receives the support of a majority of shares voted at the company's May annual meeting, the shareholders would be permitted to submit board candidates for inclusion on the company's proxy ballot the following year. Because the SEC has not yet finalized this rule (the deadline for receipt of public comments was December 22 and a SEC roundtable discussion on proxy access is scheduled for March 10), the commission has offered little guidance on how these types of proposals should be drafted. And, because they must be submitted in accordance with 14a-8 shareholder proposal rules, they can be challenged by companies under SEC no-action provisions.

Marsh & McLennan has appealed to the SEC for no-action relief from the proposal on the following grounds.

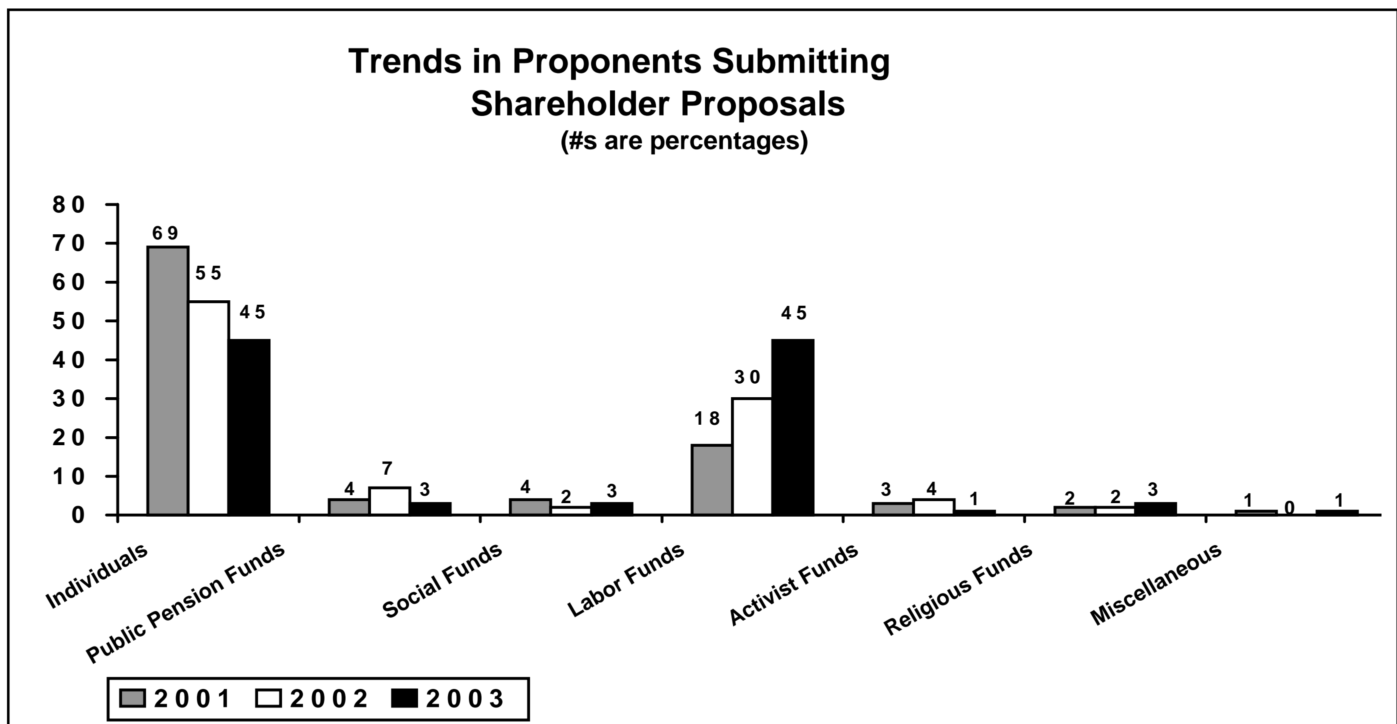
- It is false and misleading because it says the company is subject to the SEC's proposed rules on proxy access. "The proposal violates Rule 14a-9 by containing materially false and misleading statements and is therefore excludable under Rule 14a-8(i)(3) because while the proposed rules have not become final or effective, the proposal nevertheless falsely implies that the proposed rules have become final, effective and binding on the company," the no-action request says.

- It relates to the election of directors and is excludable under Rule 14a-8(i)(8).

Now shareholder activists are poised to see if the SEC will allow Marsh & McLennan to exclude the proposal or if the potential proxy access trigger will appear in the company's proxy statement.

Majority Votes for Directors

The United Brotherhood of Carpenters and Joiners of America filed, at six companies incorporated in Delaware, a new proposal requesting that "the board of directors initiate the appropriate process to amend the company's governance documents (certificate of incorporation or bylaws) to provide that nominees standing for election to the board of directors must receive the vote of a majority of the shares entitled to vote and present in person or by proxy at an annual meeting of shareholders in order to be elected or



re-elected to the board of directors." The proposal's supporting statement notes that under Delaware law, a director can be re-elected even if a substantial majority of the votes cast is withheld from that director. The funds believe that directors who register low levels of support should not be seated on boards.

Majority Vote Response

In an interesting proposal that is aimed at encouraging companies to be more responsive to shareholders, all the New York City funds ask the boards at Maytag, Starwood Hotels & Resorts and Honeywell International to adopt a policy establishing an engagement process with the proponents of shareholder proposals that are supported by a majority of votes cast (excluding abstentions and broker non-votes). The proposal also says that in adopting such an engagement policy, directors should consider including the following steps.

- Within four months after the annual meeting, an independent board committee should schedule a meeting (which may be held over the telephone) with the proponent of the proposal, to obtain any additional information to provide to the board of directors for its reconsideration of the proposal.

- Following the meeting with the proponent, the independent board committee should present the proposal with the committee's recommendation, and information relevant to the proposal, to the full board of directors, for action consistent with the company's charter and bylaws, which should necessarily include a consideration of the interest of the shareholders.

Three of the funds—the New York City Employees' Retirement System (Nycers), the NYC Teachers' Retirement System and the Police Retirement Fund—also submitted the proposal to Manor Care. A proposal that was submitted to Safeway by all of the funds was withdrawn after the company agreed to put in place a process for reviewing majority votes.

For the past four years, a variety of shareholder proposals have received majority support at Maytag, Starwood Hotels & Resorts and Honeywell International. In 2003, a shareholder proposal by Nycers asking Manor Care to repeal its classified board garnered the support of 72.7 percent of the votes cast.

The building trades report that so far a total of 47 companies have agreed to add ratification-of-auditor proposals to their proxy statements.

In addition to the New York City funds' efforts to prompt companies to become more responsive to majority votes, AFSCME has filed binding proposals at companies where majority votes on shareholder proposals have not been implemented. AFSCME says that at one of the companies targeted with this proposal, Kroger, "every year between 1999 and 2002, Kroger's board ignored majority votes for board declassification." AFSCME's new proposal requires that a "Majority Vote Shareholder Committee" meet with shareholder proponents in the wake of any unimplemented majority vote. A similar proposal submitted to Kroger in 2003 received more than 47 percent of the votes cast. In addition to Kroger, AFSCME submitted similar binding bylaw amendments to Merck; Sears, Roebuck and Eastman Kodak.

Auditor Ratification

Last fall, the building trades' funds launched a campaign urging companies that do not already include auditor ratification on their proxies to do so and, as a follow-up, they filed more than 90 proposals. "It is our view that a critical gap in shareholder rights exists through the failure of companies to present the selection of their independent auditors to shareholders for their ratification," the funds said in a letter to companies.

The new proposal addressing this issue requests "that the board of directors and its audit committee adopt a policy that the selection of the company's independent auditor be submitted to the company's shareholders for their ratification at the company's annual meeting." The building trades report that so far a total of 47 companies have agreed to add ratification-of-auditors proposals to their proxy statements. Although this proposal is new for the union funds, in 2001, Evelyn Y. Davis submitted a proposal asking Riggs National to require the annual election of its accountants. That proposal garnered 29.7 percent of the votes cast.

In addition to this huge cam-

paign by the building trades funds, the NYC funds submitted, but later withdrew, a proposal asking CMS Energy's board to adopt a policy requiring that it present the appointment of the independent auditors for shareholder ratification or rejection at the annual meeting; and that ratification require majority support of votes actually cast for or against, excluding abstentions and broker non-votes. The company agreed to adopt provisions of the proposal.

Approximately 40 percent of the largest 2,000 companies do not ask shareholders to vote to ratify their auditors. "This proposal is intended to give shareholders a means of communicating to the board and its audit committee whether they are satisfied that our auditor is sufficiently independent of management to perform properly its duties. . . . If a majority of shareholders do not ratify the audit committee's selection, we would hope—but the proposal does not mandate—that the policy would provide for the audit committee to take the shareholders' views into consideration and reconsider its choice of auditors," the NYC funds explain in their supporting statement. The funds are in follow-up discussions with a number of the companies that received the letter and the proposal, and they anticipate withdrawing the proposal at companies that agree to adopt an auditor ratification policy.

Another new proposal related to shareholder approval of the auditor was filed by the AFL-CIO at Kohl's and asks the company's board to adopt a policy requiring mandatory auditor rotation every 10 years.

Auditor Independence

In addition to seeking more shareholder input on the selection of auditors, the building trades' funds remain focused on eliminating auditors' conflicts of interest. The funds first addressed this issue in 2002, and it found a great deal of resonance with shareholders as the scandals at Enron and Arthur Andersen unfolded. In 2002, IRRC tracked 21 proposals that asked companies to restrict the functions that their auditors performed, and the average support for these 21 was 28.8 percent of the votes cast. In 2003, both the number of proposals and the level of support declined—the average level of support for the 19 proposals that went to a vote was 16.1 percent of the votes cast.

Most of these proposals—62 to date—seek to overhaul executive compensation policies under the term "commonsense executive compensation."

To prepare their target list for the 2004 proxy season, the building trades funds looked at companies in their portfolio and compared fees paid for audit-related work, tax work, and all other work to fees paid for the audit itself. They then introduced proposals at companies with the highest ratios (usually more than 50 percent of fees paid for non-audit work). So far they have submitted 29 proposals to these targeted companies and three to companies that they consider to be outliers on this issue. "The proposal we filed is a way to get [the ratio] back into line," says Edward Durkin, director of special projects for the United Brotherhood of Carpenters and Joiners of America. The proposal requests "that the board of directors and its audit committee adopt a policy stating that the public accounting firm retained by our company to audit the company's financial statements will perform only 'audit' and 'audit-related' work for the company and not perform services generating 'tax fees' and 'all other fees' as categorized under SEC regulations."

Commonsense Executive Pay

Overall, the building trades' funds plan to submit 175 proposals addressing the issue of executive compensation, which has long been a critical issue for the funds. Most of these proposals—62 to date—seek to overhaul executive compensation policies under the term "commonsense executive compensation." Durkin says the introduction of these proposals marks the beginning of a multi-year process. "We're beginning to set the standard by which our companies' compensation policies will be judged." The proposal asks companies to replace their current compensation practices with a program that includes the following features:

(1) **Salary**—The CEO's salary should be targeted at the mean of salaries paid at peer group companies, and should not exceed $1 million annually. No senior executive should be paid

more than the CEO.

(2) **Annual Bonus**—The annual bonus paid to senior executives should be based on well-defined quantitative (financial) and qualitative (non-financial) performance measures. The maximum level of annual bonus should be a percentage of the executive's salary level, capped at 100 percent.

(3) **Long-Term Equity Compensation**—For senior executives, this should be in the form of restricted shares, not stock options. The restricted share program should utilize justifiable performance criteria and challenging performance benchmarks. It should contain a vesting requirement of at least three years. Executives should be required to hold all shares awarded under the program for the duration of their employment. The value of a restricted share grant should not exceed $1 million on the date of grant.

(4) **Severance**—The maximum severance payment to a senior executive should be no more than one year's salary and bonus.

(5) **Disclosure**—Key components of the executive compensation plan should be outlined in the compensation committee's report to shareholders, with variances from the commonsense program explained in detail.

"The commonsense executive compensation principles seek to focus senior executives, not on quarterly performance numbers, but on long-term corporate value growth, which should benefit all the important constituents of the company," says the proponent's supporting statement. "We challenge our company's leadership to embrace the ideas embodied in the commonsense proposal, which still offers executives the opportunity to build personal long-term wealth but only when they generate long-term corporate value."

In selecting targets for these proposals, the funds looked at companies that significantly increased option grants in 2002.

Replace Options with Restricted Stock

Another new proposal authored by the building trades asks companies to utilize performance- and time-based restricted share programs in lieu of stock options when they develop future senior executive equity compensation plans. The proposal also recommends that the restricted shares include the following provisions:

- justifiable performance criteria and challenging performance benchmarks;

- a vesting requirement of at least three years;

- no dividends or proxy voting rights granted or exercised before the restricted shares are vested; and

- a stipulation that all shares granted under the restricted stock program to senior executives must be retained by them for the duration of their tenure with the company.

The supporting statement of this proposal notes, "In our opinion, performance- and time-based restricted shares provide a better means to tie the levels of equity compensation to meaningful financial performance beyond stock price performance and to condition equity compensation on performance above that of peer companies."

In selecting targets for these proposals, the funds looked at companies that significantly increased option grants in 2002. So far they have submitted 42 of these proposals to target companies.

Performance-Vesting Stock

The AFL-CIO unveiled another new executive compensation proposal at Intel. This resolution urges the company's compensation committee to "use performance-vesting stock in the development of future equity compensation plans for senior executives." The proposal also specifies that, "Restricted share grants for senior executives should include performance-vesting measures and share retention requirements to ensure that future equity compensation plans reward extraordinary performance and promote stock ownership."

TIAA-CREF is also gearing up for the 2004 proxy season, says Linda Scott, director, corporate governance for the influential pension fund. As it did last

year, CREF plans to concentrate much of its efforts on persuading companies to adopt performance-based executive compensation practices. In 2003, TIAA-CREF submitted to Autodesk, SBC Communications and Siebel Systems a proposal requesting that their boards include the following provisions in all incentive compensation plans that allow for stock or option grants to senior executives.

- Performance "hurdles" that must be met, or "indexing" features that govern the vesting of options or lapsing of restrictions on shares granted.

- Holding periods for a substantial portion of shares awarded and earned through stock-related plans.

- Other measures to ensure that executives face downside financial risk, which they do not face with standard fixed-price stock options.

The proposal received 35.4 percent of the votes cast at SBC Communications and 37.2 percent of the votes cast at Siebel Systems. It was withdrawn at Autodesk.

SERPS Also Targeted

The AFL-CIO, Teamsters and the LongView fund submitted a total of six proposals asking companies to allow shareholders to approve any extra benefits awarded as part of SERPS (supplemental executive retirement programs). The LongView fund also is asking Diebold to eliminate its SERPs. In 2003, three proposals asking for shareholder approval of any additions to SERPs came to a vote at Boeing; Sears, Roebuck and U.S. Bancorp. The proposal at Boeing received 14.7 percent of the votes cast and the one at Sears, Roebuck garnered 16.3 percent, but the proposal at U.S. Bancorp passed with 51.6 percent of the votes cast.

Expense Options

For the second year in a row, the building trades' funds are filing numerous proposals asking companies to expense options. Last year, the funds successfully overcame no-action challenges on these proposals, and the average level of support for 69 that came to a vote in 2003 was 47.4 percent of the votes cast. So far for 2004, the funds have submitted at least 36 proposals calling for option expensing.

This year, the funds filed these proposals primarily at industries that have publicly resisted FASB accounting rule changes on this issue, including the semiconductor and software industries.

The funds are refiling the proposal at a number of companies where they filed it last year, but only where the proposal received less than 50 percent support. Typically, proponents refile at companies where they received the highest levels of support, but in this case, Durkin says, conversations at those companies indicated, "Most of them got the message." This year, the funds filed these proposals primarily at industries that have publicly resisted FASB accounting rule changes on this issue, including the semiconductor and software industries. The funds also looked more selectively at which companies had the largest option grants.

Golden Parachutes Deflated

So far in 2004, proponents have submitted at least 29 proposals asking companies to allow shareholders to approve future golden parachutes for executives. Last year, 18 proposals came to a vote and garnered average support of 57 percent of the votes cast. Recently, Alcoa, Hewlett-Packard, Sprint, Tyco International and Union Pacific have joined the list of companies that have decided to allow shareholders to vote on certain executive severance packages. At all of these companies in 2003, shareholder proposals on golden parachutes received the support of a majority of the votes cast.

Mutual Fund Reform

All of the NYC funds acting together have launched a letter writing campaign to address another governance issue that has made headlines recently—poor corporate governance practices at mutual fund companies. The NYC funds sent letters requesting that the boards at JP Morgan Chase, Bank One, FleetBoston Financial, Mellon Financial, T. Rowe Price and Merrill Lynch establish a Mutual Funds Review Committee, composed of independent directors, to examine sales and trading

practices, supervisory and compliance systems with respect to preventing practices, such as late trading, unequal access to market timing and improper sales incentives; and to issue a report to shareholders, by September 2004 summarizing the committee's findings and its recommendation for preventing abusive and unlawful practices.

Less Focus on Board Independence

With their attention diverted toward executive compensation and other timely issues, proponents continue to submit fewer proposals aimed at increasing board independence than in the past. Linda Scott explains that TIAA-CREF is still looking to see how companies are responding to the new independence requirements included in the stock exchanges' revised listing standards. Deciding on whether to submit proposals on board independence "has gotten tricky," she explains, "because, basically we might be trying to get them to do what they will have to do anyway."

One board-related proposal has not taken a back seat in 2004. So far, shareholders have submitted 36 proposals asking companies to appoint an independent board chairman. Last year, 30 proposals addressing this issue came to a vote and received average of 26.1 percent of the votes cast. The building trades' funds, the LongView fund and various individual proponents submitted the proposals this year. Since 2001, IRRC has tracked an increase of two percentage points per year in the number of companies dividing the positions of CEO and board chair. Thirty percent of S&P 1,500 companies now have a CEO who does not simultaneously serve as the company chair, up from 26 percent in 2001. More significant, however, is the number of companies that added a lead or presiding director position to their boards over the past year. IRRC data shows that 17 percent of S&P 1,500 companies now have a lead or presiding director position, up from only 3 percent in 2002.

Shareholder-Director Communications

Just as they did last year, the New York City pension funds are submitting a proposal intended to improve communications between shareholders and boards. This year's resolution, which the funds say is based on the new listing standards proposed by the New York Stock Exchange, asks the board of directors at UnumProvident, Unocal (co-filing with (AFSCME), Amerada Hess and Kerr McGee to establish an Office of the Board to enable direct communications, including meetings between non-management directors and shareholders, on matters of corporate governance. This entity would report directly to a committee of non-management directors. All of the companies except UnumProvident have appealed to the SEC for no-action relief from the proposal. The funds also had submitted the proposal to Tupperware, but the company has the provisions in place, so the resolution was withdrawn.

In 2003, the New York City pension funds submitted proposals on shareholder communication to Acxiom, Advanced Fibre Communications, Autodesk, Checkfree, Comverse Technology, Peoplesoft and Safeco. The SEC ruled that the proposal, which requested that the companies' boards establish an Office of the Board of Directors to enable direct communications between non-management directors and shareholders, could be omitted at Advanced Fibre Communications and Peoplesoft. The commission said in its decision that establishing procedures for enabling shareholder communications related to the company's ordinary business, and, therefore could be excluded under Rule 14a-8(i)(7).

Since the SEC ruled on this proposal last year, the commission has adopted new rules that require companies to disclose detailed information about any processes they have in place for shareholders to communicate with board members, and if they do not have any such processes in place, they are required to explain why. In addition, the New York Stock Exchange's new listing standards require listed companies to disclose a method for interested parties to communicate directly with the presiding director of executive sessions (sessions at which non-management directors meet without management) or with the non-management directors as a group.

Other board-related proposals filed by LongView for the 2004 proxy season include one asking Peabody Energy to ensure that two-thirds of its board is independent.

Old Standbys

Along with the large number of innovative proposals addressing timely issues in 2004, many standard governance proposals

continue to appear in large numbers. So far, proponents have submitted 89 proposals asking companies either to redeem or allow a shareholder vote on their poison pills. Activists also have not given up on another perennial favorite, proposals asking companies to declassify their boards and elect all directors annually. So far, they have submitted about 45. In 2003, IRRC tracked 84 poison pill proposals and average support for these was 60 percent of the votes cast. Last year, 48 classified board proposals came to a vote and they garnered average support of 63.4 percent of the votes cast.

These high average votes are sending a strong message to companies—a message that more and more appear to be hearing. For instance, in 2002, at least 187 companies either adopted or extended their poison pills, but that number dropped to only about 86 companies in 2003. Similarly, a number of companies have moved away from staggered elections in recent years, sometimes by their own volition and sometimes after varying degrees of prompting by shareholders. In 2003, 29 companies asked shareholders to vote on management proposals to repeal their classified boards. For those at which IRRC tracked voting results, all but one passed under the company's voting requirements. The one proposal that did not pass was presented at Bausch & Lomb. The company *opposed* the proposal and urged shareholders to vote against it, but chose to submit it in recognition of the high support in favor of a nonbinding shareholder proposal submitted in 2002 by AFSCME that called for the declassification of the board.

Just as the standard governance proposals that appear on proxy statements year after year are considered old standbys, so too are the proponents who every year submit proposals to companies. Although union funds have taken the lead by submitting more proposals than any other group of proponents for proxy season 2004, individual activists continue to hold their own. They have submitted 33 percent of the approximately 650 proposals that IRRC is tracking so far. Long time activist John Chevedden has contributed to this total by submitting 20 poison pill proposals. Every company's favorite shareholder, Evelyn Y. Davis, also has done her part by submitting 14 proposals asking companies to adopt cumulative voting and 10 asking companies to repeal their classified boards. The Rossi Family also helped elevate the total by submitting 55 poison pill proposals. One proponent who disappeared for a couple of years is back this proxy season filing several of his signature proposals: William Steiner submitted seven proposals asking companies to hire banks to investigate the sale of the companies to the highest bidders.

—Rosemary Lally

TIAA-CREF: Quiet Activism, Resounding Results

The following article was contributed by Peter C. Clapman, who serves as Senior Vice President and Chief Counsel, Corporate Governance at TIAA-CREF, as well as a director on IRRC's board.

In the past few years we have witnessed a dramatic expansion in the ranks of "shareholder activists." The combination of corporate collapses, accounting scandals, and executive fraud, along with a three-year bear market that lasted until 2003, have given rise to increased perceptions among investors on the value of good corporate governance. Individuals and institutions have a heightened sense of ownership in the companies in which they invest and a better understanding of the necessity of vigilant monitoring of boards and management.

Today's investors are willing to address a wide range of issues with a variety of strategies. As a result, we may sometimes focus on similar issues even though we work independently. Despite our many differences, investors have a common fundamental goal: to protect our investment assets and generate long-term growth.

TIAA-CREF has long been in the vanguard of shareholder activism. In the United States, we have pressed the issue of greater board independence and the vitality of board processes. We led the fight against dead-hand poison pills, and campaigned vigorously for the right to vote on equity compensation plans. We also targeted specific companies for specific actions that we considered detrimental to shareholders. We firmly believe that our efforts have im-

proved the value of our investments, and we are gratified to see other investors follow suit. We have often found comparable issues to merit our attention in the global arena, and have utilized appropriate initiatives in such markets.

Activism can take many different forms. There are advantages and disadvantages to each, and investors have to choose for themselves the style and strategy that is best for them.

To understand the approach that TIAA-CREF has adopted, it helps to understand what our organization is. The College Retirement Equities Fund (CREF) is registered with the SEC as an investment company. Its companion organization—Teachers Insurance and Annuity Association of America (TIAA)—is a stock life insurance company. Together, TIAA-CREF comprises the principal retirement system for the nation's education and research communities. TIAA-CREF serves more than 3.2 million people at more than 15,000 United States institutions and jointly manages approximately $300 billion in assets.

TIAA-CREF is a long-term investor in the U.S. and international equity markets. We recognize that the development, vitality and integrity of public corporations are critical to the strength of our investments and to the country's overall economy and society. Moreover, we maintain that good corporate governance contributes significantly to long-term corporate performance. Accordingly, we believe that our fiduciary responsibility of advocating for better corporate governance—both improves long-term value and fosters the investor confidence necessary for the long-term viability of the market system.

We have staffed our corporate governance program sufficiently to meet our goals, including three full-time professionals, and two senior consultants who are former CEOs of major companies with current board involvement.

As a significant long-term investor committed to good corporate governance, we have considered a number of strategic options and determined that the most effective approach we can take is one that comprises education, negotiations and shareholder resolutions.

Our {TIAA-CREF's} experience has been that companies are eager to learn our views and many will want to test whether their practices are viewed by us as reasonable in today's environment.

Education is a key component of our program. We meet with directors and management to explain our views on corporate governance and present best practices regarding boards of directors, shareholder rights, executive compensation and independent advisors. Our goal is to shape how directors view their roles and their legal and practical responsibilities so that they might act in a way that truly represents shareholder interests.

The *TIAA-CREF Policy Statement on Corporate Governance* serves as a "textbook" for our education efforts. It describes in detail our views on corporate governance and serves as a guideline for our proxy voting policies. In early 2004, we published our fourth edition of the document, which reflects our reaction to recent corporate governance failures and market dysfunction and to the regulatory and legislative responses they provoked. The *Policy Statement* is available at www.tiaa-cref.org, and a copy will be mailed to the chairmen of all of our portfolio companies. We will arrange for informal opportunities for company directors, managers and TIAA-CREF managers to review the guidelines. In these settings, we are able to share concerns and gain new perspectives that help us in our efforts to improve corporate governance practices and increase long-term shareholder value.

The *Policy Statement* has been very well received by boards. Our experience has been that companies are eager to learn our views and many will want to test whether their practices are viewed by us as reasonable in today's environment.

Negotiations are arguably the most unique feature of our activism program. Our corporate governance philosophy is founded on our conviction that good corporate governance should maintain the appropriate balance between the rights of shareholders – the owners of the corporations – and the needs of the board and management to direct and manage effectively

the corporation's affairs. This is best accomplished by engaging directors and executives in open and ongoing dialogue. We can constructively produce such dialogue with our staff of professionals and senior consultants.

We regularly review our portfolio companies to identify those companies that appear to have shortcomings in their governance structures or policies. In recent years, we have focused particularly on issues of compensation because we believe compensation policies can provide a window into the board and reveal whether it functions as a truly independent body. We have tried to identify the board structures and compensation policies that most closely align the rewards of employees with those of shareholders. When we find companies that diverge from such policies, we write to them and express our concerns, and request a confidential meeting. Our aim is to resolve privately and cordially any differences we may have.

We are committed to quiet and confidential negotiations because we believe they are more productive than certain confrontational styles of activism. Most of our discussions are constructive, and many lead to improved corporate governance and enhanced shareholder communications. We have found that directors and managers tend to be more receptive and less defensive when they do not feel the threat of public exposure. Confidentiality also provides room for incremental progress. Occasionally, a company may not be willing to take all the steps we are requesting, but may be willing to take some of them. In such situations, all parties can claim "success" because their original positions have not been publicized.

Shareholder Resolutions provide us with a valuable corrective resource in those situations where negotiations break down or private discussions fail to resolve differences. In the past, we have submitted shareholder resolutions targeting specific issues, including board independence, dead-hand poison pills (effectively ending the use of this anti-takeover device) and equity-based compensation plans. We also have submitted shareholder resolutions targeting specific companies with egregious corporate governance practices. In each case, upon submission, we request a meeting with the company and indicate our willingness to engage in confidential negotiations. We keep focused on our end goal. If that can be achieved without a proxy vote, we are willing to withdraw the resolution.

We regularly review our portfolio companies to identify those companies that appear to have shortcomings in their governance structures or policies.

This approach to activism means that we do not submit large quantities of proposals and even fewer end up on the proxy ballot. In fact, in 2003 TIAA-CREF identified 25 companies as having corporate governance policies that were not adequately aligned with shareholders' interests. We met with directors and senior executives of each of these companies. After the meetings, we concluded that 15 of them were committed to making constructive revisions to their policies. We were disappointed with discussions with the remaining 10 companies and submitted shareholder resolutions. Following more constructive discussions, we withdrew the resolution at eight companies. In each such instance, an agreement was reached addressing our concerns. In some cases, we continue to monitor the company and discussions are ongoing. TIAA-CREF's resolutions came to a vote at two companies—SBC and Siebel Systems. At SBC, the resolution received 35 percent of votes cast. At Siebel Systems, it received 38 percent of votes cast.

Participation in the regulatory process can produce broader results. We comment to the SEC on proposals affecting corporate governance and to the major exchanges as well. For example, our initiative on equity-based executive compensation achieved success recently when the exchanges—with the approval of the SEC—began requiring that all such plans be submitted for shareholder approval.

TIAA-CREF's approach to shareholder activism reflects President Theodore Roosevelt's admonishment to "speak softly and carry a big stick; you will go far."

We have, indeed, gone far in building a reputation for reason-

able and constructive activism that has produced beneficial results for shareholders and their corporations. Through a program of education, negotiations and shareholder proposals, we have effectively encouraged and guided scores of companies to enhance their governance policies and improve their practices.

We recognize that our effectiveness depends in part on the many other investor activists who share our goals and employee different approaches. Whether our efforts are collaborative or complementary, they continue as a powerful force. Together we have brought about a sea change in corporate governance. Continued commitment and cooperation among all investor activists will surely enhance the value of equity investments and generate the investor confidence that will ensure a healthy marketplace.

— Peter C. Clapman

Shareholder Activism Remains Focal Point of Global Proxy Season

Increased activism, the dominant theme of the 2003 proxy season in major markets such as the United Kingdom and Canada, will continue this year. Investors appear set again to challenge management on a host of issues including executive pay and disclosure. Firms based in continental European markets also may see a spike in activism in the wake of accounting scandals at corporate giants Ahold and Parmalat, and as key markets including Germany, France and the Netherlands tighten reporting requirements on company best practices. The European Union's forthcoming *Action Plan*, a framework for corporate governance rules and recommendations for companies within each of the EU's 15-member states, will sharpen the focus on key governance issues this summer, thereby increasing the potential for activism. Japan, too, will see movement toward improved governance practices as activist shareholders continue to voice concerns at some of that nation's blue-chip companies.

United Kingdom

Last spring, Britain was the scene of a number of high-profile investor revolts over pay practices and payouts which, according to observers, are likely to occur again in 2004. Last year's spike in activism was made possible by legislation approved in August 2002 that permits investors to vote on company remuneration reports at each annual meeting of shareholders. Though non-binding, the votes allow investors to express their approval or disapproval of pay practices, and vote levels are seen as a barometer of shareholder satisfaction with overall remuneration policies. Executive compensation has been a hot-button issue at U.K. annual meetings in recent years, although payouts tend to be not nearly as high as U.S. levels. The gap between CEOs' and average employees' pay in the U.K. has never been as wide as it is in the United States, so most of the revolts have been over payouts deemed modest by U.S. standards but standing out as excessive in the U.K.

Investor revolts occurred at a number of blue-chip British firms at 2003 annual meetings. Those targeted included well known brands such as Shell Transport & Trading, Bae Systems, Hilton Group, Royal & Sun Alliance and Reed Elsevier. The firms received various levels of opposition to their remuneration reports, with Shell on the low end at 23 percent opposition, and Bae Systems on the high end with 49 percent of investors opposing the measure.

In May, GlaxoSmithKline shareholders sent shockwaves through U.K. boardrooms by becoming the first activists to lodge a majority vote against management's pay policies. Upset over a severance package that was to have awarded chief executive Jean-Pierre Garnier $24.5 million regardless of performance, almost 51 percent of the company's shareholders voted against the resolution to approve the remuneration report. Throughout the summer and fall, remuneration reports garnered high levels of opposition, but aside from Glaxo, no British company experienced a majority vote against its report.

The groundbreaking opposition to Garnier's severance package was broad and included a virtual who's who of U.K. institutional investor heavyweights. Some of those institu-

tions remain skeptical that companies have taken to heart the message shareholders intended to deliver through their opposition to remuneration reports. For example, a January meeting between Glaxo and its investors to address lingering concerns over its pay practices left some with more questions than answers.

Moreover, the Association of British Insurers (ABI), which has members that control roughly 20 percent of all equities listed on the London Stock Exchange, says it will pay particular attention to companies that allow for the retesting of options, or the practice of giving executives a second chance to receive an award if they fail to meet a performance hurdle at the first attempt. A recent ABI study finds that some 70 percent of new option plans still allow for retesting. The association also notes that roughly one quarter of companies still maintain severance contracts that would pay more than one year's salary. This issue may create public conflict this proxy season, the ABI warns, because it contradicts longstanding Combined Code recommendations that cap awards at one year's salary.

In addition to rising shareholder ire over executive compensation levels, an updated Combined Code on Corporate Governance also will spur investor activism in the United Kingdom. Last updated in 1998, all London Stock Exchange-listed companies must either comply with Combined Code recommendations or state their reasons for failing to do so.

Key elements of the updated Combined Code call for the following:

- new definitions of the role of the board, the chairman and nonexecutive directors;
- more open and rigorous procedures for the appointment of directors drawn from a wider pool of candidates;
- formal evaluations of the performance of boards, committees and individual directors;

In addition to rising shareholder ire over executive compensation levels, an updated Combined Code on Corporate Governance also will spur investor activism in the United Kingdom.

- more professional development for nonexecutive directors;
- boards at larger listed companies that are comprised of at least half independent directors;
- reinforcement of the separation of the roles of the chairman and the chief executive;
- closer relationships between the chairman, the senior independent director, non-executive directors and major shareholders; and
- a strengthened role for the audit committee in monitoring the integrity of the company's financial reporting, reinforcing the independence of the external auditor and reviewing the management of financial and other risks.

Companies with a year end date on or after Nov. 1, 2003, are expected to comply with the new provisions.

Canada

This year, IRRC expects fewer shareholder proposals to be submitted at Canadian firms than were submitted last year. In 2003, shareholders at Canadian companies offered broad support for a large crop of shareholder proposals addressing perceived shortcomings on both corporate governance practices and social policy matters. Longtime proponents of governance resolutions, such as Robert Verdun and the Association for the Protection of Quebec Savers and Investors (APEIQ), received support from more than 30 percent of the voters on many resolutions, reflecting Canadian jitters over the possibility of an Enron-like corporate failure. Proposals in 2003 included calls for separating the chairman and CEO posts, phasing out stock options from compensation packages, requiring the certification of financial reports by CEOs and CFOs, and barring loans to directors and officers.

This year, however, both Verdun and APEIQ are taking a more muted approach to their activism, which they typically target at Canada's five largest banks. Verdun, an Ontario-based investor who is well known for his perennial proposal submissions, in January lodged three proposals at each of Canada's five largest banks –

Bank of Montreal, Canadian Imperial Bank of Commerce, Royal Bank of Canada, Bank of Nova Scotia and Toronto Dominion Bank – but has since withdrawn all 15. Verdun tells IRRC the withdrawals are in keeping with his objective this year of simply forcing the banks to acknowledge where they stand on certain issues. The proposals call for the banks to ensure their advertising is truthful and easily understood – particularly advertising for consumer credit cards, says Verdun. He also is calling for the banks to disclose the identity and relationships of affiliated and related directors and to reaffirm commitments to maintaining "industry-leading" governance standards.

"It's hard to argue against the proposals," said Verdun, and "the agreement I reached with the banks will ensure that should they ever depart from the governance-related measures, they will give sufficient advance notice to shareholders, thus allowing investors the chance to mount a challenge either by lodging proposals calling for the repeal of the measures, or by other means."

APEIQ is again submitting governance-related proposals, although at press time it had targeted only the Bank of Montreal. At the bank's February 24 annual meeting, shareholders voted on the Quebec group's proposal for the bank to adopt a bylaw prohibiting the CEO from sitting on the board of an unrelated, publicly listed firm. Shareholders also were asked to vote on a proposal that would require the bank to disclose the total value of the pension benefits granted to each of its senior executives and the related annual costs, and "declare any actuarial deficit of such plans." The final proposal seeks to amend the bylaws to force senior executives and other insiders to give public notice of plans to trade company shares or exercise stock options at least 10 calendar days before doing so. The bank is opposed to each of the measures, arguing they limit flexibility and are unwarranted.

Two major accounting scandals rattled European capital markets in 2003.

On the socially responsible investing front, the Bank of Montreal is supporting a shareholder proposal put forth by trio of investors comprised of Real Assets Investment Management, Ethical Funds, and Meritas Mutual Funds. The group is calling on the bank to detail "how it manages risks associated with environmental liability," and to provide credit "only to environmentally responsible borrowers." It also seeks to ensure the bank's operations are conducted in an environmentally friendly and sustainable manner.

The trio is expected to target other banks, much as they did last year with the submission of proposals calling for the disclosure of social, ethical and environmental risks. Those resolutions garnered, on average, 22.4 percent of the votes cast at the Bank of Montreal, Royal Bank of Canada and Toronto Dominion Bank.

Observers also expect to see a handful of governance-related proposals submitted by groups such as the United Brotherhood of Carpenters and Joiners, which last year submitted auditor independence and executive compensation proposals that received solid support.

Europe

Continental Europe typically does not see levels of shareholder activism as high as those evidenced in Britain, Canada or the United States. Historically, companies based on the continent register in sum no more than a handful of shareholder proposals each year. But that may change thanks to accounting scandals that have served as a wakeup call to local investors, and to national and transnational initiatives aimed at improving governance practices.

Two major accounting scandals rattled European capital markets in 2003. The first, at Dutch retailer Ahold, occurred early in the year, while the second, at the Italian dairy conglomerate Parmalat, happened at the end. Both reminded European investors that local firms were by no means immune to Enron-like corporate failures and that tougher oversight and improved transparency were needed to prevent future problems. But in a January speech, Frits Bolkestein, head of the European Union's internal markets division, said the commission would not set about drafting "hasty and ill-conceived" legislation in the wake of Parmalat. That comment will likely force shareholders to take a more active role in oversight.

At press time, no shareholder proposals seeking to address issues raised by the accounting scandal and fraud at Ahold or at Parmalat had been lodged at European firms. However, the Dutch shareholder rights group, VEB, said late last year it is taking Ahold to court over the firm's handling of accounting irregularities that centered on the company's U.S. Foodservice subsidiary. Suggesting more irregularities have yet to be unearthed, the group is demanding the firm restate its accounts for the five-year period beginning in fiscal 1998. The VEB's suit may spur similar litigation by Parmalat shareholders and prompt greater scrutiny of accounting practices by European institutional investors, shareholder groups and watchdog agencies.

Recent national and transnational governance initiatives also may stimulate shareholder activism in Europe this year. The Netherlands, France and Germany tightened reporting requirements for firms within those markets. Holland adopted a new best practice code, while the others shored up existing codes.

Also, the European Union's "Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward," better known as the *Action Plan*, received wide backing during its consultation period, and key aspects of the plan will be put in place this summer. The first initiatives will focus on the role of nonexecutive (independent) directors on audit, nominating and remuneration board committees, as well as on enhanced disclosure of executive pay. More detailed reporting of executive pay led to an increase in the levels of shareholder activism in Commonwealth markets and may have the same effect in Europe.

Japan

Japanese firms, which have played host to a handful of shareholder proposals dealing with both governance and socially responsible investing issues, will again experience shareholder resolutions.

In 2004, the Kabunushi (shareholder) Ombudsman organization is expected to file resolutions seeking the disclosure of data about board compensation at a handful of key firms, with Sumitomo Mitsui Holdings expected to be one of the recipients. In addition, just as in years past, a number of anti-nuclear proposal are expected to be submitted to most of the country's nine major utility companies.

One shareholder activist in Japan does not plan to submit proposals at his usual target in 2004. Yoshiaki Murakami's M & A Consulting, or MAC, is not expected to take on women's clothing designer Tokyo Style. Activist fund MAC, which holds a sizeable stake in Tokyo Style, has lodged shareholder proposals each of the last two years calling on the firm to return cash to shareholders through an enhanced dividend and share repurchase program, and to allow for the appointment of an outside director.

— Subodh Mishra

The French Corporate Governance Paradox

The French corporate governance culture is often labelled a paradox by Anglo-Saxon governance experts. Perhaps this is because it gives the impression of simultaneously blending conservative and revolutionary concepts. In the article below, André Baladi helps clarify this issue drawing on his experiences as a long-standing member of the Paris Bourse/Euronext Exchange and as author of the 2003 United Nations Case Study on Corporate Disclosure in France. Baladi is a noted Geneva-based international governance expert who helped lay the foundations for the International Corporate Governance Network (ICGN) during the 1995 Spring Meeting of the Council of Institutional Investors in Washington, D.C.

The fact that France happens to rely historically on Roman Law, rather than on the Anglo-Saxon Common Law tradition, may explain the perception that the French corporate governance system is different from the Anglo-Saxon. However, the 2003 U.N. Study on Corporate Disclosure in France demonstrates that there are currently many more similarities than differences between the French and the Anglo-Saxon systems.

This U.N. Study on Corporate Disclosure in France was conducted by a team of experts, who reported their findings at the 20th Annual Session of the Intergovernmental Working Group

of Experts on International Standards of Accounting and Reporting, organized by the United Nations Conference on Trade and Development and held on Sept. 29–Oct. 2, 2003, in Geneva, Switzerland.

This team of experts studied five countries: Brazil, France, Kenya, the Russian Federation, and the United States, to attempt to provide an overview of the status of disclosure around the world, with the idea of identifying both similarities and differences. The five reports cover the countries' backgrounds; their codes; their legislation and their accounting systems.

The main features of the French corporate governance disclosure system could be outlined as follows:

- Three-century-old tradition of securities trading
- Multinational stock market, with high proportion of foreign equity investors
- Five successively updated French corporate governance codes since 1995
- Regularly updated financial legislation
- Large number of investment associations and clubs
- Compliance with global accounting and auditing standards

While both the Amsterdam and London exchanges were founded around 1602, the Paris exchange was set up in 1709.

Today, the Paris Bourse has been replaced by the first multinational stock market in the world: the Euronext Exchange, which merged the former Paris, Brussels, Amsterdam, and Lisbon exchanges. (This is in addition to the Euronext.liffe derivatives exchange in London.)

The French stock market has a very high percentage of foreign investors, which jumped from 11 percent in 1986 up to 40 percent of the French blue-chip CAC 40 (considered to be the equivalent of the U.S. Dow Jones). Several major French companies have a foreign ownership majority, e.g. Total with 65 percent, Aventis 60 percent, Lafarge 59 percent, Vinci 56 percent, Suez 52 percent, and Saint Gobain 51 percent. Moreover, foreign investors often tend to generate as much as 80 percent of the French stock market transactions.

Dual auditorship, a specific feature of French accounting, nowadays tends to be admired in countries affected by accounting and auditing scandals.

France also benefits from a high percentage of employee stock ownership.

Furthermore, France is characterized by a relatively high adaptability to changing conditions, which is evidenced by the fact that it has seen five governance codes since 1995: Vienot I + II, Hellebuyck I + II, Bouton I, followed by the New Economic Regulations (Nouvelles Régulations Economiques - NRE) of 2001, and then by the Financial Security Law (Loi de Sécurité Financière - LSF) approved in 2003.

Huge efforts are being made in France—particularly by both the Euronext Exchange and Paris Europlace—to keep pace with the proliferation of French, European and international laws, codes and reports.

Like the United States and the U.K., France also has a large number of associations that are either directly or indirectly involved in corporate governance matters, e.g. the Asset Management Association AFG, the Pension Funds Association AFPEN, and the Employee Shareholders Association AVAS.

The French accounting system will be impacted by the International Accounting Standards' changes that will consolidate accounting practices of stock-exchange-listed companies throughout the European Union by 2005.

Dual auditorship, a specific feature of French accounting, nowadays tends to be admired in countries affected by accounting and auditing scandals.

The Paris Bourse/Euronext Exchange took the initiative to invite the ICGN to hold its 1997 Conference in Paris and its 2003 Conference in Amsterdam.

Another significant pioneering example of French corporate governance initiatives is provided by the first multinational quantitative corporate governance and shareholder-value-driven equity mutual fund ever launched in the world, the ABF Europe Valeur Actionnariale (Shareholder Value) index tilted

fund, which was launched in Paris in January 1998.

What are the main corporate governance problems that remain in France today?

One problem could be the lingering "voting right caps," which artificially limit the voting rights of shareowners of certain French companies. The latter adopted a decade ago the voting restrictions of major Swiss companies (e.g. Novartis and Nestlé are affected by respectively 2 percent and 3 percent voting caps). At present, the voting caps of French companies are for example set at 2 percent at Vivendi Universal (this could partly explain the problems which affected this company in 2001-2002), 6 percent at Danone, 8 percent at Alcatel, 10 percent at Total, and 5 percent at Société Générale.

A second problem could be the "double-voting rights," which benefit shareholders who hold onto their shares several years. According to several French professionals, double-voting rights should be limited exclusively to IPOs for a maximum of five years after their launch.

A third problem is the "identification of the foreign holders" with their signatures, which was initiated under the NRE Law in 2001 (see above). This issue has been widely criticized, both in France and throughout Europe, because many believe it is discriminatory. The feasibility of allowing financial intermediaries to certify the votes of the "ultimate account holders" is being investigated.

The recent history of French corporate governance clearly indicates that the system is not cast in iron, but has a resilient capacity to adapt to rapidly changing conditions.

–André Baladi

EU Takeover Code Approved, Ending 15-Year Odyssey

A long-anticipated takeover code applicable to all European Union (EU) member states received final approval from the European Council on January 20. The code, which sets new rules for corporate takeovers in all of the 15 member states, takes effect this spring. Although the code has been welcomed in most quarters and received strong support in the EU parliament, critics argue that it does not go far enough toward unraveling some member states' longstanding takeover defenses.

The code, which regulators began crafting in 1989 and most recently presented for parliamentary approval in 2001, has languished due largely to opposition from a few, influential member states. In 2001, regulators lost in a vote that evenly divided proponents and opponents of the code. German parliamentarians, in particular, lobbied against the approval fearing the code would pave the way for hostile takeovers of German companies by foreign firms. Germany's influential labor unions, troubled by the takeover of telecommunications giant Mannesmann by Britain's Vodafone a year earlier, played a pivotal role in opposing the code. Swedish and Dutch parliamentarians joined their German counterparts in fighting adoption of the code. Corporations within those markets have long employed a variety of takeover defenses – multiple voting rights, for example – which the code would have restricted.

Bowing to pressure from opponents, the commission set about revising the code in the fall of 2001. Charged with the task of crafting a code palatable to all member states was a seven-member panel of experts headed by Dutch lawyer Jaap Winter. In a bid to address the major sticking points of the rejected version of the takeover code, the commission's revised draft did not mandate a "one share, one vote" policy, thereby allowing companies in member states, such as Sweden, to retain multiple voting rights. The draft also allowed companies to adopt anti-takeover measures such as poison pills without prior approval by shareholders, but only until 2008 when the practice will be banned.

Critics contend the new code is too watered-down and a far cry from what the law's original framers intended. Frits Bolkestein, head of the European Commission's internal markets division, which sponsored the code, believes the code does not go far enough toward ensuring the rights of shareholders. "I am not going to pretend that I am pleased with this agreement," said Bolkestein in late November. "Nor," he added bluntly, "am I going to be hypocritical by pretending that the version of the [code] represents a step forward for EU competitiveness or for the integration of EU capital markets." While Bolkestein said he believed shareholders were not being given sufficient say in how companies are run under the new code, others, including parliamentarians with close ties to

labor organizations, argued that stakeholders would lose under code provisions that benefited investors.

Most of those involved in the approval process, however, were optimistic about the draft code while acknowledging its flaws. Chris Huhne, British member of the EU Parliament told the *Economist* that, "this is not anyone's ideal takeover directive, but we cannot let the best be the enemy of good. Although it will do little to create a level playing field, it will provide important protection for minority shareholders and this will encourage cross-border ownership of shares."

Perhaps the most controversial element of the new code is its reciprocity clause that allows EU companies to adopt poison-pill-style defenses in the event of a hostile takeover bid from a company located in a country, such as the United States, that allows for such defensive measures. That provision does not sit well with many, including Peter Montagnon, head of investment affairs at the Association of British Insurers, who told the *International Herald Tribune* that he believed the clause would "build a fortress Europe and will damage the Union's prosperity."

Dutch Government Sued

While debate over the efficacy of the takeover code continues, the European Commission showed on December 17 that it intends to continue working toward the removal of takeover defenses in EU member states. The commission launched a lawsuit against the Dutch government for holding restrictive "goldenshares" in the telecom company KPN and in the postal service company TPG. The government holds only 19.4 percent of the KPN's shares and 34.8 percent of TPG's; however, the goldenshares it holds gives the company the authority to veto critical decisions made by each company's board.

Although the commission acknowledges that the golden shares are not explicitly discriminatory, it claims that the special powers attached to them could hamper the acquisition of a stake in the two companies, thus deterring investment from other member states. The commission is using this argument to suggest the shares are a violation of EU provisions ensuring the free movement of capital. Similar lawsuits also have been filed against the governments of Germany, Italy and Spain.

— David Lahire

Two New Defenses Emerge for Japanese Takeover Bids

Japanese firms with high net assets in relation to their market value are logical targets for corporate raiders, but most companies, accustomed to the security of management-friendly cross shareholdings, have seen little need for European or American style defenses, until now. In recent weeks, two companies are exploring novel defenses that entrenched Japanese managements have not found necessary in the past—increasing dividends to assuage impatient shareholders and seeking a 'white knight' to counter a hostile bid.

Until recently, poison pills and other management entrenchment tools have been virtually untested in the apparently serene world of Japanese management. But as companies continue to sell off shares held in one another, and a handful of activist funds are finding it profitable to break an old taboo against confrontation with managements, acquiescence is giving way to a new fascination with management defenses.

The latest aggressive fund to set off alarm bells among nervous Japanese corporations is Steel Partners, a hedge fund group managed by corporate raider Warren G. Lichtenstein. Its appearance in the Tokyo equity market, as Steel Partners Japan Strategic Fund, follows the launches in recent years of three corporate governance funds targeted at Japanese firms. Japan-based Sparx Asset Management and U.S.-based Taiyo Fund, each of which received $200 million infusions from Calpers in the last two years, both purposely buy large stakes in poorly performing Japanese companies, with the intention of effecting changes to boost shareholder value. The two Calpers-supported funds have so far not crossed swords publicly with Japanese firms.

Japanese firms with asset-rich balance sheets were startled over the last three years as activist fund manager Yoshiaki Murakami's MAC fund, and his fund management organization, M&A Consulting, challenged management at a handful of firms, most notably at Tokyo Style.

The struggle at Tokyo Style is still ongoing, but received the most press attention in 2002. As the clothing designer's largest shareholder, pundits credit MAC's actions with catalysing a boost in dividends and a share repurchase, although the magnitude of both fell well short of what Murakami's shareholder proposals sought. Amid predictions of a bitter struggle over the shareholder proposals, management countered with a much smaller dividend increase and share repurchase. Both Murakami and Tokyo Style's management employed proxy solicitors in costly international campaigns for and against the proposals. Despite management's victory, the travail was a wakeup call that shareholders in the cross-shareholding network are not as friendly as they were in the past.

After the event, some of Japan's largest institutional investors, including large life insurers, indicated that, despite their support for management's position in this case, they should no longer be taken for granted. Investment staff at Japan's largest institutional investor, Nippon Life, for example, ultimately decided to oppose the shareholder proposals, but reportedly agonized for many hours before reaching that decision.

Japanese firms traditionally are protected from both raids and significant dissent by comfortable majorities of voting equity in the hands of friendly firms, including major banks and insurers and other loosely affiliated firms, often in reciprocal shareholding relationships. However, the ongoing Tokyo Style struggles, the appearance of Calpers-affiliated corporate governance funds and pressures from Japan's Pension Fund Association and others for pension fund managers to vote shares according to consistent guidelines that support shareholder value, have created a new demand for management defense strategies.

In late 2003, IRRC received reports from Japanese firms concerned that Steel Partners was showing up on their share registers.

Lichtenstein's group has a history of pushing for changes in management and strategy. He is most famous for launching public proxy fights to replace directors, as well as for forcing firms to sell off subsidiaries or other assets.

While the corporate governance funds focused on Japan have cultivated a low-key public image and largely stayed out of the news, previous actions by Lichtenstein's group in the United States suggest he will be bolder.

Many of Lichtenstein's efforts to sway management take place in public, through letters of admonishment that are ultimately filed with the SEC. And the tone, if not the intent, is quite often hostile. One such letter begins: "We are pleased to hear that Christopher Pair is no longer with Herbalife International Inc." Another begins: "We continue to be shocked by the continued display of arrogance by the board of directors of Liquid Audio Inc." A letter to the chairman of Park-Ohio Industries says: "The illogic of your proposed transaction compels us to conclude that the acquisition is motivated by concerns other than maximizing shareholder value, namely the continued entrenchment of management."

In late 2003, IRRC received reports from Japanese firms concerned that Steel Partners was showing up on their share registers. In mid-January, 2004, Japanese press reports first revealed that two of Steel Partners' apparent targets, Yushiro Chemical Industries and textile firm Sotoh, were mounting unconventional defenses to hostile takeover bids. Japan's *Nihon Keizai Shimbun* reported on January 16 that Yushiro Chemical and Sotoh each received hostile bids from Steel Partners on December 19, and each "opted to resist the takeovers using a clear capital strategy, instead of the traditional defense, relying on pleas for support from major shareholders such as the firms' main banks." Yushiro sharply raised its planned dividend, in an apparent bid to discourage existing shareholders from selling out. Sotoh responded with the incorporation of a white knight holding company, traded over the counter and associated with the

Daiwa Securities Group. Observers surmise that the white knight, called NIF, is the vehicle for a management-led buyout offer to counter Steel Partners' bid.

The Dividend Defense

So far, only the Yushiro Chemical contest appears to have reached a conclusion, which has left Steel Partners reportedly "delighted" and Yushiro's management in place — albeit with a dramatically revised dividend philosophy. The chemical company, which paid out 14 yen a share last year, and was planning on paying 19 yen for the year ending in March, now plans to pay out 200 yen, with a public commitment to pay out all net profits (excluding board fees) in 2005 and future years. The *Nihon Keizai Shimbun* commented "the concept is to garner support for the present management team by rewarding shareholders."

On January 27, as Yushiro Chemical's market price soared past its book value and remained above Steel Partners' tender offer, Lichtenstein let Steel Partners' bid lapse. But the *Nihon Keizai Shimbun* quoted him that day declaring a strategic victory. Lichtenstein said he was "delighted" with the new dividend policy, and that Steel Partners intends to hold on to its shares. The share price is up more than 50 percent since he tendered the bid in mid-December. Japanese- and English-language business press reports, including one in the *Financial Times*, have noted that the January 27 share price, valuing the firm at 27.1 billion yen, shows that the firm is now trading well above its book value of 20.5 billion yen. The FT summation was typical of most other press assessments, including several in Japan, noting the confrontation "has become an example of how shareholder pressure in Japan can release value for investors."

The MBO Defense

For its part, Sotoh has launched a counter-bidding strategy that is also unprecedented in Japan. Although Sotoh, too, has seen a spike in its share price, up 65 percent from where it stood before Steel Partners' bid, observers are not convinced that much of this boost represents sustainable shareholder value enhancement.

For its part, Sotoh has launched a counter-bidding strategy that is also unprecedented in Japan.

Sotoh management has created two new entities associated with the Daiwa Securities Group, called "NIF Buyout Management," as a wholly-owned subsidiary of "NIF Ventures." It is not clear how much of NIF Ventures is held by Sotoh management or parts of the Daiwa Securities Group, but NIF Ventures is publicly traded on Japan's JASDAQ over-the-counter market.

Unlike the Yushiro bid, which sought to acquire 100 percent of that firm's voting stock, the initial bid for Sotoh was for just 33 percent of its equity, enough to give Steel Partners veto power over Sotoh's board actions. But in the heat of the bidding war, it now appears that Steel Partners is bidding for the whole pie.

In response to Steel Partners' 1150 yen-per-share bid made on December 19, NIF made a management friendly takeover bid for 1250 yen a share, which opened January 16 and closed on February 26. A spokesman for Daiwa Securities told Japan's *Nikkei*, "This is the first time in Japan that a hostile takeover bid has been fired back upon with a friendly takeover bid." On January 26, Steel Partners returned the volley, raising its bid to 1400 yen per share, and increasing its target to 100 percent of the equity. In the most recent iteration, NIF raised its bid on Feb. 5 from 1400 to 1470 yen per share, according to the *Nihon Keizai*.

Earlier Japanese press coverage reports that Steel Partners pressed Sotoh president Yoshiaki Mabuchi to boost dividends a year earlier. The English language *Nikkei Weekly* cites Steel Partners' 2003 effort, in which the challenger pointed to Sotoh's cash-heavy balance sheet. "The company had retained earnings worth some 20 billion yen ($188.7 million), more than double its annual sales, so [Steel Partners' negotiator] Kuroda argued that Sotoh was sitting on an excessively high amount of cash."

But Mabuchi balked, setting the stage for Steel Partners' bid for control, and Mabuchi's MBO defense. Mabuchi's subsequent comments to the *Nihon Keizai Shimbun*, published Feb. 6, leave little hope that management might loosen its grip on its jobs, or its mountain of cash. "It's unclear how Steel Partners

would manage the firm after an acquisition, and it is possible that their management philosophy would differ from ours. Steel Partners, is said to be focused on a return on investment, and, as a major shareholder, could be an impediment to operations." Asked about his management philosophy, Mabuchi replied, "We strive to share profits not only with shareholders, but with all stakeholders, including employees, suppliers and customers. Our firm is committed to a division of labor here in Aichi Prefecture, and cooperation through business relationships is essential."

When the journalist asked whether management has fully disclosed this management philosophy, as a listed company, Mabuchi responded bluntly. "We have set aside profits for future investments and unexpected circumstances. It's possible we have not fulfilled all our disclosure responsibilities. But the textile business is a mature industry, and I doubt that better reporting to investors would have caused the share price to rise, or avoided the current bidding war."

Mabuchi adds a note of disillusionment with being a publicly traded firm. "When we first listed on the stock exchange, there were major advantages aside from access to capital, including greater ease in recruiting, and the establishment of credit. But with this sort of thing happening, the disadvantages are greater. Going private is inevitable."

Following the latest bid volley, the share price is close to the latest NIF bid of 1470 yen, or more than 60 percent higher than the share price before the bidding started. But even in the fever of the bidding war, the *Nihon Keizai Shimbun* points out that the market valuation is still "cheap" compared to the company's breakup value, which it cites at 1630 yen per share.

Prior to the initial bids on December 19, Steel Partners was already a major shareholder in both firms, with an 8.94 percent stake in Yushiro Chemical, and 12.36 percent of Sotoh. Steel Partners Japan Strategic Fund, founded in 2002, is also a major shareholder in a number of other Japanese firms, including Bull-Dog Sauce, Myojo Foods and Chuo Warehouse. Similar to the portfolio of Murakami's MAC funds and the Calpers-affiliated governance funds, Steel Partners appears to target companies with large net assets and low market valuations.

—John Taylor

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