Corporate Governance BULLETIN

— Covering Shareholder Issues Worldwide —

Volume XIX, Number 1 **February - April 2001**

Non-Audit Fees Supersede Audit Fees, IRRC Finds

Almost three-quarters of the fees paid by more than 400 companies to their auditors in fiscal 2000 were for non-audit services, according to IRRC's review of proxy statement disclosures.

The companies reported paying a total of $1.952 billion to their auditors last year, of which 72 percent related to non-audit services on a weighted average basis. The findings are based on information disclosed in the proxy statements that were filed by 414 U.S. public companies at the Securities and Exchange Commission since early February.

For the 2001 proxy season, companies must comply with a variety of new SEC rules that are intended to improve corporate audit committee effectiveness, enhance disclosures about audit committees, and strengthen the reliability of financial statements. Among other things, the disclosure initiatives are intended to identify certain non-audit services that, if provided by an auditor to its public company audit clients, may impair the auditor's independence. The scope of the disclosure requirements does not extend to services provided to non-audit clients.

The disclosure rules apply to all U.S. public companies filing proxy statements on or after Feb. 5, 2001, for meetings at which directors will be elected. Specifically, the company's proxy statement must list the fees provided to the company's independent public accountant during the last fiscal year. The fees received by the auditors must be disclosed in three categories: fees for audit services, fees for financial information systems design and implementation services, and all other fees. The following information is required to be disclosed under these three categories.

- Audit Fees—The aggregate fees billed for professional services rendered for the audit of the company's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the company's 10Q filings.
- Financial Information Systems Design and Implementation Fees—The aggregate fees billed for information technology services.
- All Other Fees—The aggregate fees billed for all other services, including tax, valuation, actuarial and other expert services.

Some investors have been concerned about the intricate relationships between companies and their auditors. Many worry that the non-audit relationships may impair independence, especially when non-audit fees exceed the amount paid for auditing services. Based on the disclosure guidelines, IRRC finds that, overall, only 28 percent of the reported fees paid to auditors by 414 companies were for audit services, while 72 percent of the total fees were paid for non-audit services (which when broken down amounts to 8 percent for information technology services and 64 percent for all other services).

Larger companies were more likely to pay a higher proportion of the total for non-audit fees. Approximately 26 percent of fees paid by S&P 500 companies to audit firms in fiscal 2000 were for audit services, while 38 percent of fees paid by S&P SmallCap companies were for audit services. Thirty-four percent of fees paid by S&P MidCap companies were for audit services.

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Published by IRRC's Corporate Governance and Global Shareholder Services

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Corporate Governance Bulletin is published four times a year by IRRC's Corporate Governance and Global Shareholder Services. The Corporate Governance Service tracks U.S. corporate governance issues and financial performance. The Global Shareholder Service tracks international corporate governance issues in 60 markets. For more information, contact Heidi Salkeld at:

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Investor Responsibility Research Center
ISSN 1053-5489

Sixty-three percent of the 414 companies examined by IRRC disclosed that more than half of the fees paid to their auditors were for non-audit services (including financial information systems services). Twenty percent disclosed that more than 75 percent of the fees paid were for non-audit services. Eleven companies paid 90 percent or more of their total fees to auditors for non-audit services. (See table opposite story.)

The five largest accounting firms—Andersen (formerly Arthur Andersen), Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers—received 99.9 percent of all the fees reported by the companies reviewed. More than 60 percent of the total amount of fees paid to each of these firms were for services under the "non-audit services" category. Late last year, Andersen spun off its consulting services to form Accenture. KPMG sold its executive pay consulting services to William Mercer and its IT consulting arm to Cisco. In 2000, Ernst & Young sold its consulting services to Cap Gemini. Deloitte and Touche sold off its consulting arm years ago. PricewaterhouseCoopers was negotiating to sell its Management Consulting Service to Hewlett Packard, but the deal fell through. *The Wall Street Journal* reported April 9 that the firm is considering selling its unit that handles human resources, accounting and other back-office operations and has hired Morgan Stanley to review its options. PricewaterhouseCoopers' business-process outsourcing unit is small compared to the consulting arm that it considered selling to Hewlett-Packard last year. The motive, though, is the same: the firm apparently wants to avoid conflicts of interest from selling services to the same companies it audits.

Breakdown of Average Fees to Audit Companies*

	Audit Services	Financial Information System Services	All Other Services
Percent of total fees	28	8	64

*based on disclosures by 414 public companies

Companies Having Auditors that Received More than 90% of Their Total Fees for Non-Audit Services:

Company	Auditor	Percent of aggregate fees for non-audit services
Sprint	Ernst & Young	96%
Apple Computer	KPMG	93%
Moody's	PwC	93%
SBC Communications	Ernst & Young	92%
U.S. Bancorp	Ernst & Young	92%
Capital One Financial	Ernst & Young	91%
Royal Appliance Mfg.	PwC	91%
South Financial Group	KPMG	90%
Xcel Energy	Andersen	90%
Tellabs	Ernst & Young	90%
Wells Fargo	KPMG	90%

According to proxy statement disclosures examined by IRRC, Deloitte & Touche, received the least amount of money for non-audit related services. About 38 percent of the total fees paid to Deloitte & Touche were for audit services, while 62 percent were for non-audit services, including about 5 percent for information technology services. From those companies surveyed, IRRC found that the firm receiving the largest percentage of aggregate fees for non-audit services was Ernst & Young. That firm earned 76 percent of its fees for non-audit service. Of that total, 8 percent was received for providing information technology services.

Communication service companies paid higher percentages of their overall fees for non-audit services than companies in all other economic sectors. Ninety percent of fees paid by these companies to audit firms were for non-audit services. Of this total, 73 percent fall under the "all other fees" category. Technology companies also were more likely to pay a higher percentage of their total fees for non-audit services. More than 75 percent of fees paid by tech companies were for non-audit services. Among all sectors, technology companies paid the highest percentage of aggregate fees for the design and implementation of information systems. Companies in the consumer cyclicals and consumer staples economic sectors paid the highest percentage of their total fees for audit services. Consumer cyclicals companies paid 36 percent of their total fees, and consumer staples companies

Breakdown of Fees to Major Audit Firms:

Audit Firm	Percent of aggregate fees for audit services	Percent of aggregate fees for non-audit services
Andersen	34	66
Deloitte & Touche	38	62
Ernst & Young	24	76
KPMG	28	72
PricewaterhouseCoopers	25	75

paid 33 percent of their total fees for audit services.

While the percentage of fees being paid to auditors for non-audit services is high, companies are quick to point out that most are "audit-related." Some companies offer specific information on the type of services that were provided under "all other fees" category.

The disclosure of financial information systems fees and all other non-audit service fees is intended to help investors decide whether these payments might affect the independence of the auditor. Companies also must disclose in their proxy statements whether their audit committee considered if the provision of non-audit services, including information technology services, was compatible with maintaining the auditor's independence. Companies are not required to disclose the audit committee's conclusions, however. Most companies that IRRC has reviewed have not discussed the audit committee's findings.

R.H. Donnelly did disclose the findings of its audit committee regarding the impact of non-audit services on the independence of its auditor. R.H. Donnelly paid an aggregate of $1.766 million to PricewaterhouseCoopers for services performed in fiscal 2000. In its proxy statement, the company says it paid PricewaterhouseCoopers $1.4 million in fees and expenses in connection with non-audit matters (79 percent of aggregate amount paid), primarily for a special consulting project related to unspecified tax matters and the provision of internal audit services. R.H. Donnelly's audit committee considered whether PricewaterhouseCoopers' provision of these non-audit services impaired its independence. The company disclosed that "while the committee determined that the provision of such services did not impair PwC's independence, for several reasons, the company determined that it would no longer utilize PwC to manage the internal audit function after 2000."

Institutional investors said they were not expecting the percentages paid for non-audit services to be so high. "I don't think anyone expected what we are seeing, so it might take until next year for some groups to act," said Ann Yerger, director of research for the Council of Institutional Investors. Yerger points out that the council originally had recommended to the SEC that the rules not allow any non-audit services to be performed by an auditor. "It is difficult to determine what services are OK and what are not. When we see the numbers, we see why. The ban on non-audit services would have been a better way to go," she says.

One group that is acting on this issue this year is Proxy Monitor. This proxy season, the research and advisory firm has been recommending to its more than 300 institutional clients that they vote against the approval of auditing firms if more than 75 percent of the total fees a firm collects from any given company is for non-audit work. So far, Proxy Monitor has recommended no-votes at Mellon Financial, Apple Computer and First Union. Originally, Proxy Monitor had set the standard at 50 percent of fees, but later increased it. Morgan Stanley Dean Witter's auditor was caught under this previous bright line test.

Although the research and advisory firm is taking a stand on this issue, shareholders might be slow to follow suit. Deloitte & Touche, the auditing firm hired by Morgan Stanley Dean Witter, won 96 percent of the votes cast, according to a preliminary tabulation. If a majority of shareholders were to vote down an auditor, the company would not be forced to take action because such a vote would not be binding.

Ken Bertsch, director of corporate governance at TIAA-CREF, says Proxy Monitor's approach is an interesting one that eventually might lead to investors voting against members of audit committees. As for his large pension fund, he says, TIAA-CREF plans to talk to companies about this issue. "Maybe attention will be focused on those companies that are outliers," he speculates. Bertsch also explains that in 1979 the SEC tried to enact similar rules to restrict the types of non-audit services that auditors could perform, but the proposed rules did not win the approval of the full commission.

—Alesandra Monaco and Rosemary Lally

AFL-CIO Releases List of 2001 'Key Votes'

The AFL-CIO has released a list of 32 shareholder proposals and two vote-no campaigns that it considers to be the key votes of the 2001 proxy season. The list will be used to create next year's report card that will be used to grade investment managers on their voting records. The 2001 report card will be the fourth.

The proposals included in the list range from routine corporate governance proposals to resolutions related to business in Burma. According to the AFL-CIO, "The proposals on the survey were submitted by union and public pension funds, other institutional investors and employee-shareholders. These proposals represent a worker-owner view of value—one that emphasizes creating value for the long term through management accountability, partnerships with workers and other corporate constituents and responsible business practices."

Eight of the proposals focus on issues such as board diversity, international business relationships, and linking executive compensation with ethical and social performance. An additional six proposals address executive compensation. Three of these, which were submitted at Office Depot, Halliburton, and Bank of America, seek performance-based stock options.

Four proposals to declassify boards of directors were submitted to Circuit City, Conseco, Great Lakes Chemical, Trico Marine Services and Willamette Industries. This year's list also includes four poison pill proposals at Arden Realty, Boston Properties, Paul Mueller and Southwest Gas. Five poison pill proposals appeared on last year's roster.

A number of votes this year focus on the election of directors. The AFL-CIO is supporting the New York City Employees' Retirement System's vote-no campaign at Freeport McMoran Copper & Gold, and the Service Employees' International Union's vote-no campaign at Eastman Kodak. Additionally, they are following how funds will vote on a contested director election at Paul Mueller, where the Sheet Metal Workers' fund is sponsoring a proxy contest for independent candidate Jay Sushelsky.

Majority votes have become more common among the proposals listed as key votes (with four majority votes in 2000).

Four proposals on this year's list also appeared on the 2000 list. These are a confidential voting proposal at Constellation Energy; a proposal relating to International Business Machine's cash balance pension plan; and poison pill proposals at Arden Realty and Paul Mueller.

AIG, Bank of America, Great Lakes Chemical and Eastman Kodak appear on the list for a second year in row.

The AFL-CIO's project began five years ago with just 10 proposals, and it has expanded each year in number and scope. In a letter to Taft-Hartley pension funds, Richard Trumka, Secretary-Treasurer of the AFL-CIO, explained the philosophy behind the program. "As stewards of workers' savings, our first concern is always to achieve the best possible returns, so that our funds' beneficiaries can enjoy a secure and comfortable retirement. Those returns must be achieved in a way that is sustainable over the long term," he wrote. "I hope this report is useful to you in deciding which investment managers meet that standard."

As the program builds from year to year, it is possible to consider how effective the key votes have been in creating change at the company level. Majority votes have become more common among the proposals listed as key votes (with four majority votes in 2000). Last year, a proposal at General Electric sought to eliminate director pensions; this year the company has quietly eliminated the pensions. A proposal to declassify the board at Fleming was on the list in 1998; in 2000 Fleming announced that it would declassify its board. In 1997, when the AFL-CIO listed only 10 key votes, one of them was a poison pill proposal at Columbia HCA. After the shareholders approved the proposal, the board eliminated the company's poison pill.

Sometimes the effect is less obvious, but no less critical for shareholders. At AIG, last year's proposal on independent directors criticized the family fiefdom running the company. Since that time,

bowing to shareholder pressure, the son of the founder and CEO who was the heir apparent, has left the company, and the board now seeks a succession plan that will not involve someone from the family.

In cases where the companies have not adopted reforms, the AFL-CIO has shown it is willing to step up the pressure. Bank of America did not make the changes to its compensation committee that the AFL-CIO had recommended in its 1999 proposal. This year, in addition to having a proposal on the list, Bank of America is one of three companies featured on the AFL-CIO Executive Paywatch web site. At Kodak, which did not act on last year's key shareholder proposal to declassify the board, although 60.7 percent of shareholders voted in favor of it, the Service Employees' International Union (SEIU) is leading a "vote no" campaign against the directors. Next year, money managers will be graded on whether or not they withheld their votes from Kodak directors.

It is also possible to track how money managers have responded to the exercise. Certainly more of them fill out the survey each year, and scores seem to improve for individual companies as well. In 1998, a total of 15 managers scored 100 percent; in 2000, 39 managers received this top score.

Of the 15 companies that scored in the bottom tier in 1999, two are on the most improved list in the recently issued 2000 report. MFS Investment Management's score improved from 14.2 percent to 50 percent; Montag & Caldwell's score climbed from zero to 57.1 percent. Nine managers who were in the bottom tier in 1999 do not appear in the most recent issue, possibly because their Taft-Hartley clients have moved elsewhere. Only three managers – Bank of New York, J.P. Morgan Investment Management, and Rothschild Asset Management – have scored in the bottom tier in each of the past two years.

A look at the list of money managers who did not respond in 1999 also is illustrative. Of those 10 managers, six responded in 2000, and two were not in the survey. Three managers, Columbus Circle Advisors, RhumbLine, and Weiss, Peck and Greer, all scored 100 percent in votes for their Taft-Hartley clients.

2000 key votes survey

This year's survey included results from 38 proposals voted on in 2000, and more of these proposals were outside the traditional corporate governance arena. According to the report, the proposals fell into six broad categories: "encouraging greater board independence, reining in excessive executive compensation, promoting sound corporate governance practices, scrutinizing transactions that may not be in the best interest of shareholders, increasing management accountability and advancing a broad worker-owner view of value." The AFL-CIO's Office of Investment sought nominations for the most important shareholder proposals from Taft-Hartley funds, public pension funds, and other investors, and released the list of what it considered to be the key votes of the 2000 season last March. In its report, the AFL-CIO notes that "the list was assembled with attention to both the merits of the proposals and the context at particular companies," explaining that management accountability is more important at companies where management is entrenched and unresponsive, and executive compensation proposals are more critical at companies where executive compensation is excessive.

The investment managers are ranked in three tiers. Managers made the top tier if they voted on at least five of the proposals on the list and voted according to AFL-CIO guidelines in 80 percent of those cases. This year, 55 companies scored in the top tier, up from 37 last year. Thirty-nine companies scored 100 percent, voting in accordance with the AFL-CIO guidelines each time that they voted on one of the key proposals. The middle tier and largest category consists of managers that voted on five or more of the key proposals and scored between 25 and 80 percent. Also in this category are those managers who scored above 25 percent but segregated their votes, voting differently for Taft-Hartley than for other clients.

Twelve managers that voted on five or more proposals and scored below 35 percent make up the bottom tier.

To receive a copy of the key votes list, contact the AFL-CIO Office of Investment at 202/637-5372.

—Rosanna Landis Weaver

Several SEC No-Action Decisions Spark Ire of Investors in 2001

Each year, several no-action decisions by the Securities and Exchange Commission spark debate among investors. This year, the debate has centered around the SEC's decision to grant no-action relief to companies for proposals related to board independence and for proposals related to the separation of the positions of chairman and CEO.

In its first controversial ruling of the 2001 proxy season, the SEC said PG&E could exclude a proposal submitted by shareholder activist John Chevedden that asked the company to change its bylaws to require that independent directors be appointed for all future openings on the audit, nominating and compensation committees. According to the proposal, a director would be considered independent if his or her only non-trivial professional, financial or familial connection to the company or its CEO, within the past 10 years, is his or her directorship.

In the supporting statement for the proposal, Chevedden says three of the company's directors "profited directly or indirectly from their financial and management links to PG&E." He says that while Kaiser Health Plan CEO David Lawrence sat on PG&E's board, Kaiser collected $23 million from PG&E. In addition, Chevedden says while former BankAmerica CEO David Coulter sat on the PG&E board, BankAmerica collected $2.5 million from PG&E, and while AirTouch Vice Chairman Lee Cox sat on the board, AirTouch collected $1.5 million from PG&E. "These directors continue at PG&E, according to the 2000 proxy statement," writes Chevedden.

Chevedden submitted similar proposals in 1999 and in 2000 at PG&E, and these proposals were voted on by shareholders. In 1999, the proposal received 26.5 percent of the votes cast, and in 2000, it garnered 45.3 percent of the votes cast. The company did not challenge the proposal in 1999, but in 2000, the SEC rejected the company's challenge.

In its argument to the SEC in 2001, the company says the proposal should be allowed to be excluded under rule 14a-8(i)(6), which permits omission if "the company would lack the power or authority to implement the proposal." PG&E says it does not have the authority, under the law of the state of California, where the company is incorporated, to implement the proposal because the election of directors is the province of the shareholders.

More specifically, the company says the California General Corporation Law allows a corporation's board to delegate its power and authority over certain business matters to committees comprised of two or more directors. Members of these committees must be members of the board, says the law. The letter also points out that under both the California law and the company's bylaws, directors are elected by the shareholders at the annual meeting. "Thus, it is not within the power of the corporation or its board to guarantee or enforce the election of any particular person or type of person as a director at the annual meeting," the company argues.

The SEC concurred with the argument that the proposal may be excluded under rule 14a-8(i)(6). "In our view, it does not appear to be within the board's power to ensure the election of individuals as directors who meet specified criteria," says the commission's brief ruling.

Following that decision, the SEC ruled that four additional board independence proposals could be omitted from company proxy statements. A proposal at Bank of America seeking an independent audit committee and a proposal at Marriott International seeking an independent board of directors have been ruled excludable on the grounds that the companies lack the power to implement the proposals. The companies contended that the election of directors is a duty of the shareholders, not of the board of directors.

Another proposal submitted by John Gilbert to Boeing, asked the company to adopt a policy stating that its key committees will be comprised of a majority of independent directors. John Chevedden submitted to AT&T a second proposal, which was similar to Gilbert's. The SEC said each was beyond the power of the board of directors to implement.

The PG&E decision so incensed the Council of Institutional Investors that it sent a letter to the SEC saying the commission's decision "hinged on PG&E's absurd argument that the resolution could be excluded because the corporation, in the form of its board, lacks the authority to implement the proposal since PG&E's share-

holders, not the board, elect the directors." The council pointed out that a company, through its board, nominates directors and creates criteria for board and committee service. "Shareholders' only involvement in the process is to rubberstamp the nominees selected by the board," said the letter. In addition, shareholders do not have a say on who sits on various committees, the council noted. "To implement a proposal addressing committee independence, directors must simply appoint committee members who fit the independence criteria, just as they have the ability to adopt their own committee criteria and nominate directors who meet that criteria," it said.

The company contradicts the basic premise of its own argument in some of the disclosure in its 2000 proxy statement, said the council. The proxy statement says the company has a policy that at least 75 percent of its board shall be comprised of directors who are neither current nor former officers or employees of PG&E, Pacific Gas & Electric or any other of their subsidiaries. In addition, the proxy materials say the audit, compensation and nominating committees are comprised entirely of directors who are neither current nor former officers or employees of PG&E or any of its subsidiaries, not consultants to PG&E or any of its subsidiaries and neither current nor former officers or employees of any other corporation on whose board any PG&E officer serves as a member. "If the company can adopt these policies on its own, why would it lack the authority to implement similar policies recommended in the proposal sponsored by Mr. Chevedden?," asked the council.

This SEC decision could impede recent successful efforts by institutional investors to increase board independence, says the council's letter. In addition, the council brought up another issue related to shareholder rights. "We must admit we are especially troubled that it appears that large institutional investors can afford the lawyers necessary to get these proposals included whereas individual investors, like Mr. Chevedden, who submit the same kind of proposals, appear to be denied proxy access by the commission," the letter concluded.

In another controversial SEC ruling that touched upon a different governance issue, the commission granted AT&T permission to exclude a proposal submitted by Communications Workers of America Pension Fund. The resolution asked the company's board to adopt a policy to require that any future occupants of the positions of CEO and chairman not be the same person, and that the chairman be an independent director who has not previously served as the CEO of AT&T.

In the supporting statement for the proposal, the fund says separating the two positions is "particularly important in light of AT&T's dismal performance under its current chairman and CEO of three years, Mr. Armstrong." The statement also points out that during the CEO's tenure, the stock price fell to a three-year low of $18.75 on Nov. 22, 2000.

AT&T's acquisition of several communication services "under Mr. Armstrong's guidance," resulted in the company's debt mushrooming from $9.8 billion to $62 billion, says the statement. In addition the statement says the company "has also suffered operational shortcomings under Mr. Armstrong's leadership." More specifically, it says the company's business services division has experienced reduced revenue growth, and has fallen short of its goal to roll out cable telephone service.

Finally, the fund's supporting statement says the major restructuring contemplated by AT&T in November repudiates the bundled services strategy that Armstrong pursued for the past three years. "Vesting board leadership in an independent director will, we believe, allow unbiased consideration of all of the company's strategic alternatives and make the board more accountable to shareholders," it concludes.

In its ruling, the SEC notes that there is a basis for the exclusion of the proposal under rule 14a-8(i)(8) because it relates to an election for the company's board of directors. "We note that the proposal, together with the supporting statement, appears to question the business judgment of AT&T's chairman, who will stand for reelection at the upcoming annual meeting of shareholders," said the SEC's ruling.

In 1997, the SEC allowed exclusion of a similar proposal that was submitted by shareholder proponent Bartlett Naylor to Black & Decker. That proposal asked the company's board to take the necessary steps to require that an independent director, who was not formerly the CEO of the company, serve as the chairman of the board. The supporting statement for the proposal also directly tied the company's poor financial performance to the performance of the company's chair and CEO Nolan Archibald. The statement quoted extensively from a *Forbes* magazine story that criticized Archibald for some of his personal characteristics. "There are lots of

big egos among the people who head U.S. industry, but few are more expansive than Archibald's," Naylor quotes from the magazine. "Black and Decker has paid a high price for Archibald's ego," he cites *Forbes* as saying. "While the force of Chairman Archibald's personality behind closed doors of the board room may not be apparent, he reportedly runs roughshod over senior management and 'seems to think that humiliating executives is motivational,'" Naylor quotes from the magazine.

In its ruling on this proposal, the SEC said, "It appears that the actions contemplated by the proposal, together with certain contentions made in the supporting statement, question the business judgment of, competence and service of the company's chief executive officer who the company indicates will stand for election at the upcoming annual meeting of shareholders. Under these circumstances, it appears that the proposal relates to his re-election as a director and, therefore, may be omitted."

In 1998, Naylor significantly revised his supporting statement and resubmitted a similar proposal to Black and Decker. The statement simply argued the merits of an independent chair. The SEC did not grant the company no-action relief from this version of the proposal. Naylor's resolution appeared in the proxy statement, and it received the support of 17.9 percent of the votes cast.

—Rosemary Lally

Dilution Levels Continue to Rise

Although many shareholders welcome the increased use of stock to compensate management and other employees, some are growing increasingly concerned about the rising dilution levels of earnings, equity and voting power caused by this compensation practice.

The granting of restricted stock and the exercise of stock options distributes a company's voting power, earnings, and assets over a larger number of shares, thus diluting each shareholder's stake correspondingly.

A study recently released by IRRC, *Potential Dilution 2000: Potential Dilution from Stock Plans at S&P Super 1,500 Companies*, found that dilution levels at S&P 1,500 companies continue to rise. The average potential dilution of S&P 1,500 companies was 14.6 percent in 2000, up from 13.4 percent in 1999 and 12.7 percent in 1998. The median potential dilution was 12.9 percent in 2000, up from 11.6 percent in 1999. Average dilution levels within the S&P 1,500 indices demonstrate a similar trend. The average potential dilution for companies within the S&P 500 index increased from 11.4 percent in 1999 to 13.1 percent in 2000, while average potential dilution for companies within the S&P MidCap index rose from 12.4 percent in 1999 to 13.9 percent in 2000. The average potential dilution of S&P SmallCap companies, which has been the highest of all indices, increased from 16.3 percent in 1999 to 16.8 percent in 2000.

The study examines the potential dilution levels of voting power at 1,157 S&P 1,500 companies that held shareholder meetings between January 1 and July 31, 2000. The study includes 416 S&P 500 companies, 325 S&P 400 MidCap companies and 416 S&P 600 SmallCap companies. Potential dilution of voting power, as calculated by IRRC, is based on a company's outstanding voting power. Total voting power is the aggregate of the number of shares of each class of voting stock multiplied by the respective number of votes per share allotted to each class. Since most companies have only one class of voting stock, usually common shares, total voting power often equals the number of outstanding common shares. IRRC determines the dilution level by adding the number of shares available for award under stock incentive plans plus the number of shares subject to options outstanding, and dividing the sum by the company's total outstanding voting power. Shares available for award include shares available under stock option plans, stock award plans, restricted stock plans and stock purchase plans. Grants outstanding include only the number of shares outstanding that are subject to options. Both available shares and outstanding options are calculated based on the voting power of the underlying shares.

Extraordinary levels of dilution

Although about four out of every five companies in the study have voting power dilution levels below 20 percent, several companies exceeded even a 40 percent dilution threshold. IRRC found 21 companies that had dilution levels above 40 percent. Companies with the highest dilution are Nvidia, a com-

Average opposition to stock plan proposals in relation to the company's total potential dilution

Dilution threshold	Number of proposals	Average opposition
0.0% to 4.9%	17	14.9
5.0% to 9.9%	39	13.2
10.0% to 14.9%	89	16.6
15.0% to 19.9%	85	19.2
20.0% an higher	107	29.0
All levels	337*	20.7

* Number of proposals for which voting results were available.

puter software company and Autodesk, another computer software company. Nvidia's high dilution can be attributed to its two quasi-evergreen stock plans, that reserve 5 percent and 2 percent of the outstanding shares annually until the plans terminate in 2008 and 2009, respectively. In the aggregate, the company may reserve more than 16 million additional shares under both plans. Autodesk—like Nvidia—maintains two quasi-evergreen plans, which cause the company's high dilution. The company's employee stock purchase plan reserves 2 percent of outstanding shares annually and terminates in 2018. This plan feature alone creates 36 percent dilution. A second plan reserves 3.5 percent of outstanding shares annually until 2006. The shares Autodesk may reserve under these two quasi-evergreen plans would cause a 57 percent dilution of voting power.

Both Nvidia and Autodesk are companies in the computer software/service industry group within the technology economic sector. Companies in the technology economic sector historically have had the highest dilution levels. Companies with smaller market capitalization, especially technology companies, have limited cash at hand and wish to invest what they have in building their businesses. Consequently, these companies usually compensate their employees with stock options, providing them with the opportunity to own a stake in the growing company and to become financially independent if it succeeds. The downside of this trend, however, is excessive dilution levels. In 2000, the technology economic sector is again at the top with average dilution of 24.2 percent, compared to an average level of 14.6 percent for all companies included in the study. Out of the 21 companies with dilution levels above 40 percent, 10 companies are technology companies. Similarly, companies within the computer software/service industry group had the highest average dilution of 33.5 percent in 2000, followed closely by companies in the computer (hardware) industry group with average potential dilution of 33.4 percent. On the other hand, companies in the utility sector generally show the lowest levels of dilution. The average potential dilution of companies in the utilities sector was 6.0 percent in 2000, compared to the 14.6 percent average potential dilution of all companies included in the study.

Shareholder opposition to high levels of dilution

Investors consider potential dilution as one of the key factors when making voting decisions on stock-plan proposals. Many institutional investors have established guidelines to review or vote against plans when a company's total potential dilution exceeds 10 percent or 15 percent. Generally, companies with high levels of dilution face greater shareholder opposition to stock plan proposals than do companies with lower dilution. As a result of, and hand in hand with, increasing dilution levels, the opposition to stock-based plans also has increased in recent years. Average opposition to stock-plan-related proposals was 20.7 percent in 2000. This is up from 20.2 percent in 1999, 18.8 percent in 1998, and 17.4 percent in 1997.

Evergreen and quasi-evergreen plans

Evergreen plans and quasi-evergreen plans reserve a certain number of shares annually for award under the plan. Evergreen plans have no termination date; therefore, the annual replenishment of shares reserved under the plan may continue for an infinite number of years until the board terminates the plan. IRRC determines the dilution created by an evergreen plan by adding the shares that will be reserved under the plan in the following year to the shares available for grant. Quasi-evergreen plans, on the other hand, do have a set termination date. IRRC calculates the dilution created by a quasi-evergreen plan by multiplying the number of shares reserved annually under

Companies with evergreen and quasi-evergreen plans

Evergreen plans

Abbott Laboratories
Allergan
Allied Waste Industries
Bank One
Bausch & Lomb
CMS Energy
Chevron
Chiron
Comerica
Conseco
Cypress Semiconductor
Dallas Semiconductor #
Dentsply International
Dow Chemical
Edgewater Technology
Fair (Isaac)
Ivax *
Jo-Ann Stores
Leggett & Platt
Morrison Knudsen
Murphy Oil
Nordson
Oakwood Homes
OM Group
Owens-Corning
PacifiCare Health Systems
PPL
Pride International
Robert Half International
Thomas & Betts
United Technologies #
Vitesse Semiconductor
Whitney Holding

Quasi-evergreen plans

Action Performance
Allmerica Financial
Alza *
Apria Healthcare Group #
AT&T
Autodesk *#
Bank Of New York
Beckman Coulter
BellSouth
Blyth Industries
Bristol-Myers Squibb
Building Materials Holdings
Calpine
Chase Manhattan
Citigroup
Citrix Systems #
CKE Restaurants
Clarcor
Coherent (director plan)
Colgate-Palmolive
Comdisco *
Consolidated Products*
Consolidated Stores
Cummins Engine
Dell Computer
Edison International
Equifax
Express Scripts
ExxonMobil
Fidelity National Financial
Finova Group
First Bancorp Puerto Rico
First Union
Fiserv *
Ford Motor
Gateway
GATX *
General Electric
Harmon Industries
Hartford Financial Services Group
HealthSouth
Hispanic Broadcasting
HNC Software *
Hologic
Home Depot
HON Industries
Insight Enterprises
Interpublic Group
Ionics
ITT Industries
Johnson & Johnson
Legato Systems
LG&E Energy
Liz Claiborne #
LSI Logic *
Lubrizol
Lucent Technologies
Lyondell Chemical
Marshall & Ilsley *
Mattel
MBNA
Mercury Interactive
Millennium Pharmaceuticals
NCR
Newmont Mining
Northeast Utilities *#
Northrop Grumman
Novell
Nvidia *#
Old Kent Financial
Old Republic International
Owens-Corning
Phillips Petroleum
Pioneer Natural Resources
PNC Bank
Praxair #
Primark
Questar
Reliastar Financial
Ryland Group
S3
Sears, Roebuck
Sempra Energy
SouthTrust *
Sprint #
Stanley Works
Steris
Sungard Data Systems
Synopsys
Texaco
Toll Brothers #
Tyco International
Universal Forest Products
US Oncology
USX-Marathon Group
USX-U.S. Steel Group
Viad
Vintage Petroleum
Vulcan Materials
Wachovia
Warnaco Group
Westamerica Bancorporation
Xerox
Zions Bancorporation

* Evergreen/quasi-evergreen plan is a stock purchase plan
\# Company has two evergreen/quasi-evergreen plans in place

the plan by the number of years left in the plan term. Hence, companies maintaining quasi-evergreen plans often have very high dilution levels.

Many shareholders have opposed evergreen plan features, saying that shareholders should have an opportunity to approve each addition of shares to equity plans. Even though the annual dilution created by these plans may be low, the dilution created over the life of the plan cannot be determined. As the plans may extend indefinitely, shareholders may risk "creeping dilution," rising to more significant levels. Companies, on the other hand, say these plans enhance the compensation committee's flexibility and lessen the burden and cost of continually obtaining shareholder approval for additional shares. Despite investor criticism, the number of companies with evergreen plans or quasi-evergreen plans continues to rise. In 2000, a total of 134 companies had such plans in place compared to 128 companies in 1999 and 97 companies in 1998.

The number of stock purchase plans containing evergreen or quasi-evergreen features has increased even more significantly in recent years. In September 1997, the Emerging Issues Task Force of the Financial Accounting Standards Board issued an interpretation of Section 423 of the Internal Revenue Code relating to stock purchase plans. Generally, in order to avoid a compensation expense, the number of shares reserved under a plan has to be sufficient to cover all purchases during this period. As a result, a number of companies began adopting stock purchase plans that contain automatic refueling features. Previously, a company would seek shareholder approval for additional shares under a stock purchase plan when the remaining number of shares appeared insufficient for the ensuing offering period. While five companies maintained stock purchase plans containing quasi-evergreen features in 1999, a total of 13 companies had such plans in place in 2000.

Stock plans not approved by shareholders

Generally, all equity compensation plans of companies listed on a major U.S. securities market require the approval of shareholders. A longstanding exemption from this rule are "broadly based" plans, under which the majority of participants are non-officer employees. When in April 1998 the SEC approved a proposed New York Stock Exchange policy on broadly based plans, the NYSE established a task force to review comments on this rule. Institutional investors' foremost concern about the rule was the absence of a precise definition of broadly based plans in the proposed rules' text. Addressing these concerns, the NYSE task force developed an interim rule (approved by the SEC in September 2000) providing for a definition of broadly based plans. Currently, companies are not required to provide comprehensive disclosure of non-shareholder approved plans. As a result, it is difficult to obtain information on broadly based plans. IRRC found 51 companies with stock option plans in place that were not approved by shareholders.

More recently, the NYSE task force has changed its focus to consider setting maximum dilution levels to determine shareholder approval exemptions for stock-based plans. The new proposed ruling that resulted from the NYSE's consideration of maximum dilution levels is based on a different premise and somewhat different structure than the interim rule (regarding broadly based plans). The current proposed rule sets the premise that essentially all stock-based plans in which officers and directors participate require shareholder approval. However, to give companies flexibility in creating compensation arrangements, the NYSE task force determined that a company may reserve shares under non-shareholder-approved plans for up to 10 percent of the shares reserved under shareholder-approved plans. Consequently, an equity plan that would exceed the 10 percent dilution 'basket' requires shareholder approval, even if officers and directors are not participants in the plan.

Former SEC Chairman Arthur Levitt also drew attention to the 'creeping dilution' that non-shareholder approved stock plans create and called on Nasdaq to follow the NYSE in proposing rules for shareholder approval of stock option plans. Heeding the call, earlier this year Nasdaq solicited comments on the NYSE rules.

Copies of *Potential Dilution 2000: Potential Dilution from Stock Plans at S&P Super 1,500 Companies* may be obtained for $495 each through IRRC's online store at www.irrc.org or by calling Heidi Salkeld at 202/833-0700.

—Annick Siegl

Cumulative Voting Proposals Gain Support, While Overall Submissions Decline

Cumulative voting gives shareholders the option to designate their voting power toward the board nominees of their choice. Supporters of this method point out that when shareholders are no longer required to distribute their voting power evenly, the opportunities for more direct shareholder representation in the boardroom increase—particularly for institutions and well organized coalitions of interest groups. Dissenters of cumulative voting say the method divides boards into camps of various allegiances. Furthermore, argue those opposed to this method, the negative effects of these divided boardrooms are far more detrimental to a company's overall performance than a perceived lack of direct shareholder representation.

Cumulative voting has a steadily growing legion of followers, if support for shareholder proposals seeking to adopt cumulative voting is any indication. Support for such proposals has more than doubled since 1988, when IRRC began collecting data, and averaged a record-high 28.3 percent in 2000. A proposal last year at Aetna, where stock ownership is approximately 84 percent institutional, garnered 40.9 percent support. Perhaps the most dramatic sign of increasing support for cumulative voting came at the annual meeting of Fair, Issac on Feb. 6, 2001. At the meeting, shareholders shot down a management proposal that sought to eliminate cumulative voting. Approval of the proposal required a majority of shareholders. Prior to the Fair, Issac meeting, IRRC had not tracked a failed management proposal to eliminate cumulative voting since 1997.

The significance of the increase in support for cumulative voting must be considered in the context of the decrease in the number of cumulative voting proposals being submitted by shareholders. IRRC tracked a total of 50 proposals that came to a vote in 1990, but only 24 in 2000, setting a record low. Cumulative voting proposals have historically derived from a small cast of individual shareholder activists. Evelyn Y. Davis, for example, submitted half of the proposals tracked by IRRC in 2000, while organized labor submitted only one.

Cumulative Voting 2001 currently is available only to IRRC's corporate governance service subscribers. Copies of the 2000 study are available for $300 each. For more information, contact Heidi Salkeld, IRRC, 202/833-0700.

—Glenn Davis

NaStraG Legislation Revolutionizes German Market

IRRC has found that for the 2001 annual meetings it has covered so far, German companies are embracing the recent legislative changes to the German Corporation Act (Aktiengesetz). The revisions, which went into effect on January 25, 2001, reflect technological advances and include several major changes to the regulations concerning registered shares and the use of electronic media.

The "Namensaktiengesetz" (NaStraG) revisions to the Corporation Act would allow German companies to conduct proxy voting electronically and to distribute information to shareholders through electronic media. The new legislation also would allow German companies to offer proxy voting by fax, telephone and email. Ballots submitted by remote investors, however, will still have to be cast by someone attending the meeting. Companies also would be permitted to distribute notices on meetings and other corporate actions through electronic media. As a result of this legislation, many large German companies are expected to offer to shareholders the opportunity to cast their proxies through fax or telephone during the 2001 annual meeting season. The revisions also facilitate the conversion of bearer shares into registered shares.

German government officials strongly backed the recent NaStraG changes saying that re-

cent changes in communication and information technologies and an increase in the number of domestic and foreign shareholders make them necessary. Many in the German government said the outdated laws regarding registered shares prevented shareholders, and, in particular, foreign investors, from fully exercising their voting rights. This legislation is a component of recent efforts by the German government to increase the attractiveness of Germany to international investors. Other efforts have included changes to Germany's capital market, corporate governance laws, and tax regulations.

Another important aspect of the proposed NaStraG legislation is the introduction of electronic media into the company-shareholder relationship. In her comments after the passage of the NaStraG legislation by the Bundestag, Federal Justice Minister Däubler-Gmelin said the laws needed to be updated to allow enterprises and shareholders "to utilize electronic media to exercise their duties and rights under share laws as they are used to in everyday life."

Indeed, it is apparent from the annual meetings covered thus far by IRRC in the 2001 season, that German companies are embracing the legislative changes. Many firms, including BASF, Siemens and Infineon among others, have proposed resolutions to their meeting agendas to incorporate the NaStraG changes into their bylaws. The chemical producer Celanese has gone as far as to allow shareholders this year to grant proxy authority to company representatives and to submit votes to their May annual meeting online.

The reforms of the new NaStraG legislation certainly will improve the lines of communication between companies and their stakeholders. The introduction of electronic share databases will give German companies a more direct link to shareholders and support wider dissemination of corporate information. Foreign investors, who were prevented in the past from exercising voting rights due to procedural roadblocks, will be further enfranchised by the introduction of proxy voting through electronic media.

The NaStraG legislation makes several modifications to the Corporation Act regarding registered shares. The most significant change is that German companies now are allowed to maintain electronic databases of the holders of their registered shares. Electronic registers will enable firms to store information more efficiently and to be able to identify the composition of their shareholders. The new legislation also provides safeguards to shareholder privacy rights. Shareholders are now allowed to access only their own personal information in the share registry; previously all shareholders could view other shareholders' information.

Although anonymous bearer shares are still the most prevalent form of corporate equities in Germany, registered shares are becoming more common among large listed German companies, as well as medium-to small-sized companies. The transfer of ownership after the sale of a share into a company's share registry often took up to three months. The advent of the CASCADE system (Central Application for Settlement Clearing and Depositary Expansion) in 1997, which introduced the electronic transfer of trade settlement information, reduced this period to 48 hours.

Registered shares also have become more attractive equity for German companies because they are commonly used in foreign stock exchanges. To attract international capital, many large German firms in recent years have converted their bearer shares to registered shares to obtain listings on the New York Stock Exchange and other exchanges. In addition to improving communication between management and shareholders, registered shares also are regarded as a more attractive currency for corporate acquisitions through stock swaps. In addition, registered shares increase disclosure about ownership relationships and help companies identify potential takeovers. The list of German companies that have converted their bearer shares includes firms such as Lufthansa, DaimlerChrysler, Siemens, Deutsche Bank, Dresdner Bank, Celanese, Mannesmann, and Deutsche Telekom, among others. At the end of 2000, the majority of German companies listed on the Frankfurt Stock Exchange had registered shares in circulation.

—Brian Belensky

Anticipated Legislation Would Alter Japanese Boards

As Japanese market sentiment waivers between malaise and panic over the weakness of banks, life insurers and other financial institutions, the Justice Ministry's incubator for new legislation is focusing on corporate governance. An influential advisory body, the ministry's "legislative council" has not finalized its draft proposal, but Japan's press outlined a likely bill on March 28. It would introduce the option for Japanese firms to establish independent nominating, compensation and audit committees on their boards. It also would require all but the smallest Japanese firms to appoint at least one outsider to the board of directors.

At least one influential reform booster, Keio University Professor Mitsuhiro Fukao (formerly of the Bank of Japan) proposed much of the detail in the recent proposal, almost two years ago. Some pundits believe that the American Chamber of Commerce in Japan, which has been increasingly vociferous on corporate governance and regulatory reform, may have given the idea a crucial boost in recent months.

The Justice Ministry's influential legislative council, a collection of business leaders and experts who advise the leadership, appears to have agreed in late March to Fukao's ideas, which were circulated most recently in January by the Ministry of Economics, Trade and Industry (METI, the re-packaged version of the old Ministry of International Trade and Industry before it was renamed at the beginning of the year). The idea is to reward firms capitalized at more than ¥500 million (U.S. $4 million) that introduce the board reforms with a legal waiver of the requirement to maintain a separate kansayaku board, usually referred to as the "statutory auditor board."

The idea is to reward firms capitalized at more than ¥500 million (U.S. $4 million) that introduce the board reforms with a legal waiver of the requirement to maintain a separate statutory auditor board.

These so-called statutory auditor boards are less powerful, serving as second fiddle to the board of directors at Japanese firms. Theoretically responsible for double-checking the work of the external auditors, and assuring that the board of directors and management obey the law, in practice they have served as little more than a convenient honorary post at most firms.

Since 1993, Japanese law has required at least one member of the statutory auditor board to be an "outsider." For this reason, this board tier is often the only one that contains any non-executives. Most pundits believe that the Justice Ministry and the business community proposed the 1993 law to deflect growing international pressures to introduce more outsiders on the actual boards of directors. The U.S. government, in particular, hoped board independence would improve the trade balance by refocusing Japanese firms on profit maximization.

The 1993 reform was seen by Japanese managers as little more than red tape, and was never accorded much significance by international or domestic investors. Aside from only pertaining to this relatively ineffectual board, managers can exploit a narrow legal definition of an "outsider." This definition excludes only individuals who have drawn salaries or served on the board of directors of the firm (or a subsidiary) within five years before being designated an "outside statutory auditor." Technically, this has allowed firms to designate as outsiders people who worked for the firm for decades, but who became statutory auditors (sometimes a full-time post) at least five years ago.

The American Chamber of Commerce recently shot down policy proposals that would have focused on raising the profile of the

statutory auditor board, and that would have boosted the number of, or tightened the definition of, outsiders on the statutory auditor board. The chamber strongly backed eliminating the statutory board altogether in return for a commitment to maintain independent audit, compensation and nominating committees on the board.

Although details are still subject to negotiations, the legislative council's trial balloon in the Japanese newspapers in late March suggests the momentum is in line with the American Chamber and with corporate governance pundits such as Fukao. It has the following characteristics.

First, any firm capitalized at more than ¥500 million (all but the smallest firms) would have to maintain at least one member of the board of directors who has never had any "employment relationship" with the firm or its subsidiaries, (no five-year loophole). This slightly stronger definition of an outsider still does not exclude executives from affiliated firms, main banks, major suppliers or client firms, so independence is likely to remain an issue, but it would assure a nonexecutive presence on the actual board of directors.

Second, any firm of at least ¥500 million would be allowed to dispense with statutory auditor boards if the firm:

- maintains on its board of directors a nominating committee responsible for nominating candidates to the board, a compensation committee responsible for compensation issues, and an audit committee dedicated to overseeing internal and external auditing functions.
- requires a majority (50 percent or more) of each of the three committees to be comprised of outside directors.
- designates a corps of executive officers with responsibility for the actual management of the firm, who may not serve on the board.

The executive officer corps system was introduced first by Sony in Japan in 1997. Since then, an increasing number of Japanese companies have adopted the system. Under the system, the board is restructured so that it is comprised of only those directors who supervise management. As a result, the board size is reduced, the board is able to make prompt decisions and the responsibility for each director is clearer.

"Corporate officers" currently are not formally recognized in commercial law, but they would be given the following formal legal definitions and characteristics in the proposed commercial law revision:

- They would be appointed and dismissed at the discretion of the board of directors.
- Executive officers would face a requirement to report every three months to the board of directors on management developments and conditions.
- Executive officers could collectively decide on stock splits and stock dividends, without seeking shareholder or board approval.
- Executive officers would be subject to shareholder derivative lawsuits, which under current law can only name board members as defendants.

Japanese legal practice effectively has not permitted shareholder class action suits against firms (suits by shareholders who held stock during a defined period in the past), but there have been many high profile shareholder derivative suits in recent years. In these suits, shareholders name members of the board of directors (or the board as a whole) as defendants, and seek damages for losses to the firm caused by some breach of board duty. All damages are paid by the defendant board members to the company, for the benefit of all current shareholders. Some of these suits have identified very large damage claims, and much debate has focused how to manage director liability.

The proposal to include executive officers outside the board as potentially responsible for damages is expected to face intense debate. Proponents argue that the move would boost management accountability and spread the liability risk beyond the board itself, while many executives fear that it will be an excessive risk for officers.

Japan's corporate community and corporate governance experts around the world are left guessing whether, with reforms of this kind, Japanese firms will find the will and the means to identify outside directors who are sufficiently independent and committed. There is a growing consensus that the answer to this question will determine whether boards might start to really function as intended, as overseers of management—able to protect Japanese firms from rogue executives and factional strife, and to rationalize management priorities.

—John Taylor

Japan's June Voting Marathon

Will Activist Funds Respond to Better Disclosure?

This year, Japanese firms will be looking with great interest at how international investors vote on bonuses for retiring Japanese directors. IRRC surveys show these bonuses are the most frequent targets of "no" votes in Japan for three years running.

In recent years, many funds have voted against board severance bonuses for Japanese directors and statutory auditors who have served for three years or less. They have cast their votes this way even though their guidelines offer advice on how to vote based on whether the board member is an executive or nonexecutive. Calpers and several other pension funds, for example, have long held that only executive insiders should be eligible for such payments. Some institutional investors have told IRRC that the three-year standard is relatively easy to follow, and that the lack of disclosure about "insiders" and "outsiders" made the other type of guideline impossible to apply. The shortcut approach prompts many to vote against such bonuses. Several pension funds have said the large number of "no" votes should serve as a protest for the lack of disclosure about which prospective recipients are executive insiders and which are not.

Because information about the status of board members is being disclosed more frequently, those funds that believe the guidelines should address whether recipients are outsiders or insiders need to decide how they will vote on these bonuses.

Some funds might stick with the three-year rule out of convenience, and others might not. However, IRRC is tracking the growing number of Japanese firms that provide supplemental data on insider status in severance bonus proposals. This improved disclosure raises concerns because global investors continue to vote "no" even when companies think they have provided enough supplemental data to establish if the bonus is for an insider or an outsider, corporate Japan's first modest attempt to boost disclosure in response to investor voting guidelines could go unrewarded.

In proxy season 2000, many investors did not take the supplemental data disclosure into account. In a research survey of voting behavior last fall, IRRC examined voting results from pension funds with Japanese holdings.

The sample included several funds that identified insider vs. outsider status as the vote trigger. IRRC could not find any fund that made use of the fact, when firms on their portfolios clearly identified the bonus recipients as executive insiders. They cited lack of time, limitations of their voting agent, or a failure to recognize in time that the new data directly addressed their guideline.

Perhaps even more than last year, Japanese firms are wondering if their extra efforts will have "any impact at the polls."

—John Taylor

Asset-Rich Japanese Firms Targeted

This spring, Kentucky Fried Chicken joined the list of major shareholder firms that have demanded changes in Japanese management policy and have achieved results.

Seven years ago, the president of the Japanese oil company Tonen (more recently merged to become Tonen General) resigned under pressure from Exxon and Mobile (then still separate), which jointly held a controlling 50 percent share in his firm. The two oil giants prevailed, over the president, Nobuyuki Nakahara, and Tonen began to deflate its enormous cash reserves under a new president. Since then, Japanese CEOs have rarely dared to resist the stated will of a majority of shareholders.

The most recent case appears to be equally successful, but apparently more amicable. A Japanese corporate shareholder is putting pressure on Kentucky Fried Chicken Japan. The U.S. parent, Kentucky Fried Chicken, holds 31 percent of the equity, matched by Mitsubishi's 31 percent. According to an informed source, both KFC (U.S.) and Mitsubishi prevailed on KFC Japan's management to rationalize its capital deployment. KFC Japan agreed to boost its dividend from ¥30 per share to a whopping ¥140 for the year ended November 2000, and, more recently, it has told the press that it

plans to boost it further over the next three years. In fact, it says its "ordinary" dividend (implying a minimum dividend level for some time into the future) will be ¥200.

Clearly fewer sparks flew in the KFC case than at Tonen seven years earlier. Shortly after KFC Japan announced the plans for its first big boost in the dividend at a press conference last July, a senior managing director of KFC Japan, Mitsuru Uno, commented that the higher dividend and expected stock price rise "might have the effect of encouraging our two largest shareholders (KFC (U.S.) and Mitsubishi) to sell some of their holdings."

American petroleum and fast food firms are not the only ones to target wasteful asset accumulation at Japanese firms. Pundits in Japan and abroad say it contributes to a poor return on assets, it might reduce accounting transparency and it could dampen pressure on managers to efficiently pursue core business opportunities.

Japan's first home-grown hostile takeover bid, in which Yoshiaki Murakami's M&A Consulting sought to acquire asset-rich Shoei last year, spotlighted this problem. M&AC is not promising any repeat performance of a hostile takeover bid in the 2001 season, but Murakami emphasized the need for investor activism at last year's International Corporate Governance Network conference in New York. He stressed that too many Japanese firms shoulder inefficiently large loads of dormant assets. The situation exists, he said, because of taboos against hostile takeovers and a tradition in Japan of docile shareholders.

Although the bid for Shoei ultimately failed when the largest shareholders refused to sell their positions, a spokesman for M&AC said his firm is pleased with Shoei's actions after the takeover attempt. Last June, Shoei responded to a draft shareholder proposal by M&AC and increased its dividend. More recently, Shoei's board voluntarily boosted its dividend even more, and replaced long-standing president Tanehiko Kamiura, whom Murakami has characterized as "old guard."

In early February, M&AC launched a new "MAC Japan Active Shareholder Fund," in the Cayman Islands. So far, M&AC executive (and former IRRC intern), Hiroyuki Fujii, confirms the fund has signed on a number of Japanese institutional and corporate investors, several in the form of trust banks managing Japanese pension assets. The fund also is expected to begin recruiting overseas investors shortly. The new fund will pursue shareholder activism in much the same way as the Lens Fund.

M&AC's holdings in one firm, Allied Materials (the product of last year's merger of Tokyo Tungsten and Osaka Diamond Industrial), have exceeded 5 percent of outstanding shares, and M&AC was obligated to disclose this position to the Japanese Finance Ministry under Japan's "5 percent Rule." The firm remains tight-lipped about any plans to effect changes there.

In an illustration of its amicable approach, M&AC has exerted influence over Tokyu and its partial subsidiary, the Tokyu Hotel Chain. Murakami's team provided consulting services to Tokyu over the past year, and actually sought management's blessing before becoming a significant shareholder. M&AC has now bought large stakes in both the parent company and the hotel subsidiary. M&AC came to the conclusion that the group could be more efficiently run if the parent company were to buy up the publicly traded shares of the hotel chain, de-list the subsidiary, and take it private. In fact, Tokyu agreed to the suggestion, and the move is up for shareholder approval as a management proposal at the hotel company's March annual meeting.

Some investors are looking with keen interest at M&AC's future plans. Nomura Research Institute's Asset Management Research Chief Masahiko Igata notes that there are well more than 100 companies in Japan that might qualify as asset-rich to the point of being inefficient. His data shows that there are 102 firms that have share prices that appear to be smaller than their net current asset values, suggesting they would be worth more broken up and liquidated than they are worth as going concerns. Igata says he has been in contact with Murakami. M&AC may not have to look far for promising targets.

—John Taylor