



Corporate Governance

BULLETIN

— Covering Shareholder Issues Worldwide —

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While Some Firms Keep Pace with Governance Changes, Others Must Catch Up, Finds IRRC

In the aftermath of some spectacular corporate failures recently, companies continue to struggle to implement practices commonly associated with “good” governance, finds IRRC’s recently published annual analysis of the structure and composition of the boards of directors at S&P 1,500 companies.

While many firms are ensuring that a majority of independent directors sit on their boards and are creating audit committees comprised entirely of independent directors, others continue to have too few independent directors serving on their nominating committees and in positions of board leadership. IRRC analysis shows that 71 percent of S&P 1,500 companies and 66 percent of NYSE companies will need to make some type of change if the proposed rules relating to board and committee independence are implemented. The 2002 edition of *Board Practices/Board Pay 2002* covers a total of 1,245 companies in the S&P 500, MidCap, and SmallCap indices.

Landmark reforms prompted by this year’s accounting debacles will continue to stimulate gover-

nance changes. The major stock exchanges have proposed new listing rules that will require that boards and key board committees—including audit, compensation, and nominating—are comprised solely of independent directors. (At press time, the proposed listing rules were pending SEC approval.) The Sarbanes-Oxley Act of 2002 codifies audit committee authority and responsibilities, establishes new accounting firm oversight, compels top executives to certify their financial statements, and increases penalties for executive malfeasance, among other things.

These rules, along with a new level of consciousness about the critical role of governance in preventing future corporate meltdowns, are likely to sustain the recent progress toward governance “best practices” in the future.

Board and director independence

Independence is one of the key elements proposed by the stock exchanges to maintain investor confidence in public companies and

their management. Under the governance changes, proposed by NYSE, Nasdaq and Amex, boards will have to consist of at least a majority of independent directors (although the definition of independence set forth by each exchange varies). Currently, there are no requirements for overall board independence.

In recent years, many companies have made efforts to ensure that a majority of their directors are independent. The percentage of companies with at least a majority (50 percent or more) of independent directors serving on the board is 85 percent among all companies surveyed, based on IRRC’s definition of independence. IRRC’s definition says any director who is linked to the company through certain relationships, and whose views may be affected because of such link is not independent. IRRC considers the following factors to determine if a director is affiliated:

☛ A former employee of the company or of a majority-owned subsidiary.

• A provider of professional ser-

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Average Voting Results on Significant U.S. Governance Shareholder Proposals

Vote tallies on 2002 shareholder proposals indicate general increased support, on average, for major issues.

	2002		2001		Trend [^]
	# of proposals	Average vote+	# of proposals	Average vote+	
<i>(X) = proposals pending</i>					
Eliminate supermajority vote	10	61.5	12	57.9	+3.6
Repeal classified board	41	61.3	46	52.4	+8.9
Redeem or vote on poison pill	50	60.2	22	57.0	+3.2
Confidential voting	5	59.4	7	52.9	+6.5
Increase compensation committee independence	2	43.1	2	42.1	+1.0
No repricing underwater stock options	2	41.0	1	46.6	–
Separate CEO and chairman	3	35.8	3	15.7	+20.1
Vote on future golden parachutes	18	35.3	13	31.8	+3.5
Provide for cumulative voting	19	33.2	19	30.4	+2.8
Increase board independence	12	30.8	7	22.5	+8.3
Increase board diversity (1)	3	21.2	6	20.5	+0.7
Increase nominating committee independence	6	20.3	2	38.6	-18.3
Performance-based stock options	4	19.9	9	25.9	-6.0
Restrict executive compensation*	8	16.0	17	12.2	+3.8
Sell company/spin off/hire investment banker	2	13.5	21	13.2	+0.3
Disclose executive compensation	2	10.1	2	9.2	+0.9

+ *Vote as percentage of shares voted for and against, abstentions excluded*

* *Includes proposals to restrict executive pay, cap executive pay and link executive pay to performance*

[^] *Trend figures are calculated for categories with more than one proposal*

(continued from p. 1)

vices—such as legal, consulting or financial—to the company or an executive. These services may be provided either personally by the director, by an immediate family member of the director, or by the director's employer.

- A customer of or supplier to the company, unless the transaction occurred in the normal course of business. These relationships may be between the director, an immediate family member of the director, or the director's employer.

- A designee under a documented agreement between the

company and a group, such as a significant shareholder.

- A family member of an executive.
- An interlocking directorship.
- An employee of an organization or institution that receives charitable gifts from the company.

The 85 percent of boards that had majority independent boards are an increase of eight percentage points from just five years ago when 77 percent of companies had majority independent boards. Figure 1 shows that the proportion of companies with majority independent boards has increased only one

percentage point from the prior year, however, suggesting that voluntary increases in independence are leveling off.

Despite the increase in the overall proportion of companies with majority independent boards, many boards still do not contain enough independent directors to satisfy activists. These shareholders encourage companies to ensure that at least two-thirds of their directors are independent. Only 57 percent of companies analyzed have boards that are at least two-thirds independent.

Some companies will have to

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make significant changes to their boards to comply with the proposed independence rules. For example, the five companies listed in Table 2, which are those in the study with the least independent boards at the time they held their 2002 annual meetings, will need to alter the composition of their boards to reach the 50 percent independence level.

Board committees

Corporate governance reforms initiated by the major exchanges and under the Sarbanes-Oxley Act also will affect board committees. Generally, the new exchange rules will tighten the definition of independence for audit committee members, and will require that the functions of the compensation and nominating committees be carried out by a committee of independent directors, or, if the company does not have a committee, by a majority of their board's independent directors.

Nominating committees will be most affected by the new exchange rules. Only 74 percent of the companies surveyed have nominating committees in place, and only half of those committees are 100 percent independent. The percentage of companies with nominating committees increased from 68 percent last year, the biggest jump in several years. This may be in response to increasing pressure from investors and governance advocates making the director recruitment process more independent of management. The prevalence of nominating committees is directly tied to company size—88 percent of S&P 500 companies currently have nominating committees, while only 63 percent of SmallCap companies have committees with nominating responsibilities.

Independence levels on audit and compensation committees already are high because they currently are subject to regulation or stock exchange requirements. Even with existing regulations, however, fewer than 75 percent of companies have 100 percent independent audit or compensation committees. Previous stock exchange rules adopted in late 1999, which were designed to provide a framework for audit committees and to improve audit committee effectiveness, have affected the independence of audit committees. The average level of independence on audit committees now stands at 90 percent, an increase of eight percentage points since 1998. Seventy-one percent of audit committees are now 100 percent independent, up from just 50 percent in 1998.

Corporate governance committees and guidelines

Only 41 percent of companies analyzed have a committee in place with corporate governance responsibilities—a committee that oversees the governance policies and processes of the board and company. Proposed NYSE rules would require all listed companies to have nominating/governance committees and to adopt and disclose corporate governance guidelines.

These guidelines would have to be included on each company's website and be available in print at the request of any shareholder. Companies often do not disclose corporate governance guidelines. Only 44 study companies disclosed their corporate governance guidelines in either their 2001 or 2002 proxy statements.

Board leadership

In recent years, corporate governance activists have advocated that companies have an independent leader on the board—either an independent board chair or a lead director. These activists contend that CEOs who also serve as board chairs effectively control the board of directors. Companies do not appear to share that view. Only 7 percent of companies have an independent board chair, according to IRRC's definition of independence, and only 3 percent have designated a lead director.

Although it is common practice for companies in other markets, particularly the United Kingdom, to separate the board chair and CEO positions, companies in the United States have not caught on to this idea. Recently, as part of its proposed new listing rules, the NYSE considered requiring companies to separate their CEO and board chair positions. Ultimately,

Figure 1

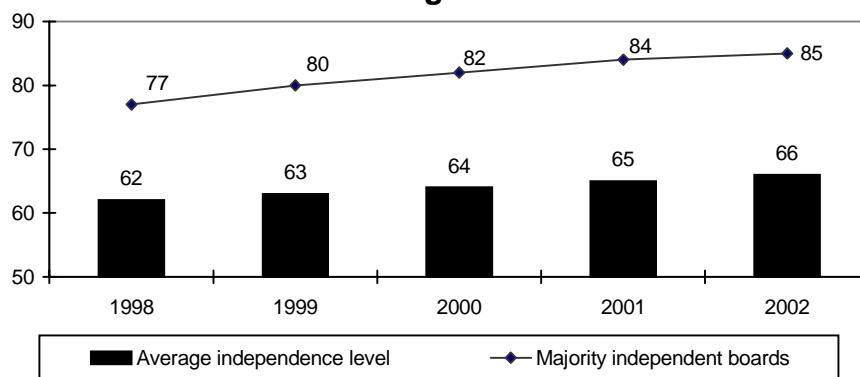


Table 2: Top five least independent boards*

Company	S&P Index	Board size	# Independent directors	% Board Independence
Dreyer's Grand Ice Cream	MidCap	8	1	12.5
Papa John's International	MidCap	8	1	12.5
Bed Bath & Beyond	S&P 500	7	1	14.3
Atmel	MidCap	6	1	16.7
Nature's Sunshine Products	SmallCap	6	1	16.7

* Based on board structure disclosed as of the 2002 annual meeting

this requirement was not included in the final rules. Had the NYSE gone ahead with this proposal, it would have resulted in significant changes to the structure of boards at NYSE-listed companies.

Leadership of the board continues to be held by the CEO at most companies—only 27 percent of the companies in this year's study have separated the positions of CEO and chair, and only about a quarter of those are considered "independent" chairs. Nine percent of all the companies surveyed have a non-employee director who still has ties to the company serving as board chair, and 84 percent of these directors once were employed by the company.

Table 3 illustrates a three-year trend that suggests that more companies are separating their chair and CEO positions; however the companies are not ensuring that their chair is independent of management. SmallCap companies are most likely to separate the positions. Smaller companies also are more likely to have an independent director serving as board chair.

In 2002, just 3 percent, or 41

of the companies surveyed, have identified a "lead" director (typically an independent board member). Of these 41 companies, more than half are in the S&P 500 index. Although the NYSE stopped short of requiring listed companies to have lead directors, its proposed rules mandating that non-management directors hold regular executive sessions without the CEO present are likely to result in an increase in lead director designations (alternatively, companies may establish a lead director position to be held by non-management directors on a rotating basis).

Board diversity

In recent years, there has been more focus on diversifying boards of directors. Diversified boards are encouraged for multiple reasons. Many believe that if a board's strategy for selecting qualified candidates includes selecting those from a variety of backgrounds, then a policy of diversified recruitment will follow through to all levels of the company. A diverse board projects a positive image for current and prospective employees

and investors, and for the community. In addition, a diverse board can provide added insights that can influence decision making.

One of the most important reasons for diversification may be that women and minority directors tend to be more independent than other directors. Eighty-six percent of directorships held by women are classified as independent. This is significantly greater than the percentage of independent directors among all directors surveyed: out of 11,833 directors, 70 percent are considered independent. Like women, minority directors are likely to be independent directors: 82 percent of the directorships held by minorities are classified as independent.

The demand for diversity on boards is hindered by a lack of diversity in executive suites, from where most companies recruit their directors. Only 1.6 percent of all directorship positions are held by female CEOs, and minority CEOs hold 1.6 percent of all directorships. Because so few women and minorities hold top executive positions, companies often are competing for the same individuals to diversify their boards.

In order to comply with the new regulations that will be imposed by the NYSE, Nasdaq and AMEX, most companies will need to make some changes to their current governance structures. IRRC's analysis of S&P 1,500 companies highlights the latest trends and the changes that companies must make in these corporate governance areas. —Stacey Burke

Table 3: Trends in separate chairman/CEO at S&P 1,500 companies

	# with separate chair/CEO	% with separate chair/CEO	% with non-employee chair	% with independent chair
All Companies				
2002	342	27%	16%	7%
2000	272	23%	13%	6%
Three- year change	71	5%	3%	1%

Shareholders' Focus on Stock Options Intensifies

Excessive executive pay and the increasing use of stock options to compensate CEOs have been long-standing concerns for activist investors. Stock-based grants and option awards generally are made under stock incentive plans that must be approved by shareholders, but investor concern has deepened, especially over issues of dilution, option expensing and stock-based grants made outside of shareholder-approved equity plans. With these so-called "broad-based" plans, shareholders are stripped of their control over the creeping dilution to their investments resulting from those grants.

The recent market downturn and the corporate scandals that depleted many employees' retirement savings while executives made fortunes have led to even more focus on non-shareholder-approved plans. Consequently, the stock exchanges, the SEC, and other prominent players in the corporate governance arena have proposed rules and issued opinions on the matter. (See Table 2 on p. 8.)

Stock plan approval

On June 6, 2002, the New York Stock Exchange (NYSE) Corporate Accountability and Listing Standards Committee submitted a report to the NYSE board recommending significant changes to the exchange's corporate governance rules. Current NYSE rules exempt a stock option or stock purchase plan from shareholder approval if it is "broadly-based." A plan is "broadly-based" if at least a majority of the non-officer employees are eligible to receive stock option

grants under the plan. In addition, at least a majority of the stock awards and stock option grants during any three-year period must be awarded to non-officer employees under the plan. Other exemptions to the existing shareholder approval requirement are for inducement grants to new employees and plans that meet certain dilution limits. The report recently issued by the NYSE Corporate Accountability and Listing Standards Committee recommended that all equity plans be subject to shareholder approval. As proposed, the new rule would require that shareholders be given the opportunity to vote on all equity compensation plans. Exemptions would be made to permit inducement grants to new employees and for certain tax-qualified plans, i.e. employee stock ownership plans and 401(K) plans. Assumption of pre-existing grants in connection with a merger or acquisition would be exempt as well. (See Table 3 on p. 10.)

The Nasdaq and AMEX followed suit by submitting similar proposals to change corporate governance rules to require shareholder approval of all equity compensation plans. Both the NYSE and the Nasdaq have submitted their proposals to the SEC. The comment period for the new NYSE listing standards ended October 29; the Nasdaq's ended November 1. Both proposals currently are awaiting further SEC action.

In a September 2002 speech before the Council of Institutional Investors, SEC Chairman Harvey L. Pitt announced his support for the changes proposed by the NYSE

and the Nasdaq. He said the SEC is "working hard to pull together a comprehensive rulemaking to address these issues and it will include reforms such as requiring stockholder approval of all stock option programs..." Now that Pitt has announced his resignation, his post, his successor may or may not move quickly to implement these reforms.

Earlier, in December 2001, the SEC issued a ruling on the disclosure of information on equity compensation. According to the new rule, companies are required to disclose all shares reserved under equity compensation plans. Shareholder-approved and non-shareholder-approved compensation plans must be listed separately. All public companies with fiscal years ending on or after March 15, 2002, and with shareholder meetings on or after June 15, 2002, are required to comply with the ruling.

This information is required to be disclosed in annual reports on Forms 10-K and 10-KSB. In addition, the information also must be included in a company's proxy or information statement in years in which the company is submitting a compensation plan for shareholder approval. The new equity table must include the number and weighted average exercise price of outstanding options, warrants and rights, as well as the number of securities available for future issuance under existing equity compensation plans.

The number of companies with non-shareholder-approved plans known to IRRC has increased greatly in recent years, which is

partly due to the enhanced disclosure requirements. According to the previous edition of the *Stock Plan Dilution* study, IRRC was aware of 131 plans (i.e. 10 percent of 1,219 study companies) that are in place without shareholder approval. This number has almost doubled and now stands at 237 plans among the 1,458 companies that are included in the latest edition of the study (i.e. 16 percent).

An analysis of the enhanced information now disclosed in SEC filings shows that, on average, non-shareholder-approved plans account for 10 percent of the total company overhang (or the sum of outstanding grants and shares available divided by total outstanding common). Among the 120 companies examined, an average dilution of 2.3 percentage points was created by non-shareholder approved plans. The average overall company dilution for these early reporting companies is 22.8 percent.

Shareholder proposals

TIAA-CREF focused its efforts on broad-based plans during 2002 by submitting shareholder proposals to five companies (Adobe Systems, Autodesk, Cadence Design Systems, Synopsys and Mentor Graphics) that have active option plans that did not receive shareholder approval. (See Table 1 below.) The proposals asked the companies to submit all equity compensation plans with material dilution, and amendments to add shares to those plans, to shareholders for approval. All five companies have a high total company overhang of above 20 percent.

The SEC ruled that the proposals submitted to Adobe Systems, Autodesk, Cadence Design Systems and Synopsys could be omitted from the company's proxy

statements because they relate to "ordinary business." Mentor Graphics did not challenge the proposal at the SEC and gave shareholders an opportunity to vote on it at the 2002 annual meeting. The proposal passed, receiving 57.2 percent of the votes cast. (See Table 1.)

Good-bye to the ordinary business rule?

In an SEC Staff Legal Bulletin dated July 12, 2002, the commission announced that it changed its 'ordinary business' rule policy on shareholder proposals regarding the approval of stock plans. "We believe that the public debate regarding shareholder approval of equity compensation plans has become significant in recent months. Consequently, in view of the widespread public debate regarding shareholder approval of equity compensation plans and consistent with our historical analysis of the 'ordinary business' exclusion, we are modifying our treatment of proposals relating to this topic."

Going forward, the SEC would no longer allow companies to exclude a shareholder proposal if the proposal calls for shareholder approval of equity compensation plans in which only senior executive officers and directors may participate.

In addition, companies may no longer omit shareholder proposals from their proxy statements if the proposal calls for shareholder approval of equity compensation

plans for senior executives, directors and the general workforce that would result in material dilution to existing shareholders.

In September 2002, SEC Chairman Pitt proposed that the "ordinary business exception" be eliminated from the list of reasons that companies could use to exclude otherwise valid shareholder proposals. If implemented, his proposal would significantly affect the number of shareholder proposals that ultimately are included in company proxy statements, including those that address non-shareholder-approved plans. In addition, if proposed changes to the listing requirement of the NYSE, Nasdaq and Amex relating to shareholder approval of all equity compensation plans are adopted, shareholder proposals on this matter no longer will be needed. (As illustrated in Table 2, governance activists would welcome that action.)

Option expensing

The question of if and how to require companies to expense the cost of stock option grants also has received much attention in the wake of the accounting scandals at Enron, WorldCom and others. A recent Bear Stearns study on options concluded that the aggregate diluted earnings per share (EPS) for S&P 500 companies would drop 20 percent if the fair value of employee options were charged to earnings.

Current Financial Accounting
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Table 1: Shareholder proposals calling for shareholder approval of equity compensation plans

<i>Company</i>	<i>Proponent</i>	<i>Status</i>
Adobe Systems	TIAA-CREF	omitted
Synopsys	TIAA-CREF	omitted
Autodesk	TIAA-CREF	omitted
Mentor Graphics	TIAA-CREF	57.2 percent (passed)
Cadence Design	TIAA-CREF	omitted

Table 2: Key players in corporate governance on the issue of shareholder approval of equity compensation plans

Conference Board

In September, the Conference Board issued suggestions on executive compensation best practices, which call for shareholder approval of all stock plans because, the groups says, shareholders should have the final say in determining how much dilution they may suffer as a result of equity compensation programs. The Conference Board also mandates shareholder approval of material modifications of existing arrangements, including stock option repricings.

The Corporate Library

In a comment letter on the proposed Nasdaq rules, Michelle Edkins, Corporate Governance Director of the Corporate Library, says, We support whole heartedly Arthur Levitt s recent comment that shareholder approval of any plan that materially dilutes their ownership interest is a matter of basic corporate fairness. Many of the stock option plans in operation at Nasdaq-listed companies, in particular, involve a considerable transfer of wealth from the existing shareholders to the officers and directors.

National Association of Corporate Directors

In an August press release, the National Association of Corporate Directors announced its support for the proposed listing requirements released by the NYSE and Nasdaq. The NACD adds that it has collaborated closely with both NYSE and Nasdaq in the development of the proposals, particularly on issues regarding board independence and director education.

Business Roundtable

In section IV of its *Principles of Corporate Governance*, the Business Roundtable says, Because stockholders have a particular interest in the amount and nature of equity compensation paid to directors and senior management, corporations should obtain stockholder approval of new stock options and restricted stock plans in which directors or executive officers participate.

Council of Institutional Investors (CII)

The Council of Institutional Investors says in its policies, Shareholders should have the opportunity to vote on all equity-based compensation plans that include any director or executive officer of the company. Shareholders should also have the opportunity to vote on any equity-based compensation plan where the number of reserved shares, together with the company s outstanding equity-based awards and shares available for grant, may have a material impact on the capital structure of the company and the ownership interests of its shareholders. Generally, 5 percent dilution represents a material impact, requiring a shareholder vote.

TIAA-CREF

In its *Policy Statement on Corporate Governance*, TIAA-CREF says, All plans that provide for the distribution of stock or stock options to employees and/or directors should be submitted to shareholders for approval. TIAA-CREF expects that all stock-based plans for which executives and directors are eligible, and any plan that could result in significant dilution, will be submitted to shareholders for approval. TIAA-CREF has developed decision-rules to guide its voting of proxies related to these proposals.

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Standards Board (FASB) rules permit companies to report stock option grants in one of two ways. Under APB 25, the "intrinsic value" method (used by most publicly traded companies) measures compensation cost as the excess of the market price of the stock at the grant date over the exercise price.

As most stock options are granted at 100 percent fair market value on the grant date, companies using the "intrinsic value" method of stock option accounting essentially have a "zero" charge against their earnings. The second method, the "fair value" method under FAS 123, determines compensation cost based on the fair value of the award, generally using Black-Scholes methodology, and recognizes it as an expense in the income statement. Under FAS 123, all companies are required to disclose the fair value of all options granted. Companies using the intrinsic value accounting method need to do this only in a note to the financial statements on a pro forma basis.

In early October, FASB proposed changes to the current method of accounting for stock-based compensation that amend the transition and disclosure provisions of FAS 123. The proposed changes provide three methods of transition for companies that voluntarily adopt the fair value method of recording expenses relating to employee stock options.

In addition, FASB proposed to amend the requirements of FAS 123 to require clearer and more prominent disclosures about the method and cost of stock-based employee compensation, and to increase the frequency of those disclosures. Companies will be required to list the costs of stock-based compensation in the "Sum-

mary of Significant Accounting Policies," which generally is disclosed in the first footnote to the company's financial statements.

Currently, the pro forma income and earnings per share are required to be disclosed in the equity compensation footnote to consolidated financial statements, which includes information on equity incentive plans. FASB solicited comments on the proposed rules until Nov. 4, 2002. It plans to issue the amendment to Statement 123 by the end of this year, and its provisions would be effective immediately. The proposed disclosures in annual financial

During the past few months, more than 100 companies have announced that they will begin to charge the cost of stock options to their earnings statements.

statements would be required for fiscal years ending after Dec. 15, 2002. The proposed disclosures to be provided in interim financial information would be required as of the first interim period beginning after Dec. 15, 2002.

In a July 2002 news release, FASB says recognizing compensation expenses that relate to the fair value of employee stock options granted is the preferable approach under current U.S. accounting standards (*FASB Statement No. 123, Accounting for Stock-Based Compensation*). In addition, the International Accounting Stan-

dards Board (IASB) has announced plans to issue a proposal for public comment. That proposal would require companies using IASB standards to recognize, starting in 2004, the fair value of employee stock options granted as an expense in arriving at reported earnings. During the past few months, more than 100 companies have announced that they will begin to charge the cost of stock options to their earnings statements. Among them are such blue-chip companies as General Electric, General Motors, Citigroup, Coca-Cola and Amazon. Also in July 2002, TIAA-CREF announced an intensive campaign to urge public companies to begin expensing stock options. The Council of Institutional Investors has indicated that it plans to follow suit.

Shareholder proposals

Labor funds began to file option expense proposals this year at companies with late 2002 annual meeting dates. Doing so allows them to take advantage of the recent publicity surrounding the issue of option expensing. IIRC currently is tracking 62 option expense shareholder proposals. (See Table 5 on pages 13 and 14.)

Earlier this year, the SEC ruled that National Semiconductor could omit the option expense proposal based on the fact that the company's choice of how to expense its options is a choice of accounting methods and, therefore, relates to ordinary business matters. The proposal requested that the board of directors establish a policy and practice of expensing in the company's annual income statement the costs of all future stock options issued to company executives. As a result of the SEC's decision on National Semiconduc-

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Table 3: Shareholder approval of equity plans current and proposed listing rules

Stock Exchange	Summary of <i>proposed</i> listing rules	Summary of <i>current</i> listing rules
NYSE	<p>To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans, except:</p> <ul style="list-style-type: none"> • inducement awards, • plans relating to mergers or acquisitions, and • tax qualified and parallel nonqualified plans. 	<p>Shareholder approval is required with respect to a stock option or purchase plan, or any other arrangement, for officers or directors except:</p> <ul style="list-style-type: none"> • pursuant to a broadly-based plan (at least a majority of the company's full-time employees are eligible to receive stock or options under the plan; and at least a majority of the shares of stock or shares of stock underlying options awarded under the plan during any three year period must be awarded to employees who are not officers or directors of the company); • inducement awards; • no officer or director may acquire more than 1 percent of the company's outstanding stock, or all non-shareholder approved arrangements do not authorize more than 5 percent of the company's outstanding stock for issuance.
NASD	<p>Shareholder approval is required when a stock option or purchase plan is to be established or materially amended or other arrangement made pursuant to which options or stock may be acquired by officers, directors, employees, or consultants, except for:</p> <ul style="list-style-type: none"> • tax qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans; • plans relating to an acquisition or merger; or • inducement grants. <p>Inducement grants, tax qualified non-discriminatory benefit plans, and parallel nonqualified plans are subject to approval by either the issuer's compensation committee, or a majority of the issuer's independent directors.</p>	<p>Shareholder approval is required for a stock option or purchase plan pursuant to which stock may be acquired by officers or directors, except:</p> <ul style="list-style-type: none"> • broadly based plans or arrangements including other employees (e.g. ESOPs); • inducement grants; • plans or arrangements that authorize the lesser of 1 percent of common stock outstanding, 1 percent of the voting power outstanding, or 25,000 shares.
Amex	<p>Amex-listed companies must obtain shareholder approval of all stock option plans subject to limited exceptions, and brokers will not be permitted to vote their customers' shares on stock option plan proposals without instructions from the customer.</p>	<p>Shareholder approval is required to list additional shares reserved for options granted or to be granted to officers, directors or key employees, except for:</p> <ul style="list-style-type: none"> • inducement grants not to exceed 5 percent of the company's outstanding common stock; • under plans in which all of the company's employees participate; • and under plans for officers, directors or key employees that do not authorize the issuance of more than 5 percent of outstanding common stock in any one year, or more than 10 percent in any 5-year period under all non-shareholder approved arrangements.

(continued from p. 9)

tor, companies have been able to omit these types of proposals because of their infringement on the “ordinary business” rule. So far, Clayton Homes and SWS Group chose not to challenge the option expense proposal at the SEC and consequently included the proposal in their proxy statements. Clayton Homes shareholders voted on the proposal at the company’s October 30 annual meeting, and it received the support of about 24 percent of votes cast according to a preliminary tally. At SWS Group’s November 6 annual meeting, 30.1 percent of the votes cast supported the proposal.

The SEC finally took a stand on the option expensing issue on December 6 when it issued a decision on a proposal submitted to National Semiconductor. The full commission’s decision said, “in the future, we will not treat shareholder proposals requesting the expensing of stock options as relating to ordinary business matters.” The proponent that submitted the proposal, the United Brotherhood of Carpenters and Joiners of America, had appealed the original no-action letter issued in July by the SEC, which had allowed the company to omit the proposal because the commission said it pertained to the company’s ordinary business. The AFL-CIO also joined the campaign urging the SEC to reconsider its position on stock option expensing. In an August 30 letter, AFL-CIO Associate General Counsel Damon Silvers challenged the SEC’s previous decision to allow National Semiconductor to omit the option proposal from its proxy statement. He argued for inclusion of such proposals on the grounds that stock option expensing is a significant policy issue and that it relates to executive compen-

sation, and thus falls under the existing commission staff policy of allowable proposals.

Although the SEC’s December 6 decision will allow many option expensing proposals to be included in companies’ 2003 proxy statements, National Semiconductor held its meeting on October 18 and did not include the carpenter’s proposal in its proxy statement.

On October 11, the SEC staff issued a rather vague opinion on an option expensing proposal submitted to Mercury Computer Systems. The staff said at that time it could not “express any view with respect to whether it concurs or does not concur with [Mercury

The AFL-CIO joined the campaign urging the SEC to reconsider its position on stock option expensing.

Computer Systems’] view [to] omit the proposal.” The resolution, which was submitted by the International Brotherhood of Teamsters and requested that the board establish a policy and practice of expensing in the company’s annual income statement the costs of all future stock options issued to company executives, was not included in the company’s proxy statement for its November 19 special meeting. The company said without an official change in the SEC’s position, it omitted the proposal on the grounds of existing precedent (namely the National Semiconductor decision). The Teamsters challenged the company’s decision not to include their proposal in the proxy statement. In a letter to

Gary Olin, director of communications at Mercury Computer Systems, the Teamsters’ General Counsel Patrick Szymanski demanded that the company cease and desist all publication and distribution of its proxy materials that excluded the option expensing proposal. In addition, the union wrote a letter to the Director of the SEC’s Enforcement Division urging the commission to take action against the company.

The building trades unions, led by the United Brotherhood of Carpenters and Joiners of America, are focusing on the issue of stock options with two proposals for the upcoming 2003 proxy season. The first asks the company’s board of directors to establish a policy of expensing in the company’s annual income statement the costs of all future stock options issued. In the proposal’s supporting statement the proponents note, “The lack of option expensing can promote excessive use of options in a company’s compensation plans, obscure and understate the cost of executive compensation and promote the pursuit of corporate strategies designed to promote short-term stock price rather than long-term corporate value.” Ed Durkin, director of special projects at the Carpenters says, “Ultimately this needs to be handled as a universal change, but in the meantime this is an opportunity for shareholders to go on record with their support.” Table 3 on page 13 lists recent option expensing proposal submissions.

The second proposal asks the company’s board to adopt an executive compensation policy that all future stock option grants to senior executives be performance-based. For the purposes of this resolution, that means the option exercise price is linked to an in-

dustry peer group stock performance index, so that the options have value only to the extent that the company's stock price performance exceeds the peer group performance level. "Implementing an indexed stock option plan would mean that our company's participating executives would receive payouts only if the company's stock price performance was better than that of the peer group average," note the proponents. "By tying the exercise price to a market index, indexed options reward participating executives for outperforming the competition."

Carpenters' funds have filed the "expense options" proposal at Analog Devices, Bear Stearns, R.R. Donnelley, Genuine Parts, Lehman Brothers, and Starbucks; and have filed proposals seeking indexed options at Morgan Stanley, SunTrust Banks and Tyco International. The Laborers International Union funds have filed a proposal to expense options at Cincinnati Financial and proposals to index options at Bear Stearns and Texas Instruments. The Sheet Metal Workers International Association has filed a proposal to index options at General Electric. (Calpers recently announced that it would be co-filing a similar proposal at GE with the LongView fund. It is not clear whether SMWIA is a co-filer of that resolution or is filing an additional resolution on the same topic.)

In the past, when proposals seeking indexed-priced options were filed, companies argued that adopting the proposals' recommendation would put them at a competitive disadvantage because that type of option requires a variable charge to earnings under current accounting rules. They contended that their operating income would

thus appear lower than that of competitors. Now, these union funds are using the continued public attention surrounding stock option accounting as an impetus to take the issue a step further and look at the basis by which options are awarded.

The funds are paying particular attention to companies that already have announced their intention to expense options. With the argument related to the expense of performance-based options eliminated, the funds hope strong

The labor funds are paying particular attention to companies that already have announced their intention to expense options.

shareholder votes will encourage these companies to index their options. The funds have filed indexing proposals at the following companies that have either expensed or plan to expense their options: Morgan Stanley, Goldman Sachs Group, SunTrust Banks, and General Electric. The funds expect to file proposals at a number of the approximately 135 companies that have announced that they are adopting this policy change.

Total overhang continues to rise

Through option expensing and shareholder approval of stock plans, investors hope to rein in widespread use of options to compensate executives and the resulting stock option overhang. IRRC's

latest analysis of 1,458 companies listed in one of the three S&P indices (S&P 500, S&P MidCap 400, S&P SmallCap 600) indicates that average company dilution has again increased in the past year.

Average overhang from stock plans at the S&P 1,500 companies studied now stands at almost 16 percent. This is up from about 14 percent in 2002. The latest findings, which are included in IRRC's upcoming *Stock Plan Dilution 2003* study, show continuation of trends from previous years. The average dilution of most economic sectors is between 12 percent and 15 percent. Exceptions are the Energy and Utility sectors at the low end of the spectrum (both 8 percent average dilution) and Information Technology companies at the high end of the spectrum (24 percent average dilution). Average dilution among the three S&P 1,500 indices falls between 15 percent (S&P 500 companies) and 18 percent (SmallCap companies). MidCap companies have an average dilution of 17 percent in 2002.

Companies continue to use stock options liberally to compensate their employees. The number of options granted in the last fiscal year dilutes shareholder interests by an average of 2.5 percent. The annualized average three-year grant rate is 2.3 percent, up from 2.1 percent in the prior year. CEOs received on average 10 percent of all options granted. One quarter of all options granted in the last fiscal year went to the top five executive officers.

The study, which also contains information on non-shareholder-approved plans, voting on stock plans, evergreen plans, and stock purchase plans, may be ordered at www.irrc.com.

—Annick Dunning

Table 5: Shareholder proposals on stock option expensing

Company	Proposal	Proponent	Status
Analog Devices	Expense future stock options	Carpenters	pending
Apple Computer	Expense future stock options	Carpenters	pending
Bear Stearns	Expense future stock options	Carpenters	pending
BellSouth	Expense future stock options	Carpenters	pending
Black & Decker	Expense future stock options	Carpenters	pending
Boston Scientific	Expense future stock options	Carpenters	pending
Capital One Financial	Expense future stock options	Carpenters	pending
CarrAmerica	Expense future stock options	Carpenters	pending
Caterpillar	Expense future stock options	IBEW	pending
Cincinnati Financial	Expense future stock options	LIUNA	pending
Clayton Homes	No comp. that is not expensed	Laborers	24%
Coca-Cola	Expense future stock options	Carpenters	pending
Convergys	Expense future stock options	LIUNA	pending
Donnelley (R.R.)	Expense future stock options	Carpenters	pending
DPL	Expense future stock options	Carpenters	pending
E.W. Scripps	Expense future stock options	LIUNA	pending
Eastman Kodak	Expense future stock options	LIUNA	pending
EMC	Expense future stock options	Carpenters	pending
Entergy	Expense future stock options	Carpenters	pending
Equifax	Expense future stock options	Carpenters	pending
Equity Office Properties	Expense future stock options	Carpenters	pending
Fluor	Expense future stock options	Carpenters	pending
FPL	Expense future stock options	Carpenters	pending
Gateway	Expense future stock options	Carpenters	pending
Genuine Parts	Expense future stock options	Carpenters	pending
Georgia-Pacific	Expense future stock options	Teamsters	pending
Halliburton	Expense future stock options	Carpenters	pending
Hershey Foods	Expense future stock options	Carpenters	pending
Kimberly-Clark	Expense future stock options	Carpenters	pending
Kinder-Morgan	Expense future stock options	LIUNA	pending
Lehman Brothers	Expense future stock options	Carpenters	pending

Table 5: Shareholder proposals on stock option expensing (cont'd.)

Company	Proposal	Proponent	Status
Lilly (Eli)	Expense future stock options	Carpenters	pending
Lockheed Martin	Expense future stock options	Carpenters	pending
Maximus	Expense future stock options	Longview	pending
MBNA	Expense future stock options	AFSCME	pending
Mercantile Bankshares	Expense future stock options	Carpenters	pending
Mercury Computer	Expense future stock options	Teamsters	omitted
Meredith	No comp. that is not expensed	Carpenters	omitted
MIPS Technologies	Expense future stock options	Sheet Mtl. Wrkrs.	omitted
National Semiconductor	Expense future stock options	Carpenters	omitted
NCR	Expense future stock options	LIUNA	pending
Parker-Hannifin	Rpt. on impact of expensing	Carpenters	withdrawn
PeopleSoft	Expense future stock options	AFSCME	pending
PG&E	Expense future stock options	Carpenters	pending
R.R. Donnelly	Expense future stock options	Carpenters	pending
Reebok	Expense future stock options	Carpenters	pending
ResMed	Expense future stock options	Sheet Mtl. Wrkrs.	omitted
SWS Group	No comp. that is not expensed	Sheet Mtl. Wrkrs.	30.1%
Siebel Systems	Expense future stock options	AFSCME	pending
Starbucks	Expense future stock options	Carpenters	pending
Sysco	Expense future stock options	Electrical Wrkrs.	omitted
T. Rowe Price	Expense future stock options	Carpenters	pending
TECO Energy	Expense future stock options	Carpenters	pending
TXU	Expense future stock options	Carpenters	pending
UnitedHealth Group	Expense future stock options	AFSCME	pending
US Bancorp	Expense future stock options	Carpenters	pending
Verizon Communica.	Expense future stock options	CWA	pending
Washington Mutual	Expense future stock options	Carpenters	pending
Wells Fargo	Expense future stock options	Carpenters	pending
Weyerhaeuser	Expense future stock options	Teamsters	pending
Yahoo	Expense future stock options	Carpenters	pending
Zale	No comp. that is not expensed	Sheet Mtl. Wrkrs.	omitted

Director Compensation Continues to Evolve, IRRC Study Shows

As investors become more fervent in their calls for directors who are actively engaged in the companies they oversee, companies, as well as shareholders, have a renewed interest in director compensation practices.

IRRC's *2002 Board Practices/Board Pay* study, which includes data from 1,245 companies, finds that elements of director compensation rise as the demands and responsibilities on corporate directors increase. Areas of significant change in director compensation practices include an increase in the value of the annual retainer and board meeting fees and an increase in the proportion of companies that grant stock options to directors on an annual basis. Benefits awarded to non-employee directors continue to stagnate or decline. (See Figure 1.) In addition, IRRC has identified companies that have begun to pay extraordinary compensation to audit committee members.

The most common element of director compensation is the board retainer, which includes cash and the value of any unrestricted annual stock awards. Ninety percent of the study companies pay a board retainer, equal to \$29,350, on average, up 3.7 percent from 2001. The median value of \$25,000 is unchanged from last year. Of the companies that pay a board retainer, 19 percent pay at least part of it with unrestricted stock; 4 percent pay the entire board retainer in unrestricted stock.

Fewer companies are paying board meeting fees than in the past, particularly among large companies. Since 1997, the prevalence of

board meeting fees at S&P 500 companies has fallen from 83 percent to 72 percent. However, those that do pay such fees are paying more every year. The average board attendance fee among all companies—\$1,468—has increased by 4 percent since 2001 and 8 percent since 2000. The median value is \$1,200, and 40 percent of the companies that pay a board attendance fee set it at \$1,000 per meeting. Five percent pay directors per diem fees for services beyond normal board duties. Only 10 companies in the study financially penalize directors for poor meeting attendance.

Seventy-two percent of all companies pay a fee for attending each audit or compensation committee meeting; the average fee is \$1,041. Of the study companies, 12 percent reduce meeting fees in the event that more than one meeting is held on the same day. The average retainer payable for serving on the audit or compensation committee

is \$7,718. Only 8 percent of study companies use committee retainers, however.

Seventy-four percent of all companies in the study offer some type of stock option to directors, up from 70 percent in 2001. The proportion of companies making annual option grants to directors rose by a hefty 10 percentage points this year, from just 58 percent in 2001. The average value of an annual stock option grant remains essentially unchanged, at \$64,758, but the average value of a one-time stock option decreased by 8 percent. (IRRC estimates the present value of a stock option grant by dividing the underlying shares' market value as of the last fiscal year-end by three). The average annualized value of a one-time option grant is \$31,187 (IRRC annualizes one-time grants by dividing the estimated present value by five).

IRRC recently has taken note of a number of companies paying

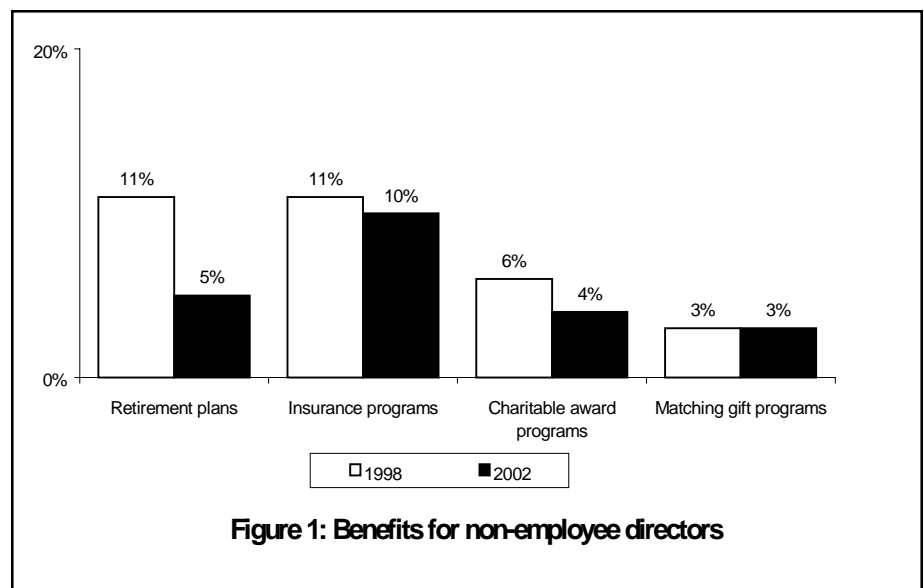


Table 1: Cash, equity-based compensation, and total remuneration for a typical non-employee director in 2002

Index	Avg. cash comp.	Cash % of total	Avg. equity-based comp.	Equity-based % of total	Average total remuneration
S&P 500	\$47,832	33%	\$96,627	67%	\$144,459
MidCap	\$34,534	34%	\$66,461	66%	\$100,995
SmallCap	\$28,266	37%	\$47,809	63%	\$76,075
S&P 1500	\$36,763	34%	\$69,070	66%	\$106,584

more for audit committee service than for service to other committees, such as compensation or nominating. Many of these companies pay additional fees to the chair of the audit committee. The study lists approximately 40 companies with compensation policies favoring audit committee service. Many expect this number to grow over the next year, considering the burdens that have been placed on audit committee members.

Stock accounts for lion's share of total compensation

For the first time, IRRC estimated non-employee directors' total remuneration and found that

it stands at \$106,584, of which about one-third is paid in cash. A total remuneration figure provides a simplified means for comparing director compensation practices among peer groups. Directors' actual remuneration normally depends on a number of variables, such as meeting attendance, the number of committees on which they serve, or the future direction of the company's stock price. For this reason, the formula used for estimating a "typical" director's total remuneration assumes perfect attendance at all board meetings and two key committees—audit and compensation—during the previous fiscal year. The 2002

study indicates that despite the bear market, the annualized value of disclosed equity-based compensation comprises approximately two-thirds of a typical director's total remuneration. Equity-based compensation includes the value of stock awards (including unrestricted annual awards) and stock options. The Health Care and Information Technology sectors have the highest average total remuneration, finds IRRC.

In addition to providing total remuneration estimates, the 2002 study benchmarks each component of director pay for three S&P indices, 10 revenue groups, and 10 economic sectors. —Glenn Davis

Corporate Governance Officers Help Ensure Compliance with Good Governance Practices

The following story was contributed by IRRC Board Member Terence Gallagher. Gallagher is CEO of Corporate Governance Associates. He recently retired as Vice President-Corporate Governance of Pfizer. He assumed that position in 1992 and had worked for Pfizer since 1966. He also serves as co-chair of the Council of Institutional Investors and chair of the Coordinating Committee of the Corporate Governance Task Force of the Business Roundtable.

The market for corporate control that intensified in the late

1970s and 1980s alerted institutional investors who had been acquiring a significant number of shares that they should take action. These institutions were concerned that they had no effective voice in the terms under which the changes of control occurred. A traditional solution might have been for them to sell their shares in the companies involved, but the institutions owned shares of so many companies that they believed the so-called "Wall Street Walk" would not work. As an alternative, they sought to have more influence over

how companies reached the decisions that affected shareholders.

Institutional shareholders then turned their attention to the corporate governance structures within the corporations. They identified criteria that could be measured from the outside and pressured companies to adopt these. During the 1980s and 1990s, many companies did, in fact, adopt some or all of the structural elements of good corporate governance. Efforts by institutions and organizations such as IRRC to monitor the extent to which companies had

complied with best practices encouraged more compliance. Nevertheless, this was a voluntary system without legal sanctions, and, thus, the only consequence of non-compliance was increased pressure from the institutions.

Pfizer was one of the first corporations to recognize the importance of good corporate governance—a realization that resulted primarily from its corporate culture. The company is heavily regulated and cannot test or market its pharmaceutical products without government approval. Coming from this perspective, the company decided to take a proactive stance and try to affect the environment in which it operated. Pfizer's management then began to view corporate governance as another form of regulation of the corporation. My appointment as Vice President of Corporate Governance was a direct result of this philosophy. Pfizer then proceeded to adopt many of the best practices advocated by institutions and other organizations.

Even at Pfizer, however, there were some measures that did not appear to be necessary or appropriate. An example of a provision that Pfizer decided not to adopt was the separation of the chairman and CEO positions. This combination had worked well for many years, and the board believed it was inappropriate to change. Because the company opted not to separate the two positions, institutional investors asked that a lead director be designated, but again the Pfizer board decided that the heads of its three key committees—audit, compensation and corporate governance—would act as the lead director when questions arose in their areas of expertise. Another issue was the elimination of Pfizer's poison pill. Here, the corporate governance committee asked that

the company review the reasons why institutional investors oppose poison pills. The company found that investors object to poison pills because they believe that they entrench management, last too long (typically 10 years), and are not subject to shareholder approval. The committee asked that the company create a pill that would address these concerns.

Pfizer then devised a TIDE, or Three-Year Independent Director Evaluation pill. All decisions related to the pill are made by the independent corporate governance committee, which also reviews the pill at least every three years. The committee did not agree to have a shareholder vote on the pill because the board believed it was its prerogative to adopt such a measure. I spent time explaining our reasoning on this to institutional investors. For the most part, they agreed that Pfizer still was practicing good corporate governance even if it did not follow their specific best practices in all areas.

With the adoption of the Sarbanes-Oxley Act and the pending adoption of new listing standards by the exchanges, much of what constitutes a good corporate governance structure now will be a matter of law and regulation rather than of best practice. To some observers it may seem that the advocates of good corporate governance have accomplished their goals. However, a nagging question is how the recent scandals occurred at companies that already had adopted many elements of a good corporate governance structure. The answer lies in the difference between structure and process. Having in place corporate governance principles, conflict of interest rules and an independent board are not enough if the process of compliance with the

structure is ignored. The element that still is missing in virtually all companies is a senior person with the prime responsibility of overseeing compliance with the process. The various disciplines—legal, financial and human resources—oversee elements of the process within their jurisdictions, but a corporate governance officer ties these various aspects together to assure full compliance. Such a position requires the complete authority of the chairman and CEO. Also, he or she must act as a liaison to the board members to help them fulfill their fiduciary duties, which most directors believe are expanding. D&O insurers have said that when deciding whether, and at what rates, to provide coverage, they look positively on companies that have corporate governance officers who enjoy significant status in their corporations.

In addition to overseeing the process, the corporate governance officer has the unique function of establishing a continuing relationship with the company's major shareholders. During my tenure as VP Corporate Governance for Pfizer, this was a vital function that I accomplished by maintaining individual contact with institutional investors and by being active in their trade associations. I also kept in contact with other activist groups. These relationships proved invaluable when a question arose that needed to be explained to institutional investors. It also allowed me to keep them advised of what was happening at Pfizer both in its business and its community activities.

For all of these reasons, now is the time for companies to seriously consider creating a corporate governance officer position.

—Terence Gallagher

Management Proposals Up, Shareholder Proposals Down in 2002 Global Proxy Season

On the international front, the number of management-sponsored proposals rose by 14 percent this year, according to IRRC statistics drawn from a sample 2,021 global companies, including 865 based in Japan. Conversely, the number of shareholder proposals on global ballots declined, due principally to waning activism in Japan. On the legislative front, the European Union made strides in its attempt to harmonize proxy voting requirements, and U.K. legislators implemented plans to sharpen the focus on executive pay by mandating that firms secure a non-binding, shareholder ratification of their pay policies.

Proposal overview

The number of management proposals increased by 40 percent at 865 Japanese firms tracked by IRRC, and a much more modest 2.3 percent at firms outside of Japan. (See tables on page 19.) The sharp rise in Japan can be attributed to Japanese commercial law changes that expanded the number of board resolutions and capital proposals — such as share repurchases, stock issues

and other matters relating to share capital. Specifically, the legal changes forced firms to seek shareholder approval for amendments to their bylaws in order to abolish par value systems and to allow for the use of treasury stock. Likewise, board proposals shot up in response to management calls to amend company articles to reflect an increase in terms for the statutory auditor board. Board terms were pushed up from three to four years in an effort to increase the stature of statutory auditors, who have been widely regarded as having only a limited or even ceremonial role. In theory, this board is responsible for assuring that business is conducted in compliance with the law by overseeing the board, the audit process and management. Last year, capital and board proposals represented just 5.6 percent of the total number of management proposals at Japanese companies tracked by IRRC. This year, that figure shot up to 32 percent.

The volume of board propos-

als also increased at some non-Japanese firms, particularly those in France. In order to comply with the *New Economic Regulations*, or NER, French firms began amending their articles on board practices and size this year. The NER — an amendment to the Commercial Code of Sept. 18, 2000, meant to improve French governance practices — suggests that boards be comprised of between three and 18 directors and that members serve a term of up to six years. The ratification of the NER by French lawmakers half way through this year's proxy season means that many companies with early meetings will be implementing similar amendments next year. The 21 percent increase in board proposals at companies outside of Japan from 2001 to 2002 markedly contrasts with the 8 percent jump evidenced between 2000 and 2001.

Other notable changes this year included an 8 percent increase in the number of compensation proposals at 1,156 non-Japanese companies tracked by IRRC. The

(continued on p. 20)

Global Shareholder Service Proxy Season* Voting Statistics 2000-2002

I. Restructuring Proposals 2000-2002						
	Non-Japanese Firms 2002	Japanese Firms 2002	Non-Japanese Firms 2001	Japanese Firms 2001	Non-Japanese Firms 2000	Japanese Firms 2000
Restructuring/Recapitalization	28	3	34	1	32	3
Merger/Acquisitions	66	33	63	17	110	23
Divestiture/Spinoff	31	0	26	0	37	2
Intra-Company Contracts	37	33	40	23	21	18
Dissolve/Liquidate Company	1	0	2	0	2	0
Joint Venture/Strategic Partnership	3	0	6	3	8	0
Totals:	166	69	171	44	210	46

Source: IRRC Proxy Voter Database of 1,156 Non-Japanese Companies; 865 Japanese Companies

* The period between January 1 and June 30

Global Shareholder Service Proxy Season* Voting Statistics 2000-2002

II. Management Proposals at non-Japanese Companies 2000-2002			
	2002	2001	2000
Routine	5,388	5,345	4,845
Capital	2,210	2,182	2,153
Compensation	822	762	710
Board	908	753	698
Takeover Defenses	50	35	38
Restructuring	166	171	210
Miscellaneous	208	283	413
Totals:	9,752	9,531	9,067

III. Management Proposals at Japanese Companies 2000-2002			
	2002	2001	2000
Routine	2,947	2,600	2,566
Capital	1,424	242	282
Compensation	1,128	1,394	1,320
Board	150	45	27
Takeover Defenses	0	0	0
Restructuring	69	44	46
Miscellaneous (mainly board related)	391	48	92
Totals:	6,109	4,373	4,333

IV. Shareholder Proposals 2000-2002			
	2002	2001	2000
Japan	64	75	70
All Other Markets:	73	75	88
Totals:	137	150	158

Source: IRRC Proxy Voter Database

Sample Size: 1,156 Non-Japanese Companies; 865 Japanese Companies

*The period between January 1 and June 30

increase is in keeping with a trend going back to 2000 when legislation was enacted allowing for stock-based incentive plans in many continental European markets. Moreover, the increase in compensation proposals reflects a greater number of U.K. firms submitting their pay policies to a shareholder vote in anticipation of pending legislation that mandates that firms do so in January 2003. As a percentage of overall management resolutions, compensation proposals held steady. In 2002, compensation proposals represented 8.4 percent of total management proposals, up slightly from 8 percent in 2001.

Restructuring proposals at non-Japanese companies, such as mergers and acquisitions, divestitures, and joint ventures, saw a 3 percent decline from 2001. (See Table 1 on page 18.) The drop from last year is in keeping with a trend dating back to 2000 when international capital markets entered a downward spiral, forcing many firms to put the brakes on plans to effect stock-financed mergers and acquisitions.

Despite the decline in restructuring resolutions, extraordinary general meetings (EGMs) increased at the non-Japanese firms tracked in this study. The 17 percent rise over 2001's figures contrasts with the 31 percent decrease evidenced between 2000 and 2001. The precipitous decline during that period can largely be attributed to the aforementioned drop in stock-financed mergers and acquisitions. This year's increase reflects a return to a more balanced figure.

Shareholder proposals trailed off markedly in Japan. The 15 percent decline among Japanese firms, due mainly to waning activism on socially responsible investing issues, pulled the total down

8.6 percent. Still, the overall number of markets, other than Japan, where shareholder proposals appeared on company ballots, held steady this year at 10 markets. Albeit in fewer numbers, Japanese firms, mostly utility companies, played host to a perennial medley of shareholder proposals that covered a range of issues from director bonuses to nuclear power.

Governance reforms

Corporate governance reforms received fresh attention this year in the wake of widely publicized accounting scandals at major U.S. firms including Enron and Global Crossing. Regulators the world over sought to assure jittery investors that their markets were well governed and firms, consequently, immune to an Enron-type meltdown.

To that end, Germany issued its first code of corporate governance, while the Bouton Committee in France tightened the Vienot report, commonly referred to as that market's governance bible. Italy's business community and regulators made moves similar to their counterparts in France, and European Union parliamentarians adopted legislation mandating that all companies in member states use International Accounting Standards beginning in 2007. In the U.K. this summer, regulators moved to redefine the role of nonexecutive directors to ensure their independence, while in Canada, proposals for the creation of an independent body to oversee the accounting industry were introduced.

While these issues were pivotal, much of the attention this proxy season focused on initiatives dealing with proxy voting in the European Union, as well as executive pay in Britain.

In late September, the Expert Group on Cross-Border Voting, chaired by former Unilever legal advisor Jaap Winter, issued its recommendations to streamline proxy voting at companies based in the European Union. The group identified three core questions that needed to be addressed: who is entitled to vote or should have the right to determine how the votes are executed; which entities should be enabled to exercise voting rights; and how markets can provide assurance that these entities receive the relevant information to exercise their voting rights in an informed manner.

The group's findings are now being debated by the European Commission, and, if approved, will radically alter Europe's proxy voting and governance landscape. Most critically, Winter's report calls for an end to shareblocking, or freezing share trading in the run up to a shareholder meeting, a practice which has long been the bane of investors who are edgy about holding illiquid assets. Also, the report recommends standardized regulations for all markets concerning the identification of shareholders and the establishment of voting rights. The report, if adopted, also is likely to boost historically low proxy voting levels in markets such as France and Germany by promoting the use of electronic voting platforms.

Also during this proxy season, the U.K. government submitted legislation designed to curb executive pay. Still in the process of being ratified, the legislation would require companies to submit their pay policies and practices to non-binding shareholder votes each year. The move would amend the Companies Act of 1985, bringing greater transparency to the process of deciding executive pay.

The Department of Trade and Industry, the legislation's sponsor, calls on companies to publish a report on director pay as part of their annual reporting cycle, and subject that report to a shareholder vote at each annual meeting. Although the vote would not be binding, analysts believe it would "shame" companies into adopting more investor friendly pay policies. Details of individual

directors' pay packages and justification for any compensation packages given in the preceding year must be revealed in the reports. Also, the names of any remuneration consultants used, whether they were appointed independently, and whether they provided any other services to the company must be included. A forward-looking statement of the company policy on director pay, including

details on incentive and share option schemes; an explanation of how packages relate to performance; and a performance graph providing information on the company's performance in comparison with an appropriate share market index also must be contained in the reports.

The legislation will take effect for companies holding annual meetings on or after Jan. 1, 2003.

—Cristina Yen & Subodh Mishra

Parliamentarians Set to Approve European Union Takeover Code

After 13 years of extensive work and hard-fought political battles, a takeover code governing all European Union (EU) markets now sits in the legislative queue. On October 2, the European Commission (EC) presented its revised proposal for a directive on a common EU takeover code, roughly 14 months after the first proposal was rejected. The new version makes cross-border takeover bids easier, strengthens protections for minority shareholders during a takeover bid, and provides a framework for cross-border corporate restructurings. Analysts believe the new directive, reworked to address major sticking points from the previous version and strategically released on the heels of Germany's elections, stands a good chance of becoming law.

Last July, EU parliamentarians voted down a much anticipated takeover code that would have unraveled longstanding takeover defenses common among most EU members. Germany, in particular, lobbied against the takeover code fearing it would pave the way for hostile takeovers

of German companies by foreign firms.

Much of the German unease with a common, transnational takeover code stemmed from lingering discomfort over London-based Vodafone's hostile takeover of Mannesmann, a German telecommunications giant, in 2000. Workers at Mannesmann said they were not consulted fully before management approved the deal, and they demanded legislation that would give them more say in the face of takeover bids. Union advocates argued that the EU's proposed takeover directive did not give an adequate voice to workers' concerns. In addition, recently approved legislation allows German companies to ask shareholders for blanket authority to issue an antitakeover defense on an annual basis, for up to 18 months, even before a takeover bid is made. This too was a major sticking point in last year's EU legislation, which spelled out that companies could convene shareholder meetings to approve defenses only after a takeover bid had been made.

In late 2001, the EU called on

a seven-member panel of experts to address these and other sticking points. The committee of academics, industrialists and lawyers was headed by Jaap Winter, legal advisor to the Anglo-Dutch group Unilever. The committee's work, dubbed the Winter Report, was published early this year and has formed the basis of the takeover directive now awaiting approval.

New code addresses old concerns

In drafting the new takeover code, the European Commission took into account most of the recommendations contained in the Winter Report. In his speech touting the release of the code, Frits Bolkestein, the head of the EC's Internal Markets division, said the "new proposal provides concrete responses to the concerns raised by the European Parliament when it rejected the previous proposal last year." Notably, the new version does not mandate a "one share, one vote" policy, thereby allowing member states to retain multiple voting rights. This exclusion was necessary to form as broad a coali-

tion as possible, according to Bolkestein. The new version does include the original provision that requires boards to obtain shareholder approval prior to adopting takeover defenses. This stems from the commission's belief that the future of a company should be decided by the owners, not the managers. The provision is at odds with common practice in some member states. Other key elements of the code include:

- **Equitable Price:** Under a mandatory takeover bid, the bidder would be required to extend an offer to purchase all the remaining shares held by shareholders of a target company at the highest price of the company's shares during a period of six to 12 months prior to the offer;

- **Squeeze-out right:** This provision would allow the holder of a large majority of a company's share capital, between 90 and 95 percent, to require the remaining minority shareholders to sell the majority shareholder their stake at a fair price; and

- **Sell-out right:** This is the reverse of the "squeeze-out right." Under this provision, minority shareholders could require the majority shareholders to buy their stake at a fair price.

The new takeover code also seeks to neutralize takeover barriers in the different member states to effectively "level the playing field." In particular, the new version of the directive spells out three areas through which the EU plans to bring equity to the takeover process:

1) Greater transparency and

disclosure: All listed companies would have to disclose capital and control structures and their takeover defenses in their annual reports. Additionally, these structures and defenses would have to be submitted for shareholders' review at least once every two years;

2) Removing share transfer restrictions: (Also called the "break-through rule.") After a takeover bid has been announced, any share transfer restrictions, whether prescribed by company statutes or by contractual agreement, would no longer be applicable during the period allowed for

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acceptance of the bid. Additionally, voting rights restrictions would be lifted when shareholders vote on the adoption of takeover defenses and during the general meeting called by the offeror after a successful takeover bid. Special shareholder rights would not be applicable when nominating and removing directors in the first general meeting after a takeover; and

3) Revision clause: This clause allows the European commission to review the aforementioned provisions five years after the code is adopted to ensure it continues to reflect market developments.

While many of the contentious

items in the code's first draft have been ironed out, criticism has not disappeared. Klaus-Heiner Lehne, a German member of the European Parliament who helped engineer the legislative defeat of the first draft, said the new version is a vast improvement over the original one, but that amendments would be necessary to work out remaining "deficiencies."

The government of recently re-elected German Chancellor Gerhard Schroeder has gone on record as saying "the European Commission's draft proposals fail to create a uniform, Europeanwide framework for takeovers." The government contends that under the new version of the takeover code, "German companies would be forced to forgo defensive instruments, whereas companies in other member states, retaining multiple voting rights, would be able to put up effective defenses. There is no convincing reason for this unequal treatment. The Commission's stated reasoning that it is not proven that multiple voting rights are able to prevent takeovers isn't justifiable." While the takeover code does not eliminate takeover defenses in the form of multiple and special voting rights, it does restrict the use of poison pills. German companies no longer employ multiple voting rights as a defense, but continue to rely on poison pills as a means of warding off unwanted bids.

In addition to the German government, Dutch members of parliament voiced their objections. Dutch company law allows companies to adopt a panoply of takeover defenses, including poison pills and non-voting shares. The takeover code limits the use of many of these measures, thus leaving the door open for hostile bids of unprotected Dutch companies.

Despite these criticisms, observers suggest the revised takeover directive now stands a good chance of being adopted. Many ascribe their optimism to a proviso within the code granting German firms a three-year transition period for the implementation of some of the new rules, including those dealing with poison pills. Additionally, the EC waited to unveil the new directive until after Germany's presidential elections to avoid a confrontation with Gerhard Schroeder over what has become known as the Volkswagen law – a takeover code that could have overturned the car manufacturing giant's prohibition against any one shareholder holding more than 20 percent of the firm's equity. Officials of the German state of Lower Saxony, who hold 19 percent of Volkswagen's stock, said the new takeover directive would keep the defense in place, thereby refuting those arguing that the car maker and national icon was at risk.

Some analysts predict that even if Dutch Parliamentarians unite with their German counterparts to oppose the takeover code, they will not be able to rally enough support to defeat it. If approved, the code would take effect Jan. 1, 2005.

—David Lahire

U.K. Investors Fight Attempts to Mandate Proxy Voting

Faced with the prospect of legislation that would force institutional investors to take on a decidedly more activist role, the U.K. investment community has rallied to promote voluntary principles on shareholder activism. If effective, the watershed moves may avert plans by Prime Minister Tony Blair's Labour government to act on recommendations set out in last year's Myners Committee report on the state of institutional investment in the U.K.

In response to a request in 2000 by the Labour government to examine the state of institutional investment in the U.K., Gartmore Investment Management Chairman Paul Myners last year released a set of recommendations designed to promote greater involvement by fund managers in the activities of the companies in which they are invested.

One of two salient Myners' recommendations suggests that principles on shareholder activism promoted by the U.S. Employee Retirement Income Security Act (ERISA) be incorporated into U.K. law. This, says the committee, would make intervention in companies, where it is in shareholders' and beneficiaries' interests, a duty for fund managers. Myners pointedly accused fund managers of failing to take to task underperforming companies. Gordon Brown, Chancellor of the Exchequer, backed Myners' approach saying the government would seek to ensure a "clearer duty on fund managers to promote beneficiaries' interests." The government's idea of "clearer duty," according to many, would include legislation

making proxy voting mandatory, something the U.K. investment community has long resisted. Moreover, Myners himself is against forced voting because he says it could result in knee-jerk votes in favor of management.

Myners does support legal changes that would raise the duty of care for trustees, requiring them to be familiar with investment matters where they make investment decisions.

The Labour government has been determined to see both of the above recommendations made into law, spending much of the past year drafting legislation to that effect. While raising the duty of care is of less concern to the U.K. investment community, the threat of mandatory voting prompted two key initiatives by the investment community aimed at dissuading the government from enacting prescriptive legislation.

Hermes, the London-based fund manager owned by the British Telecom Pension Scheme, is using its \$63 billion worth of muscle to help the U.K. investment community voluntarily begin assuming a more activist role. In October, the institution released *The Hermes Principles*, a set of 10 principles ostensibly meant to answer: "What should owners expect from U.K. public companies and what should these companies expect from their owners?"

The Hermes Principles cover four key areas, communications with shareholders, financial reporting, strategic planning and the promotion of social, ethical and environmentally sound practices. Touching on a number of impor-

tant issues affecting companies and investors in today's capital market, Hermes, notably, calls on companies to adopt performance evaluation and incentive systems designed to focus managers' attention on long-term shareholder value. The fund also calls for companies to manage relationships with their employees, suppliers and customers, while behaving in an ethical manner with regard to the environment and society as a whole.

Giving context to the principles, Tony Watson, chief executive of Hermes Pensions Management, said: "These principles are not intended to be a burden. It is not in our clients' interest for their agents to place a burden on what they own. These are disciplines more akin to a 'Highway Code' than rigidly policed requirements."

A copy of the *Hermes Principles* was sent to the board of every listed U.K. company.

Hermes' move comes on the heels of the release of the Institutional Shareholders' Committee's statement of principles on shareholder activism. These principles written by the ISC — an umbrella group for the U.K.'s largest insti-

tutional investor associations — call on institutional investors to:

- vote their shares at all meetings;
- refrain from automatically supporting management's recommendations;
- maintain and publish statements of their policies;
- monitor the performance of and maintain an appropriate dialogue with those companies;
- intervene where necessary;
- evaluate the impact of their policies; and
- in the case of investment managers, report back to the clients on whose behalf they invest.

Institutions are being asked to detail their governance policies in contracts with clients.

The ISC has stressed to its constituents the importance of subscribing to these principles. ISC

Chief Lindsay Tomlinson told *The Financial Times* that the committee had warned members that they must adhere to the group's recommendations or risk facing "some legislation that is probably not going to be very easy to deal with."

Financial Secretary to the Treasury Ruth Kelly, said: "The government has a clear objective to promote more active engagement by institutional shareholders in relation to companies in which they invest. The industry's new principles are a major step, which we welcome. However, the key test will be the impact on industry behavior. We will monitor progress closely."

Both Hermes' and ISC's initiatives highlight the manner in which the U.K. institutional investment community has chosen to head-off potential legislation that would make activism mandatory. The ISC's work has convinced the government to table proposed legislation while it tests the principles' efficacy. The government intends to review the impact of the principles after two years to see whether legislation is still necessary.

—*Subodh Mishra*