



CORPORATE GOVERNANCE PRINCIPLES & Proxy Voting Guidelines

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About the State Board of Administration

The Florida State Board of Administration (SBA) is an agency of Florida state government that provides a variety of investment services to various governmental entities. FRS Trustees are dedicated to ensuring that the SBA invests assets and discharges its duties in accordance with Florida law, guided by strict policies and a code of ethics to ensure integrity, prudent risk management and top-tier performance. The SBA has three Trustees: the Governor, as Chairman, the Chief Financial Officer, as Treasurer, and the Attorney General, as Secretary. All three of the Trustees of the Board are elected statewide to their respective positions as Governor, Chief Financial Officer, and Attorney General. The Board of Trustees appoints six members to serve on the Investment Advisory Council. The Investment Advisory Council provides independent oversight of SBA’s funds and major investment responsibilities. The SBA is an investment fiduciary under law, and subject to the stringent fiduciary duties and standards of care defined by the Employee Retirement Income Security Act of 1974 (ERISA), as incorporated into Florida law.

As of September 30, 2009, the net asset value of total funds under SBA management was approximately \$132 billion. The FRS Pension Plan provides defined pension benefits to over 1.1 million members. The strong long-term performance of the FRS Pension Plan, the fourth-largest public pension fund in the nation, reflects our commitment to responsible fiscal management. The SBA strives to meet the highest ethical, fiduciary and professional standards while performing its mission, with a continued emphasis on keeping operating and investment management costs as low as possible for the benefit of Florida taxpayers.

We encourage you to review additional information about the SBA and its corporate governance program, as well as the FRS, on our website at www.sbafla.com

INTRODUCTION

The Florida State Board of Administration (SBA) manages the fourth largest U.S. pension fund and other non-pension trust funds with assets spanning domestic and international capital markets. Our primary function is to represent the interests of our stakeholders so that they will see fair returns on their investment; therefore we have a clear interest in promoting the success of companies in which we invest. To ensure returns for our shareowners, we adopt internationally recognized governance practices for well-managed public companies. These include independent boards, performance-based executive compensation, accurate accounting and audit practices, transparent board procedures, and policies covering issues such as succession planning and meaningful shareowner participation. Essentially, we address and work with the companies in which we invest to ensure the maximization of long-term shareowner value.

The SBA takes an active role in strengthening corporate governance. Sound corporate governance practices enhance shareowner value and thereby play an important role in achieving our financial objectives as a long-term investor. To implement our corporate governance program, the SBA works with many different organizations, including the Council of Institutional Investors (CII), International Corporate Governance Network, Glass, Lewis & Co. (GLC), Riskmetrics Group (RMG), PROXY Governance Inc. (PGI), Investor Responsibility Research Center Institute for Corporate Responsibility (IRRC), GovernanceMetrics International (GMI), Equilar, The Corporate Library (TCL), the Conference Board Corporate Governance Center, and the Stanford Institutional Investor Forum.

Although we believe that it is essential to confront corporate boards with poor governance practices, we also recognize the necessity of allowing boards to direct the businesses that they have been entrusted to oversee without excessive interference; therefore, we do not attempt to mandate business strategies for the companies we own. However, to balance our position, we vote “against” any proposal that limits shareowner rights or makes it more difficult for shareowners to have a voice in company practices, as well as certain board structures, poison pills, super-majority requirements, and others.

CORPORATE GOVERNANCE PRINCIPLES

The SBA believes that, as a long-term investor, good corporate governance practices serve to protect and enhance our long-term portfolio values.¹ To this end, voting rights should be exercised for the exclusive benefit of Florida Retirement System (FRS) members and their beneficiaries (i.e. as members of the FRS Pension Plan or Investment Plan) as well as other non-pension clients.

The SBA is reliant on its Corporate Governance Principles to direct its activities related to corporate governance and proxy voting. These Principles, in conjunction with other relevant policies, set the parameters for the SBA's shareowner activism and provide a framework for SBA corporate governance initiatives. The SBA's Proxy Voting Guidelines are formulated and revised in accordance with these principles.

In accordance with the Department of Labor (DOL) Interpretive Bulletin §2509.08-2, stock ownership rights, which include proxy votes, participation in corporate bankruptcy proceedings, and shareowner litigation, are financial assets. They must be managed with the same care, skill, prudence, and diligence as any other financial asset. They must be exercised to protect and enhance long-term portfolio value and for the exclusive benefit of pension plan participants and beneficiaries as well as the clients and beneficiaries of other fiduciary accounts. Pursuant to the provisions set forth in the Employment Retirement Income Security Act of 1974, this is generally referred to as the “duty of loyalty” or the “exclusive purpose” rule. Under this rule, fiduciaries, defined as any person who, in part, “exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets” must act solely in the interest of plan participants and beneficiaries in making decisions concerning the management or disposition of plan assets.² While the SBA is exempt from most provisions of ERISA, we agree with this treatment of the value of proxy voting rights and follow the standard as a part of our fiduciary duty. Section 215.47(10) of the Florida Statutes encompass the prudent persons standards and fiduciary responsibilities of the SBA and its employees.

Managing stock ownership rights and the proxy vote includes the establishment of written proxy voting guidelines, which must include voting policies on issues likely to be presented, procedures for determining votes that are not covered or which present conflicts of interest for plan sponsor fiduciaries, procedures for ensuring that all shares held on record date are voted, and procedures for documentation of voting records. The following corporate governance principles and proxy voting guidelines are primarily designed to cover publicly traded equity securities. Other investment forms such as privately held equity, limited liability corporations, privately held REITs, etc. are not specifically covered by individual guidelines, although broad application of the principles and guidelines can be used for these more specialized forms of equity investments.

The primary role of shareowners within the corporate governance system is in some ways limited, although critical. Shareowners' primary functions are to communicate with management and to step in only when management has failed. This means they have two primary obligations: 1) to monitor the performance of the company and 2) to protect their right to act when it is necessary.

¹ CFA Centre for Financial Market Integrity, “The Corporate Governance of Listed Companies: A Manual for Investors,” 2009.

² Lannof, Ian D., “DOL Advisory Opinion 2007-07A.” Groom Law Group, February 2008.

A study conducted by NYU's Pollack Center for Law & Business revealed that external and internal governance mechanisms are strong complements. The importance of internal governance crucially depends on the extent of external governance and vice versa. In addition, effective corporate governance design relies on a combination of high exposure to the market for corporate control and a high degree of monitoring by shareowners.³

In the 1930's, Benjamin Graham and David Dodd succinctly described the agenda for corporate governance activity by stating that shareowners should focus their attention on matters where the interest of the officer and the stockholders may be in conflict. This includes questions about preserving the full integrity and value of the characteristics of ownership appurtenant to shares of common stock. For example, the right to vote may be diluted by a classified board or by dual class capitalization, and the right to transfer the stock to a willing buyer at a mutually agreeable price may be abrogated by the adoption of a poison pill.

Since management and board composition change over time, while shareowners continue their investment, shareowners must ensure that the corporate governance structure of companies will allow them to exercise their ownership rights permanently. Good corporate management is not an excuse or rationale upon which institutional investors may relinquish their ownership rights and responsibilities.

The proxy voting system must be an even playing field. Neither management nor shareowners should be able to dominate or influence voting dynamics. A 2006 article analyzed the corporate governance implications of the decoupling of voting power and economic ownership through methods such as vote trading and equity swaps, methods largely hidden from public view and not captured by current regulation or disclosure rules. This method has been used by finance-savvy activist hedge funds, for example, who have borrowed shares just before the record date in order to better support proposals they favor, reversing the transactions after the record date. The SBA believes that enhanced disclosure rules are critical to reveal hidden control of voting power.^{4, 5}

Management needs protection from the market's frequent focus on the short-term in order to concentrate on long-term returns, productivity, and competitiveness. Shareowners need protection from coercive takeover tactics and directors with personal agendas. Ideal governance provisions should provide both sides with adequate protection. They should be designed to give management the flexibility and continuity it needs to make long-term plans, to permit takeover bids in cases where management performance is depressing long-term value, to ensure that management is accountable to shareowners, and to prevent coercive offers that force shareowners to take limited short-term gains.

A study on shareowner activism and corporate governance in the United States found that shareowner opposition has slowed the spread of takeover defenses, such as staggered boards, that require shareowner approval. However, shareowners have failed in their efforts to get companies to roll back takeover defenses and, perhaps more importantly, managers frequently ignore even a majority shareowner vote in favor of a proposal.⁶

GLOBAL STANDARDS OF CORPORATE GOVERNANCE

The SBA believes strongly that good corporate governance practices are important to encourage investments in countries and companies in a globalized economy where gaining access to capital markets is increasingly viewed as critical. A comparative analysis of corporate governance in US and international firms shows that the ability of controlling shareowners to extract private benefits is strongly determined by a country's investor protection. Thus, if investor protection is weaker, improvements in firm-level governance will be costlier for the controlling shareowner.⁷

Over the last several years, many countries, international organizations, and prominent institutional investors have developed and implemented international policies on corporate governance and proxy voting issues (e.g., the Organization for Economic Cooperation and Development (OECD), and the International Corporate Governance Network (ICGN)). Many of these promulgated guidelines recognize that each country need not adopt a "one-size-fits-all" code of practice. However, the SBA expects all capital markets to exhibit basic and fundamental structures that include the following:

1. Corporate Objective

The overriding objective of the corporation should be to optimize the returns to its shareowners over time. Where other considerations affect this objective, they should be clearly stated and disclosed. To achieve this objective, the corporation should endeavor to ensure the long-term viability of its business, and to manage effectively its relationship with stakeholders.

2. Communications & Reporting

Corporations should disclose accurate, adequate and timely information, in particular meeting market guidelines where they exist, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares. Material developments and foreseeable risk factors, and matters related to corporate governance should be routinely disseminated to shareowners. Shareowners, the

³ Martijn Cremers, K.J., Nair, V., 2003. "Governance Mechanisms and Equity Practices."

⁴ Hu, Henry T.C. and Black, Bernard S., "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms". As published in *Business Lawyer*, Vol. 61, pp. 1011-1070, 2006 Available at SSRN: <http://ssrn.com/abstract=887183>.

⁵ Christoffersen, S.E.K., Geczy, C.C., Musto, D.K., and Reed, A.V. (2006). *Vote Trading and Information Aggregation*.

⁶ Black, B., 1998. "Shareowner Activism and Corporate Governance in the United States."

⁷ Aggraval, Reena et al, 2007, "Differences in Governance Practices between US and Foreign Firms: Measurement, Causes, and Consequences", Charles A. Dice Center for Research in Financial Economics, Working Paper 2007-14.

board, and management should discuss corporate governance issues among them. Where appropriate, these parties should converse with government and regulatory representatives, as well as other concerned bodies, so as to resolve disputes, if possible, through negotiation, mediation, or arbitration. For example, investors should have the right to sponsor resolutions and convene extraordinary meetings. Formal procedures outlining how shareowners can communicate with board members should be implemented at all companies and be clearly disclosed.

3. Voting Rights

Corporations' ordinary shares should feature one vote for each share. Corporations should act to ensure the owners' rights to vote and apply this principle to all shareowners regardless of their size.

4. Corporate Boards

The Board of Directors, or Supervisory Board, as an entity, and each of its members, as individuals, is a fiduciary for all shareowners, and they should be accountable to the shareowner body as a whole. Each member should stand for election on a regular basis, preferably with annual election cycles. Corporations should disclose upon appointment to the board, and thereafter in each annual report or proxy statement, information on the identities, core competencies, professional or other backgrounds, factors affecting independence, other commitments, and overall qualifications of board members and nominees so as to enable investors to weigh the value that they add to the company. Information on the appointment procedure should also be disclosed annually. Boards should include a sufficient number of independent, non-executive members with appropriate qualifications. Responsibilities should include monitoring and contributing effectively to the strategy and performance of management, staffing key committees of the board, and influencing the conduct of the board as a whole. Accordingly, independent non-executives should comprise no fewer than three (3) members and as much as a substantial majority. Audit, Compensation and Nomination committees should be composed entirely of independent non-executives.

5. Executive & Director Compensation

Remuneration of corporate directors or supervisory board members and key executives should be aligned with the interests of shareowners. Corporations should disclose in each annual report or proxy statement the board's policies on remuneration and, preferably, the remuneration of individual board members and top executives; so that shareowners can judge whether corporate pay policies and practices meet this standard. Broad-based employee share ownership plans or other profit-sharing programs are effective market mechanisms that promote employee participation.

6. Strategic Planning

Major strategic modifications to the core business of a corporation should not be made without prior shareowner approval of the proposed modification. Equally, major corporate changes that, in substance or effect, materially dilute the equity or erode the economic interests or share ownership rights of existing shareowners should not be made without prior shareowner approval of the proposed change. Shareowners should be given sufficient information about any such proposal early enough to allow them to make an informed judgment and exercise their voting rights.

ACTIVE STRATEGIES & COMPANY ENGAGEMENT

The objective of SBA corporate governance engagement is to improve the governance structures at companies in which the SBA owns significant shares in order to enhance the value of SBA equity holdings.

A recent paper on the evolution of shareowner activism in the United States affirms that activism by investors has increased considerably since the mid-1980s due to the involvement of public pension funds and institutional shareowners. The study identifies the potential to enhance value of investments as the main motive for active participation in the monitoring of corporations. However, as shareowner activism entails concentrated costs and widely disbursed benefits, only investors with large positions are likely to obtain a large enough return on their investment to justify the costs.⁸

The two primary obligations of shareowners are to monitor the performance of the companies and to protect their right to act when necessary. The SBA has neither the resources, nor the expertise, to micromanage companies in which it holds publicly traded stock. Furthermore, the legal duties of care and loyalty rest with the corporate Board of Directors, not with the shareowners. For these reasons, the SBA views its role as confined to fostering improved management and accountability within the companies in which we own shares. Other recent SBA corporate governance activities have included dealing with conflicts of interest within organizations with which we do business.

Department of Labor (DOL) Interpretive Bulletin \$2509.08 states that voting proxies is a fiduciary responsibility and that proxies should be treated like any other financial asset, executed in the best interest of beneficiaries in accordance with written guidelines.

Additionally, Florida Law may prohibit investment in companies or mandate reporting on certain investments due to geopolitical, ethnic, religious, or other factors. Compliance with these laws and any related reporting requirements have

⁸ Gillan, Stuart L. and Laura T. Starks, 2007, "The Evolution of Shareowner Activism in the United States", *Journal of Applied Corporate Finance*, Volume 19, Number 1, Winter 2007, Published by Morgan Stanley.

similarities to corporate governance issues and will be consolidated organizationally.

Consistent with prudent and responsible investment policy, all or some of the following measures may be instituted when a corporation is found by the SBA to be under-performing market indices or in need of corporate governance reform:

- The SBA will discuss the corporate governance deficiencies with a representative and/or the Board of Directors. Deficiencies may occur in the form of policies or actions, and often result from the failure to adopt policies that sufficiently protect shareowner assets or rights. The SBA may request to be informed of the progress in ameliorating such deficiencies.
- Under SEC Rule 14(a) 8⁹, shareowner proposals may be submitted to companies with identified performance deficiencies. Shareowners proposals will be used to place significant issues on a company's meeting ballot in order to allow all shareowners to approve or disapprove of significant issues and voice the collective displeasure of company owners.
- Any other strategies to achieve desired corporate governance improvements as necessary.

⁹ Rule 14a-8 is an SEC rulemaking promulgated under the Securities Exchange Act of 1934 and offers a set of procedural requirements governing how and when shareowners may submit resolutions for inclusion in a corporation's proxy statement.

II. PROXY VOTING GUIDELINES

Empirical Basis for Proxy Voting Guidelines

The SBA's voting guidelines are based on rigorous empirical research, industry studies, investment surveys, and other general corporate finance literature. We believe that sound proxy voting policies should be based on both market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. Empirical citations should provide evaluation of specific items over long time frames, in excess of 3 years. Studies should also be extensive in scope and analyze companies of various market capitalizations across U.S. and foreign markets.

Disclosure of Proxy Voting Decisions

The SBA discloses all proxy voting decisions once they have been made, approximately seven to 10 calendar days prior to the date of the shareowner meeting. Disclosing proxy votes prior to the meeting date improves the transparency of our voting decisions and supports widespread public disclosure of SBA investment decisions. Disclosing proxy votes in advance of their effective dates will fully emphasize the SBA's position on proper corporate governance practices. Historical proxy votes are also archived for a period of five years and available electronically on the SBA's website.¹⁰

Proxy Voting and Securities Lending

The SBA participates in securities lending in order to enhance the return on its investment portfolios. In the process of lending securities, the legal rights attached to those shares are transferred to the borrower of the securities during the period that the securities are on loan. As a result, the SBA's right to exercise proxy voting on loaned securities is forfeited unless those affected shares have been recalled from the borrower in a timely manner (i.e. on, or prior to, the share's record date). The SBA has a fiduciary duty to exercise its right to vote proxies and to recall shares on loan when it is in the best interest of our beneficiaries. The ability to vote in corporate meetings is an asset of the fund which needs to be weighed against the incremental returns of the securities lending program.

Although the SBA shall reserve the right to recall the shares on a timely basis prior to the record date for the purpose of exercising voting rights for domestic as well as international securities, the circumstances required to recall loaned securities are expected to be atypical. Circumstances that lead the SBA to recall shares include, but are not limited to, occasions when there are significant voting items on the ballot such as mergers or proxy contests or instances when the SBA has actively pursued coordinated efforts to reform the company's governance practices, such as submission of shareholder proposals or conducting a detailed engagement. In each case, the direct monetary impact of recalled shares will be considered and weighed against the discernable benefits of recalling shares to exercise voting rights. The SBA recognizes that it may not be possible to determine, prior to a record date, whether or not shares warrant recall. Further, the potential operational and investment consequences of recall upon the securities lending program's collateral investment pool will be taken into consideration. In order to determine if securities will be recalled, individual circumstances shall be evaluated on a case-by-case basis. One situation in which securities lending could conflict with maximization of shareowner value may occur in the case of special meetings with the right to convert shares at a premium. This can occur in the case of a Special Purpose Acquisition Company (SPAC), with investors being allowed the alternative of a conversion of shares to cash. If shares are on loan at the time of the special meeting, the ability to exercise conversion rights for those shares is lost.

The SBA is a long-term investor. Certain external investment managers are authorized to use strategies that include shorting in portfolios managed on our behalf. In the potential event that a combination of securities lending and short selling activity led to voting rights at a company meeting despite a net negative economic exposure, the SBA would view such conditions as temporary and cast any votes in the economic well being of the firm for the long term. Under no circumstance would the SBA cast votes contrary to shareholder value due to the use of short selling or securities lending within its portfolios.

The SBA supports enhanced disclosure in voting reports in the form of votes cast, number of shares voted, and number of shares on loan over the record date. This enhanced transparency allows beneficiaries and recipients of voting reports to have a more complete understanding of the stewardship of their assets. The number of shares voted or on loan for corporate meetings is relevant information for plan participants, mutual fund investors and retail clients seeking to determine how well the governance of invested companies is monitored.

The SBA opposes the practice of borrowing shares for the primary purpose of exerting influence or gaining control of a company without sharing the risks of ownership. The SBA views an attempt by any entity to deliberately distort the voting outcome at a shareholders' meeting to be detrimental to the proper functioning of equity capital markets.

In the rare event that the SBA received a proxy ballot to vote shares that were on loan as of the record date, we would vote such shares in the best interest of the long-term firm value and our beneficiaries. Shares on loan are only out of the SBA's legal possession on a temporary basis, and we will act as a long-term investor in any voting action.

¹⁰ Registered investment advisors are required pursuant to Rule 30(b)1-4 of the Investment Company Act of 1940, known as the SEC's rule "N-PX," to report their proxy votes by August 31st of each year, covering voting decisions made over the prior year ending in June. Although the SBA is not legally required to file N-PX reports with the SEC, it does make identical reporting publicly available at www.sbafla.com, including real time voting decisions prior to shareowner meetings.

BOARD OF DIRECTORS

Director elections are considered to be one of the most important voting decisions that shareowners make, especially because shareowners are only given the opportunity to review their companies' operations once a year at the AGM. Thus, if detailed information on boards or nominees is available, shareowners should scrutinize it closely. Directors function as the representatives of shareowners throughout the year and are therefore a crucial avenue of ongoing influence on management.

Levels of disclosure regarding directors vary widely. In some countries, such as the United States, United Kingdom, Canada, and Australia, companies publish detailed information such as director biographies, share ownership, and related information that aids shareowners in determining the level of director independence. In many other countries, the only information available on directors is their names, while still other countries disclose no information at all. In cases where detailed information about directors is not available, it would be counterproductive to vote against directors on the basis of a lack of information. Opposition to specific nominees or boards should be supported by specific problems or concerns.

The effectiveness of the board is a direct function of its composition and structure. In developed markets including the United States, Canada, United Kingdom and Australia, the stringent board independence standards mandated by relevant market listing rules have enabled shareowners to raise the bar of "best practices" for board independence. Many institutions and even members of the corporate community, such as the Business Roundtable, National Association of Corporate Directors (NACD), and a blue ribbon panel of the Conference Board, now advocate that a substantial majority of directors be independent. As a result, a two-thirds threshold has become commonplace in shareowner proposals.

While numerous studies have been conducted on the benefits of board independence, much evidence reveals that board independence is desirable and has a positive impact on institutional investors' perception of a corporation. A survey for Russell Reynolds Associates found that institutional investors are more closely examining the composition of boards. Over a majority of the survey participants stated that family ties on the board and boards with dismissed CEOs or other dismissed executives are significant concerns in addition to director interlocks and board members serving on multiple boards.

Fortunately, corporate boards of publicly-listed companies in developed markets generally provide for a high level of independence. By contrast, many of their counterparts in emerging markets in Asia, Latin America, the Middle East, etc. exhibit very low independence structure coupled with poor board transparency. Boards in emerging markets, which have traditionally been, and in some cases, continue to be dominated by families, find themselves at a significant disadvantage when it comes to attracting foreign institutional investors. Family-dominated boards need reform as it would help improve a company's credit status, which would enable it secure cheaper borrowing rates on debt financing. A greater level of institutional participation would also foster longer-term perspective to the market, prompt improvements in corporate governance and even help entice more international private equity investment into the country. It is believed that many international constituents have been reluctant to pursue activity in the Middle East because many companies do not provide for a reasonable level of due diligence during investment, partnership, or exit opportunities.¹¹

Boards without adequate independence from management may suffer from conflicts of interest and impaired judgment in their decision-making. In addition to poorer transparency, directors with ties to management may be perceived to be less willing and able to effectively evaluate and scrutinize company strategy and performance.

Election of Directors: CASE-BY-CASE

The SBA generally votes FOR directors up for election. However, after taking into consideration unique country-specific practices and disclosure standards¹², the SBA may vote AGAINST (i.e., "withhold" support for) director nominees for one or more of the following reasons:

- Lack of stock ownership.
- Poor attendance at meetings (e.g., if less than 75 percent attendance rate)
- Whether they are inside or outside of the company (i.e., director independence). The SBA strongly disfavors board representation that does not meet a minimum two-thirds independence threshold, and will routinely withhold support from individual director nominees who are not independent (excluding the CEO) in those circumstances where the full board comprises less than 50 percent independence levels.
- Negligence in board committee performance.
- Ignored a material shareowner proposal that was either approved by a majority of votes cast or approved by a majority of the shares outstanding.
- Overboarding – the SBA will likely withhold support from a director who serves on more than 3 boards, which the SBA considers as overboarded, and who is employed in a full-time position. Directors with significant outside responsibilities

¹¹ Saigol, Lina, "Family-owned Businesses Need to Reform." FT Report – Corporate Finance 2008, May 2008.

¹² For instance, Italy amended its "Consolidated Financial Act" to mandate that Italian issuers reserve a certain number of board seats for candidates presented by minority shareowners. This mandate affects Board of Director elections, Supervisory Board elections, and Board of Statutory Auditor elections. See, "Italian Issuers- Guidelines for the election of the Board of Directors (or Supervisory Board) or Board of Statutory Auditors," Trevisan & Associati February 19, 2009 available at http://www.trevisanlaw.it/en_mask.html?5 (last visited March 2, 2009).

- (e.g. is CEO of a separate company) sitting on more than one external board may also have support withheld.¹³
- Poor performance across all company boards upon which the individual serves as a director.

According to a study on corporate governance performance of U.S. industrial firms between 1989 and 1995, empirical evidence suggests that busy outsider directors are associated with weak corporate governance. When a majority of outside directors serve on three or more boards, firms exhibit lower market-to-book ratios, as well as weaker operating profitability. When a majority of outside directors are overboarded, the sensitivity of CEO turnover to performance is significantly lower than when a majority of outside directors are not busy. Investors react positively to the departure of overboarded directors, while firms, whose directors acquire an additional board seat and become overboarded, end up experiencing negative abnormal returns.¹⁴ In light of such findings, the SBA generally limits directorships to 3 boards if a director is employed in a full-time position and one board for directors who serve as CEO of a separate company.

The SBA believes that director performance is paramount to sound corporate governance. It is important that directors, as shareowner representatives in the boardroom, not only be independent of management but also effectively exercise their fiduciary duty through good performance. A paper by the Global Corporate Governance Forum recommends using board evaluations as open communication to focus on inadequacies, identify strategic priorities and become more efficient through the review of policies and procedures [GCGF, Board Performance Evaluation]. Evaluations can help uncover breakdowns in committee functioning and responsibility. The SBA takes into account the performance of a director across all boards on which the director serves. Underperformance, or exceptional performance, on any given board provides a more complete depiction of an individual's capabilities as director.

Evaluations can be particularly helpful in assessing audit committee performance as the audit committee is responsible for independent oversight of the company's financial statements and, in the absence of a separate risk committee, is also often responsible for risk oversight. Regular self-assessments are critical to a productive audit committee. The SBA will consider the audit committee's performance, especially as it relates to oversight and risk management, when voting on individual committee members. Evidence of poor audit committee performance are financial restatements, including as a result of option backdating, unremediated material weaknesses, attempts to limit auditor liability through auditor engagement contracts, as well as, potentially, exposure to the subprime mortgage crisis.

Shareowners can take issue with under-performing directors through "vote no" campaigns. An empirical study found that "vote no" campaigns are an effective tool to voice concerns with a particular director, and ultimately pressure the company to take action. The study specifically finds a forced CEO turnover rate of 25 percent in firms targeted with "vote no" campaigns.¹⁵ This underscores that performance is an essential component of governance and should be considered when evaluating election of director proposals. Where a clear pattern of underperformance exists, even external to the company in question, the SBA will review that director's qualification to serve on the board on a case-by-case basis.

The SBA generally will not consider age as a rationale for withholding votes. Length of service on a board is sometimes a factor in determining independence for a director, but is not used to justify a withhold vote except in rare instances with unusual circumstances.

Election of Directors (Japan): CASE-BY-CASE

Japanese boards are dominated by insiders, and the few outside directors are generally affiliated outsiders from a main bank, parent company or business partner. While independent directors are still very rare in Japan, the SBA believes a shift to independent directors (even on an incremental basis) would increase the degree of company oversight and shareowner representation. The SBA may vote against the chairman and additional nominees unless a substantial portion of the board is independent. Additionally, attention should be focused on the independence of the statutory auditors, who should fulfill the oversight function at Japanese companies. The SBA will vote against directors in cases of scandal or other malfeasance, or egregiously poor performance.

However, since 2003, Japanese companies have been given the option of switching to a U.S.-style "board-with-committees" structure. Such companies abolish their board of statutory auditors, and must create audit, compensation, and nomination committees of at least three directors each. A majority of committee members must be outside directors. In order to separate responsibility for management execution and oversight, these companies must also create a board of executive officers, whose members are appointed by the board of directors. In these cases, the role of the outside directors becomes much more important, and the SBA believes that the independence of the outsiders is critical to effective corporate governance under the new system. Therefore, the SBA will vote against outside director nominees at such companies where we believe that the nominees cannot fulfill the role of independent monitor of the company's activities.

¹³ Neil Roland, "Directors at troubled companies overbooked, research firm claims" *Financial Week* (February 25, 2009) available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20090223/REG/902239979/1038/EXCLUSIVES> (last visited February 25, 2008) (this article gives examples of overboarding problems at struggling U.S. financial institutions).

¹⁴ Fich, Eliezer M. and Anil Shivdasani, 2006, "Are Busy Boards Effective Monitors?," *The Journal of Finance*, Vol. 61, No. 2, pp. 689-724 (36), Blackwell Publishing.

¹⁵ Diane Del Guercio, Laura Seery, and Tracie Woidtke, "Do Boards Pay Attention when Institutional Investor Activists 'Just Vote No,'" available at <http://ssrn.com/abstract=575242>.

Additionally, the SBA may vote against the reelection of representative directors in cases where a company implements a poison pill or similar antitakeover measure pursuant to a board resolution, giving shareowners no opportunity to vote on the matter. Such decisions will be made on a case-by-case basis, where the SBA will oppose nominees to indicate a vote of “no-confidence”.

Under recent changes mandated by the Corporate Law which took effect in 2006, Japanese companies must now disclose the participation of outside directors and statutory auditors at meetings of the board of directors (and in the case of statutory auditors, meetings of the board of statutory auditors as well). Most companies interpret this as a call to disclose the number of meetings attended. Meanwhile, as the number of outsiders in Japan continues to increase, we are seeing some cases of low attendance rates, apparently caused by scheduling conflicts.

Pursuant to the greater disclosure, the SBA has adopted the same policy used at U.S. companies: namely, opposing the reelection of directors who fail to attend at least 75 percent of board meetings, unless the company discloses a legitimate reason for the poor attendance. The same policy should be applied to statutory auditors because they will not be able to properly fulfill their oversight function if they fail to attend meetings of the board of directors and board of statutory auditors. Attendance via webcast or teleconference will be deemed equivalent to attendance in person.

Elect a Corporation as a Director (France): CASE-BY-CASE

The SBA considers whether the corporation, which is proposed to act as a director, will represent the interests of all shareowners.

Limit Director Tenure: AGAINST

The SBA votes AGAINST proposals to limit the tenure of outside directors. While we agree, in principle that new outside directors often bring in fresh ideas that benefit shareowners we do not believe this requirement is an appropriate way to achieve that goal. It is an artificial and arbitrary imposition on the board, and it could conceivably harm shareowners’ interests by forcing some experienced and knowledgeable directors from serving on the board.

Age Limits: AGAINST

The SBA votes AGAINST shareowner or management proposals to limit the tenure of outside directors through mandatory retirement ages. Similar to tenure limits, rather than imposing a narrow rule on director age limits, shareowners gain much more by retaining the ability to evaluate and cast their vote on all director nominees once a year and by encouraging companies to perform periodic director evaluations.

Change or Approve Size of Board: CASE-BY-CASE

There have been a growing number of management proposals that intend to limit a shareowner’s ability to alter the size of the board, while at the same time, allowing management to increase or decrease the size of the board at its discretion. Corporate management argues that the purpose of such proposals is to prevent a dominant shareowner from taking control of the board by drastically increasing the number of directors and electing its own nominees to fill the newly created vacancies. Other scenarios may include a board’s downsizing in response to business changes or acquisitions. The SBA generally supports such proposals if we feel management is not coercive.

Classified Board: AGAINST

A classified, or staggered, board is one in which directors are divided into three “classes” with each director serving three-year terms. All directors on a non-classified board serve one-year terms and the entire board is re-elected each year. Studies performed by SEC economists and by academics support the view that classified boards are contrary to shareowner interests, showing negative effects on share value for companies that adopt classified boards. For example, the SEC studied the impact of 649 antitakeover proposals submitted between 1979 and 1985. The proposals consisted of fair price provisions, institution of supermajority vote requirements, classified board proposals, and authorization of blank check preferred stock. Stocks within the group showed an average loss in value of 1.31 percent. The study also found that the proposals were most harmful when implemented at firms that have higher insider and lower institutional shareholdings.

A 2002 academic study covering hostile bids between 1996 and 2000 showed that classified boards nearly doubled the odds of a target remaining independent. However, the findings revealed that a staggered board structure did not provide any countervailing benefits in terms of higher acquisition premiums. In fact, for the period covered, it resulted in the loss of \$8.3 billion for target shareowners by impeding value-creating transactions without any offsetting increases in alternative transaction or stand-alone target returns.¹⁶ Additional studies reveal that staggered boards bring about, and not merely reflect, reduction in firm value, especially for companies that establish classified boards in the corporate charter, which shareowners cannot amend, as opposed to such boards established in the company’s bylaws, which shareowners can amend.¹⁷ Finally, a 2001 study found that between 1990 and 1999, firms with weak shareowner rights, including classified board structures, exhibited lower net profit margins and sales growth and made more capital expenditures and acquisitions than firms with a high degree of shareowner rights.¹⁸

¹⁶ Bebchuk, Lucian Arye, John C. Coates IV, and Guhan Subramanian, “The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, & Policy.” National Bureau of Economic Research Working Paper No. W8974, May 2002.

¹⁷ Bebchuk, Lucian Arye and Cohen, Alma, “The Costs of Entrenched Boards.” *Journal of Financial Economics*, Vol. 78, pp. 409-433, 2005.

¹⁸ Gompers, Paul A., Joy L. Ishii, and Andrew Metrick, “Corporate Governance and Equity Prices.” National Bureau of Economic Research Working Paper No. W8449, August 2001.

A study on the relationship between board classification, takeover activity, and transaction outcomes for a panel of firms between 1990 and 2002 finds that board classification does not have an impact on the likelihood that a firm, once targeted, is ultimately acquired. However, the study reveals that bidding shareowner returns are 2.7 percent lower when bids involve classified targets.¹⁹

Furthermore, empirical evidence supports the belief that staggered boards, by entrenching inefficient managers, may motivate managers to adopt a lower level of debt, thereby avoiding disciplinary mechanisms associated with leverage. According to a study, results show that staggered boards are likely to bring about, and not to merely reflect, lower leverage. At the same time, the study finds that there appears to be no significant impact on firm value as a result of excess leverage.²⁰

The SBA opposes classified boards and their provisions because we believe that annual accountability will ultimately lead to increased corporate performance. Classified boards also decrease corporate accountability by protecting directors from election on an annual basis. Alternatively, the SBA supports changing from a staggered board structure to annual elections for all directors.

Adopt Cumulative Voting: FOR

Cumulative voting guarantees that shareowners of a certain size will be able to elect at least one of their candidates to the board of directors, even if the candidate does not win a majority vote. In contrast, only majority shareowners are guaranteed board representation at companies without cumulative voting. The opposite is also true when cumulative voting is in effect. A majority position, either alone or as a bloc of votes, may not always be sufficient to control the board, while a majority position is always guaranteed board control at companies without cumulative voting. The difference has to do with the way votes are counted and distributed in director elections.

At companies with cumulative voting, the total number of votes each shareowner may cast is determined by multiplying the number of shares owned by the number of board slots up for election. Shareowners may cast all their votes for one nominee, for a combination of nominees or may spread their votes across the entire board. This means that shareowners of a certain size will always be assured of having at least one of their choices for a director elected to the board. For example, consider a company with a 10-member board and 500 shares outstanding. The total number of votes that may be cast is 10 x 500, or 5,000. In this case, a shareowner with 51 shares (10.2 percent of the shares outstanding) would be guaranteed one board seat.

The SBA will make certain exceptions on proposals to adopt cumulative voting in light of the introduction of proxy access and majority voting reforms that directly address the voting process.

As an alternative for cumulative voting, a majority vote standard ensures board accountability in uncontested elections. Boards elected under such a majority vote structure are sufficiently accountable to shareowners, as this standard has emerged in the last few years as a catalyst to make director elections meaningful rather than merely symbolic. Although majority voting is meaningful in uncontested elections, it can potentially serve as an anti-takeover mechanism in contested elections. Cumulative voting, on the other hand, is meaningful primarily in contested elections.

The SBA may also vote against proposals to adopt cumulative voting if the company has adopted true majority voting (not a resignation policy), as well as proxy access or a similar structure that proactively encourages shareowners to nominate directors to the company's ballot.

Director Indemnification: CASE-BY-CASE and in accordance with State Laws

Indemnification literally means "to make whole." When a corporation indemnifies its directors and officers it means the corporation promises to reimburse them for certain legal expenses, damages and judgments incurred as a result of lawsuits relating to their corporate actions. In effect, the corporation becomes the insurer for its officers and directors. The corporation then purchases insurance to cover its own risk. The vote will be in favor if the damage was caused by violations of the duty of care provided that a "good faith" standard was satisfied. In addition, votes will be cast for increased indemnification proposals where a director's defense was unsuccessful, unless there is a final adjudication that the director acted in bad faith and not for a purpose that he or she reasonably believed to be in the best interest of the company.

Conversely, the SBA votes AGAINST such proposals if coverage expands beyond mere legal expenses and to acts, such as negligence, that are more serious violations of fiduciary obligation than carelessness is, or for violating the duty of care.

State corporation statutes govern whether a corporation may indemnify a corporate director or corporate officer in a particular instance. For instance, Section 607.0850 of the Florida Statutes regulates indemnification of corporate directors by Florida corporations. Many states model their indemnification statutes on the Model Business Corporation Act or the Revised Model Business Corporation Act.

Director Liability: CASE-BY-CASE

Liability means a director's or officer's personal financial assets are not at risk if the individual loses a lawsuit that results in a financial reward or damages to the plaintiffs. Most corporations that indemnify their officers and directors also limit or eliminate

¹⁹ Bates, Thomas W., David A. Becher and Michael L. Lemmon, 2007, "Board Classification and Managerial Entrenchment from the Market for Corporate Control", electronic copy available at: <http://ssrn.com/abstract=923408>

²⁰ Jiraporn, Pornsit and Yixin Liu, 2008, "Capital Structure, Staggered Boards, and Firm Value," Financial Analyst Journal, Volume 64, Number 1.

the personal liability of the individuals.

The SBA votes AGAINST proposals to limit or eliminate liability for monetary damages of directors and officers for violating the duty of care. The SBA votes FOR liability proposals provided such expanded coverage is for cases where a director's or officer's legal defenses were unsuccessful because either the director was found to have acted in good faith and in a manner that he/she reasonably believed was in the best interests of the company or if the director's legal expenses would be covered.

Establish/Amend Nominee Qualifications: CASE-BY-CASE

The SBA evaluates proposals that establish or amend director qualifications on a case-by-case basis. Votes should be based on how reasonable the criteria are and to what degree that they may preclude dissident nominees from joining the board.

Require Two or More Nominees per Board Seat: AGAINST

The SBA opposes shareowner proposals requiring two candidates per board seat.

Separate Chairman & Chief Executive Officer (CEO): CASE-BY-CASE

The SBA believes that separating the positions of Chairman of the Board and CEO may improve the decision-making process at firms with records of significant underperformance when compared to market and peer group benchmarks. While there are many instances where executives and boards perform well while simultaneously serving as Chairman and CEO, recent studies find that the increase in separation of chairman and CEO positions at US companies from 2000-2004 were driven significantly by monitoring needs, and not only advisory needs. The same study indicates that financial restatements are received more favorably in firms that have a separation of leadership than in firms that do not, suggesting potential value effects of the decision to separate the chairman and CEO positions.²¹

Separating the duties of Chairman and Chief Executive Officer is a necessity when dealing with the issue of CEO succession planning. Research released in August, 2009 by The Conference Board shows that responsibility for a succession plan should be passed to a standing committee within the Board of Directors. In today's struggling economy there has been a sharp increase in the number of C-suite executive's stepping down from their position. However, The Conference Board reports that "an alarming 51 percent of corporate secretaries surveyed in 2008 reported their organizations do not rely on a detailed succession plan for C-suite executives."²² This is particularly disturbing when taking into account the costs of these increased executive turnovers. Faulty integration of a new senior manager can cost an organization 10 to 20 times the executive's salary in opportunity cost. In order for succession plans to be effective, they should be headed by an independent board chair or lead director; otherwise, the succession planning process may become politicized and possibly cause harm to the organization's cohesiveness and strategic focus. The use of an independent leader will allow the succession committee to implement internal and external transparency, while simultaneously decreasing the risk of instability when the company inevitably faces turnover.

Further evidence supporting the separation of Chairman and CEO was provided by Booz Allen's annual CEO succession study.²³ The study concluded that "Nonchairman [sic] CEOs are now the best performers," with non-chairmen in North America producing shareowner returns three times as high as those of individuals serving as CEO/chairman. In addition, a 2006 Moody's study cited the increased effectiveness of an independent chair or lead director, stating that "the arguments against independent board leadership are outweighed by advantages offered by clarity of accountability and the strengthened ability of independent directors to respond quickly in a crisis."²⁴ Moreover, investors benefit when the role of chairman is not held by the former CEO. The presence of the former CEO as chairman can have the effect of insulating the current CEO from performance concerns. One study found that in 2006, all of the long-serving underperforming CEOs in North American who departed their companies either held the combined title of CEO/Chairman or served under a chairman who was a former CEO.²⁵

The SBA generally votes FOR shareowner proposals asking that the Chairman and CEO positions be separated, i.e., an independent Chairman. Unless the company has a strong countervailing governance structure, including a designated lead director who is appointed from the ranks of the independent board members and who has the authority to develop and set the agenda for meetings and to lead sessions outside the presence of an insider Chair, resolutions to separate the Chairman and CEO positions are in the best interest of shareowners.

Require Independent Board Chairman: CASE-BY-CASE

For several years, there has been ongoing discussion over the merits of a separate and independent board chair versus a combined or non-independent chairman/CEO structure. While the latter has been a prevalent practice among US companies for many years, some investors argue that the combined role limits accountability and is indicative of a poor governance structure.

This lack of a consensus opinion on the matter has led to myriad different structures, including:

²¹ Grinstein, Yaniv and Valles Arellano, Yearim, "Separating the CEO from the Chairman Position: Determinants and Changes after the New Corporate Governance Regulation." March 2008.

²² Tonello, Matteo, John C. Wilcox, and June Eichbaum, "The Role of the Board in Turbulent Times... CEO Succession Planning." The Corporate Board, August 2009

²³ Lucier, Chuck, Paul Kocourek, and Rolf Habbel, "CEO Succession 2005: The Crest of the Wave." Strategy+Business, May 2006.

²⁴ Taub, Stephen, "CEO as Chairman Still the Rule in US." CFO.com, August 3, 2006.

²⁵ Lucier, Chuck, Steven Wheeler, and Rolf Habbel, "The Era of the Inclusive Leader." The Corporate Board, September/October 2007.

- Separate and independent chair/CEO
- Combined chair/CEO
- Combined chair/CEO with an independent lead director
- Combined chair/CEO with a presiding director

Each structure has its advocates and opponents; however, from a governance perspective, it appears that the majority of investors prefer an independent chair or an independent lead director with a well-defined role in managing the board. Similar to our approach on proposals to separate chairman and CEO positions, the SBA generally supports proposals requiring the position of chairman to be filled by an independent director unless there are compelling reasons to oppose the proposal, such as a strong countervailing governance structure. This should include:

1. Designated lead director, elected by and from the independent board members with clearly delineated duties. Alternatively, the role may reside with a presiding director, vice chairman, or rotating lead director. At a minimum the duties should include:
 - i. Presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors
 - Serves as liaison between the chairman and the independent directors
 - Approves information sent to the board
 - Has formal control of the agenda setting process—developing and approving meeting agendas for all board meetings.
 - Approves meetings schedules to assure that there is sufficient time for discussion of all agenda items
 - Has the authority to call meetings of the independent directors
 - If requested by major shareowners, ensures that he is available for consultation and direct communication
2. The company publicly discloses a comparison of the duties of its independent lead director and that of its chairman;
3. The company publicly discloses a sufficient explanation as to why it chose not to give the position of chairman to the independent lead director;
4. 2/3 independent board;
5. All independent key committees;
6. Established governance guidelines;
7. The company should not have underperformed both its peers and index on both a one-year and three-year total shareowner returns basis, unless there has been a change in the Chairman/CEO position within that time; and
8. The company does not have any problematic governance issues.

Require Majority of Independent Directors: FOR

Shareowners are best served when their board includes a significant number, preferably a supermajority, of independent outside directors. They can bring the most objectivity and a fresh perspective to the issues facing the company since they are not employed at the company and thus are not susceptible to the problems insiders often face. The conflicts of interest problems boards face when designing executive compensation policies, as well as responding to takeover offers, are much less severe for outsiders than executive officers. Perhaps the most important role of outside directors is to objectively evaluate the performance of top management.

A 2006 study on options backdating, identifying a link between manipulation of stock options and corporate governance, examines the occurrence of grants given at the lowest price of the month (“lucky grants”) for the period of 1996-2005. The authors of the paper find that 1,150 lucky grants took place during the observed period while 12 percent of companies provided such grants due to manipulation. According to the study, lucky grants are more likely to occur when the firm lacks a majority of independent directors and when the CEO has longer tenure—both factors associated with greater CEO influence on the company’s pay-setting and governance processes. The paper also finds that grant manipulation is not concentrated in any one sector, rather, it was found to be widespread across all industries. Grants from manipulation do not appear to have served as substitutes to other forms of compensation, and the gains to CEOs from such grants are estimated to exceed 20 percent of the value of the grant, increasing the CEO’s total compensation by more than 10 percent.²⁶

As a general rule, we consider a two-to-one ratio of independent outsiders to insiders and affiliated outsiders to be a reasonable standard. We strongly disfavor board representation that does not meet this minimum two-thirds independence threshold, and

²⁶ Bebchuck, Lucian, Yaniv Grinstein and Urs Peyer, 2006, “Lucky CEOs”, available at http://papers.ssrn.com/abstract_id=945392

routinely withhold support from individual director nominee who are not independent (excluding the CEO) in those circumstances where the full board comprises less than 50 percent independence levels. Furthermore, the SBA believes strongly in restricting membership on compensation, audit, and nominating committees to independent outside directors only

Limit the Number of Non-Independent Directors: CASE-BY-CASE

Proposals that seek to limit the number of non-independent board members often define who would be considered non-independent and describe a time period during which the criteria may be met. Since shareowners are well served by a majority of independent directors, the SBA is likely to support proposals that seek to limit the service of non-independent directors provided that the terms of the limits, including number of directorships and independence criteria, are reasonable and not overly restrictive. Limiting the number of company executives, relatives, and prior employees that serve on the board is expected to result in a better system of monitoring on behalf of shareowners.

Independent Committees: FOR

As stated above, the SBA votes FOR proposals asking that the audit, compensation, and nominating committees be comprised exclusively of independent directors. We believe that independent directors face fewer conflicts of interests and are better prepared to protect shareowner interests under most corporate scenarios.

Our opinion is further supported by the conclusion drawn upon by academic studies that have examined whether audit committees and board characteristics are related to earnings management by the firm. Empirical studies have revealed a non-linear negative relationship between audit committee independence and earnings manipulation. Additionally, significant relation is found only when the audit committee has less than a majority of independent directors. Furthermore, earnings management is positively related to whether the CEO sits on the board's compensation committee. The results suggested that committees structured to be more independent of the CEO may be more effective in monitoring the corporate financial accounting process.²⁷ Finally, an academic comparative study on governance also finds that audit committee independence is associated with higher value of firms both in the United States and worldwide.²⁸

Establish a Nominating Committee: CASE-BY-CASE

It is a fundamental tenet of corporate governance that the board should be an independent body capable of providing objective oversight of management and company's overall direction. The SBA believes that this goal can best be achieved when those entrusted with the responsibility of proposing nominees for election to the board are independent of the CEO and have no personal interest in the company arising from a salary, a retainer (other than fees received for service as a director), a consulting agreement, or any other significant business agreement.

If the company's performance has been below average and the nominating committee is to be composed of independent directors, a vote may be cast FOR the proposal.

Establish an Enterprise Risk Management Committee: CASE-BY-CASE

The SBA generally encourages companies, especially financial companies, to have a standing enterprise risk management committee of the board with formal risk management oversight responsibilities.²⁹ Traditionally, risk management has been the purview of the audit committee at most companies. However, with the increased responsibilities and resultant time commitment for audit committees as a result of rule making under Sarbanes-Oxley, we believe the formation of a committee dedicated to identifying and managing risk may be warranted. Poor or nonexistent risk management controls exacerbated catastrophic losses for companies and shareowners during the 2008 credit crisis when many boards did not fully appreciate the level of risk to which the company was exposed. We believe all companies should have in place robust, effective risk mitigation policies.

In the Institute of International Finance's Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, the IIF established recommendations advocating corporate adoption and implementation of the Chief Risk Officer position and the development of either a risk committee as part of the corporate board of directors, or at the very least, adding the role of risk management to the audit committee's duties.³⁰ However, the SBA believes that a separate risk management committee would be the best option in most circumstances because many audit committees are overworked and the complexity of risk management may surpass the skills and knowledge of many audit committee members. A recent National Association of Corporate Directors (NACD) white paper recommended boards consider assigning risk management responsibilities to certain committees to help ensure adequate coverage, potentially assigning the board governance committee with allocating such responsibilities. The NACD report noted that risk oversight is a full board responsibility, with maintenance of an appropriate risk management infrastructure encompassing risk identification, monitoring, and mitigation as a key duty.³¹ While the trend is leading toward more banks developing these risk management committees, "the presence of a dedicated risk committee is still not common

²⁷ Klein 2006

²⁸ Aggraval, Reena et al, 2007, "Differences in Governance Practices between US and Foreign Firms: Measurement, Causes, and Consequences", Charles A. Dice Center for Research in Financial Economics, Working Paper 2007-14.

²⁹ In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) defined Enterprise Risk Management (ERM) as, "a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives".

³⁰ Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, Institute of International Finance, July 2008, available at <http://www.iif.com/regulatory/> (last visited March 11, 2009) [hereinafter IIF].

³¹ "White Papers: Series I – Risk Oversight/Transparency/Strategy/Executive Compensation," National Association of Corporate Directors, March 2009.

practice across large banks.”³² Additionally, many banks that do have committees do not hold meetings on a regular basis and their committees are not made up of qualified members.

As part of the director election process, we may withhold support for individual directors if there are indications that a director failed to understand company risk exposures and/or failed to take reasonable steps to mitigate the effects of the risk, leading to large losses (e.g. in the form of write-downs for mortgage-related losses). In those instances where the board or committee is responsible for risk management and risk oversight, under the terms of its charter, we believe shareowners need to enforce accountability on those directors responsible for failing to properly execute that oversight.

Advisory Committee: CASE-BY-CASE

The main purpose of a shareowner advisory committee is to advise the board on shareowner concerns and to create a formal means of communication between company stockholders and company management. Such committees do not have any decision-making authority and they remain advisory in nature. Their scope does not stray into matters concerning the day-to-day management of company operations but is limited to only those subjects involving corporate governance instead. The SBA generally votes FOR advisory committee proposals that are intended to improve poor corporate governance.

Use of Majority Voting For Election of Directors: FOR

The board of directors is elected to represent the company's shareowners, and its primary responsibility is to monitor management. Shareowners need an appropriate and effective method for expressing their satisfaction or lack thereof with the board's performance of its duties. The SBA supports any proposal that provides shareowners the ability to better monitor the board and make its members more accountable to shareowners. Most corporations use plurality voting under existing state laws, whereby management can nominate an individual director and, if the election is uncontested, approve its own nominee to the board with just a single vote. The SBA favors the majority voting method for the election of unopposed candidates and favors the plurality method only in rare cases where multiple candidates seek the same directorship, to ensure an election winner.

In October 2006, the Majority Vote Work Group, a joint effort between a number of institutional investors and corporations, issued a report on the findings of the group's examination into issues associated with the majority vote standard. The report's findings include the assertion that failure of a director to be elected by a majority of votes cast may indicate loss of shareowner confidence in the director or the board, and that election of directors by less than a majority vote may lead shareowners to question the value of the election process. The report also supports the application of the plurality standard to any contested director election, where there are more nominees than board seats available, even if a majority vote standard were applied to uncontested election of directors. The investor members of the group note an increase in shareowner support for proposals to adopt the majority vote standard, reaching an average support of 48 percent in the 2006 proxy season.³³

In November of 2007, Neal, Gerber & Eisenberg LLP published a survey of 534 companies that have adopted provisions regarding majority voting in director elections. The study found that two-thirds of the companies in the S&P 500 have adopted some type of majority voting. In February 2006, only sixteen percent of the companies in the S&P 500 had adopted majority voting. Forty-two percent of companies surveyed adopted policies on majority voting while thirty percent of companies adopted bylaws addressing the issue. Twenty-eight percent of companies adopted both policies and bylaws. Just over half of the companies surveyed have a true majority voting requirement while the rest retained the plurality vote standard with a discretionary policy addressing the status of nominees who receive a majority withhold vote.³⁴

The SBA strongly endorses majority voting for the meaningful accountability it affords shareowners and because it provides another element to the system of checks and balances of power within the corporate structure. The SBA will therefore support shareowner proposals at companies with a discretionary policy towards majority voting seeking for the company to adopt true majority voting, through a formal bylaw amendment.

Office of the Board: FOR

The SBA generally supports shareowners proposals requesting that the board establish an Office of the Board of Directors in order to facilitate direct communications between shareowners and non-management directors, unless the company has all of the following:

- Established a communication structure that goes beyond the exchange requirements to facilitate the exchange of information between shareowners and members of the board
- Disclosed information with respect to this structure to its shareowners
- Heeded majority-supported shareowner proposals or a majority withhold vote on a director nominee
- Established an independent chairman or a lead/presiding director. This individual must be made available for periodic consultation and direct communication with major shareowners.

³² "Risk Governance at Large Banks: Current Status and Credit Implications." Moody's Global Banking, July 2009.

³³ Majority Vote Work Group Report, October 2006.

³⁴ Allen, Claudia H., November 2007, "Study of Majority Voting in Director Elections", Neal, Gerber & Eisenberg LLP

Equal Access: FOR

The SBA votes FOR proposals that allow significant company shareowners access to management's proxy material in order to evaluate and propose a voting recommendation on proxy proposals and director nominees or to nominate their own candidates to the board. Proposals to allow shareowners equal access, or "proxy access," to management's proxy are among the most important corporate governance items upon which shareowners are asked to vote. They are designed to even the playing field in the proxy system by giving large company shareowners room in management's proxy statement to, depending on how the resolution is worded, discuss the merits of management's director nominee(s), nominate and discuss director candidates nominated by shareowner(s), or discuss management proposals other than director nominees. The proxy system is, in theory, the cornerstone of corporate accountability. In order for it to work properly, shareowners must have enough information with which to evaluate all proxy proposals that could have an economic impact on share values, i.e., director nominations, anti-takeover proposals, executive compensation proposals, corporate governance proposals, etc.

In 2009, the SEC proposed to allow shareowners the right to place director candidates within the company's proxy materials. "By making it easier for shareholders to replace directors, proxy access can contribute to making directors more accountable to shareholders and more attentive to their interests."³⁵ The SBA supports this proposal, which would set an access default with the freedom to opt-out to a no-access regime.

Minimum Stock Ownership: FOR

The SBA supports proposals that require directors to own a minimum amount of company stock. One of the best ways for directors to align their interests with those of the shareowners is to own stock in the corporation.

A prototype of a set of Share Ownership and Retention Guidelines should link a significant portion of an executive's compensation to the company's stock performance. In this manner, the interests of management are better aligned with the interests of shareowners.

The guidelines should annually review and identify the positions covered by directors and executives. The annual review should also provide information on whether guidelines are met, and should describe what action is taken for non-compliance. Furthermore, the guidelines should identify what compensation types may be considered as ownership and what compensation types are not taken into account. Ownership levels should be linked to an individual's corporate position, with the greatest ownership target assigned to the CEO. Significant targets should be set for non-employee directors in the form of multiples of their annual salary. Finally, the guidelines should identify the time allowed to participants to meet the guidelines, and provide for penalties for non-compliance in the signified timeframe.

Per the SBA's model ownership guidelines, non-employee directors need to maintain ownership of a number of shares having a market value equal to five times their annual retainer. Senior executives are required to achieve and maintain an ownership position expressed as a multiple of salary as follows:

Chief Executive Officer	15X Salary
Chief Operating Officer	10X Salary
Chief Administrative Officer	8X Salary
President	7X Salary
Other Senior Executives	5X Salary

Require Director(s) be Non-Executives: CASE-BY-CASE

In general, non-executive directors are best suited to provide the oversight role expected of them by shareowners. Proposals to increase or set a minimum number of independent directors, therefore, generally promote shareowner interests. However, the boards of many growth companies are comprised of management/owners, often including the founder. Since the interests of these management directors are already aligned with the shareowners, a requirement that would entail a significant change in the board may not always be appropriate in these cases.

Adopt Two-Tiered (Supervisory/Management) Board Structure: CASE-BY-CASE

Companies in many foreign countries have a two-tiered board structure, comprising a supervisory board of non-executive directors and a management board with executive directors. The supervisory board oversees the actions of the management board, while the

³⁵ Bebchuk, Lucian A. and Scott Hirst, "Private Ordering and the Proxy Debate." Harvard Law School. Discussion Paper No. 653. 11/2009 Available at SSRN: <http://papers.ssrn.com/abstract=1513408>

management board is responsible for the company's daily operations. At companies with two-tiered boards, shareowners elect members to the supervisory board only; the supervisory board appoints management board members. In Austria, Brazil, the Czech Republic, Germany, Peru, Poland, Portugal, and Russia, two-tiered boards are the norm. They are also permitted by Company law in France and Spain.

The merits of the new structure will be weighed against the merits of the old structure in terms of its ability to represent shareowners' interests adequately, provide for optimal governance structure, and also to generate higher shareowner value.

Ratify actions taken by Board during past year provided that local law does not exempt directors from liability for wrongful misconduct or suits arising from falsification of accounts: FOR

We favor these proposals unless there is clear evidence of negligence or action counter to shareowners' interests. Many countries require shareowner discharge of the board or management for actions taken in the previous year. In most cases, discharge does not preclude future shareowner action in the event that wrongdoing is discovered.

In June 2008, Manifest and Morley Fund Management analyzed governance practices in continental Europe and issued a report that emphasized the country-specific implications of discharging directors. "Directors' Liability Discharge Proposals: The Implications for Shareowners" stressed that the nature and scope of directors' liabilities vary by jurisdiction. "Each market has its own rules, regulations and best practice guidelines against which informed decisions should be measured and carefully weighed." One similarity noted in the report was that "in all the markets covered by the study, a failure to grant a discharge from liability does not have an immediate effect on the liability of directors, but merely leaves the possibility open for the company to initiate an action for liability."

Approve proposed/completed transactions between directors and company: CASE-BY-CASE

A transaction between a parent company and its subsidiary, or a company's dealings with entities that employ the company's directors, are usually classified as related-party transactions and are subject to company law or stock exchange listing requirements that mandate shareowner approval. Shareowner approval of these transactions is critical as they are meant to protect shareowners against insider trading abuses.

The SBA will consider whether the proposed transaction unduly favors the director(s) at the expense of the company or was completed at arm's length. We vote FOR reviews of director transactions by independent committees.

Designate directors to represent company in judicial proceedings: FOR

By the time a company has reached the point of having to restructure, it may be in desperate straits, and attempts to forestall a lifesaving financial operation by voting against this item is counterproductive to shareowners' best interest.

AUDITORS

Most major companies around the world use one of the major international auditing firms to conduct their audits. As such, concerns about the quality and objectivity of the audit are minimal, and the reappointment of the auditor is usually a routine matter. In the United States, companies are not legally required to allow shareowners to ratify the selection of auditors; however, a growing number are doing so. Typically, proxy statements disclose the name of the company auditor and that the board is responsible for selection of that firm.

The auditor's role in safeguarding investor interests is critical. Independent auditors have an important public trust, for it is the auditor's impartial and professional opinion that assures investors that a company's financial statements are accurate.³⁶ Therefore, the practice of auditors providing non-audit services to companies must be closely scrutinized. While large auditors may have internal barriers to ensure that there are no conflicts of interest, an auditor's ability to remain objective becomes questionable when fees paid to the auditor for non-audit services such as management consulting, general bookkeeping, and special situation audits exceed the standard annual audit fees. While some compensation for non-audit services is customary, the importance of maintaining the independence of the auditor is paramount. Auditor independence from the firm being audited is essential to promote objectivity and reduce the potential for abuse.

In addition to ensuring that the auditor is free from conflicts of interest with the company, it is also important to ensure the quality of the work that is being performed. As such, a Glass Lewis trend report noted that the number of restatements is on the decline, down 17 percent from 2006, with one out of ten companies filing restatements in 2007 versus one out of nine companies filing restatements in 2006.³⁷ Despite the decline, restatements persist and can have a negative impact on the perception of the auditor's ability to perform an independent, accurate audit. The integrity of the audit comes into question especially in instances where a company has a significant restatement.

Ratification of Auditors: CASE-BY-CASE

³⁶ Hollis Ashbaugh-Skaife, et al, *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity* June 10, 2008

³⁷ Glass, Lewis & Co., "Restatement Trend Alert: Out of Sight, Out of Mind", 2006

The SBA votes FOR proposals to ratify auditors unless there is reason to believe that the auditing firm has become complacent in its duties or its independence has been compromised. For example, non-audit fees, primarily tax and other consulting fees, can exceed audit fee revenue by a large margin, impairing an audit firm's objectivity. The SBA believes all publicly held corporations should rotate their choice of auditor's periodically. Shareowners should be given the opportunity to review the performance of the auditors annually and ratify the board's selection of an auditor for the coming year. Independent public audit firms should not be the auditors of any company for which they simultaneously provide other services, including other non-audit or information services; audits should be carried out by an independent external auditor. Moreover, the Audit Committee should oversee the firm's interaction with the external auditor and disclose any non-audit fees completed by the auditor. In the event of serial or significant restatements, the SBA will take a closer look at the auditor's performance when considering whether or not to support the re-appointment of the auditor.

Appoint External Auditors and Authorize Directors to Set Auditors' Remuneration: FOR

Shareowners are typically asked to approve the appointment of the independent auditors and to fix their remuneration at every annual shareowner convening. Because most major companies in international markets employ one of the major international auditing firms to conduct their audits, concerns about the quality and objectivity of the audit are generally minimal. As such, the reappointment of the auditor is usually a routine matter and the SBA generally votes in favor of the appointment, unless there are reasons to question their independence.

Appoint Internal Statutory Auditors (Japan, Hong Kong, South Korea): FOR

Most votes for auditors in Japan are to approve internal statutory auditors (also known as corporate auditors) rather than external auditors. Statutory auditors have the right to attend board meetings, although not to vote, and the obligation to cooperate with the external auditor and to approve its audit. They are required by law to keep board members informed of the company's activities, but this has become a largely symbolic function. They do not have the ability to remove directors from office. Internal auditors serve for terms of four years, and may be renominated an indefinite number of times.

Companies must designate at least half of their internal auditors as independent. While companies have complied with the technical requirements of the law, many have ignored its spirit. It is in shareowners' interests to improve the audit and oversight functions in Japan and to increase the accountability of companies to shareowners. Therefore, the SBA will not support internal auditors specified as independent but with a past affiliation with the company.

Companies are also allowed to nominate alternate statutory auditors, who would serve only if an auditor becomes unable to complete his or her term. By designating an alternate in advance, companies are spared the need to convene an EGM to fill a vacancy on the board of statutory auditors. Alternate statutory auditors who are designated as independent should be held to the same standards as other nominees for independent auditor. As with directors, the Corporate Law requires companies to discuss the role played by the outside (independent) statutory auditors, including their attendance at meetings of the board of directors and board of statutory auditors. Where a statutory auditor attends fewer than 75 percent of such meetings, without a reasonable excuse, the SBA will generally vote against the auditor's reelection.

In other capital markets, such as South Korea, proposals seeking shareowner approval for statutory auditors' fees are not controversial. Generally, management should disclose details of all fees paid to statutory auditors well in advance of the meeting date so that shareowners can make informed decisions about statutory auditor remuneration requests.

Remove/Accept Resignation of Auditors - CASE-BY-CASE

The SBA seeks to ensure auditors have not been pressured to resign because of their zeal in providing full disclosure.

Auditor Indemnification and Limitation of Liability: CASE-BY-CASE

Auditor indemnification and limitation of liability are evaluated on a CASE-BY-CASE basis. Factors to be assessed by the SBA include, but are not limited to:

- The terms of the auditor agreement- the degree to which these agreements impact shareowners' rights;
- Motivation and rationale for establishing the agreements;
- Quality of disclosure; and
- Historical practices in the audit area.

The SBA will consider voting against auditor ratification if the auditor engagement contract includes provisions for alternative dispute resolution, liability caps, and caps on punitive damages (or the exclusion of punitive damages). Such limitations on liability and indemnification shift the risk from the auditor to the company, and therefore, the shareowners. The staff of the Securities and Exchange Commission ("SEC") has stated that it believes caps on punitive damages in audit contracts are not in the public interest and makes the auditor no longer independent.³⁸ The SBA will also consider voting against audit committee members when a company has entered into an agreement with its auditor requiring alternative dispute resolution and punitive liability caps.

³⁸ U.S. Securities and Exchange Commission, Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence – Frequently Asked Questions, December 13, 2004.

Approve Accounting Transactions (other than dividend): CASE-BY-CASE

In many international markets, proposals to approve accounting transfers are common and are often required to maintain specified balances in accounts as required by relevant market law. Companies are required to keep specific amounts in each of their reserves. Additionally companies may, in some instances, be required by law to present shareowners with a special auditors' report confirming the presence or absence of any non-tax-deductible expenses, as well as the transfer of these to the company's taxable income if applicable.

In the absence of any contentious matters, the SBA is generally in favor.

Audit Firm Shareowner Proposals: CASE-BY-CASE

Shareowner proposals normally ask companies to prohibit their auditors from engaging in non-audit services (or cap the level of non-audit services) or recommends rotation of the audit firm.

In 1992, the American Institute of Certified Public Accountants' (AICPA) SEC Practice Section released its position regarding mandatory rotation of audit firms of publicly held companies. AICPA concluded that there was no credible evidence that rotating audit firms would improve the quality of audits. AICPA explained that a mandatory rotation "would dramatically increase costs for firms, clients and the public. In addition, it would increase the likelihood of poor audits, by depriving auditors of the most valuable tool: experience with a client and the resulting comprehensive knowledge of its business and operations."³⁹

The concept of term limits for audit firms was encouraged in a 2002 study by the Conference Board's Commission on Public Trust and Private Enterprise. The Commission advocated rotation if the audit firm has been employed for a substantial amount of time (over ten years); when one or more former partners or managers of the firm are employed by the company; or when significant non-audit services are provided to the company. Apart from building shareowner confidence, the study cited other advantages of rotation:

- The incoming audit firm would be able to take a fresh look at the company's finances, accounting practices and the former firm's audit;
- It would reduce the financial incentives for an auditor to compromise its judgment on borderline accounting issues;
- The audit firm would not be risking a lengthy stream of revenues by disagreeing with management; and
- Knowing its work will be reviewed by another firm would deter questionable judgments by the current audit firm.

While there are costs to companies in changing auditors periodically, the Commission contended that such costs would be significantly less than the market costs resulting from the loss of investor confidence arising from inaccurate financial information.⁴⁰

A 2002 Harvard Business Review study observed that auditors are inclined to have a bias toward the companies that hire them. The authors argue that real independence would require automatic rotation of the audit firm, the prohibition of non-audit services, and a ban on auditors from going to work for their former clients.⁴¹ A number of institutional investors advocate a term limit for audit firms of five to seven years, though some shareowner initiatives have suggested four-year cycles.⁴²

The SBA votes CASE-BY-CASE on shareowner proposals related to audit firm fees, rotation requirements and related issues based upon the following:

- The tenure of the audit firm
- The company's establishment and disclosure of a renewal process whereby the auditor is regularly evaluated for both audit quality and competitive price
- The length of the rotation period advocated by the proposal
- Significant audit-related issues

PROXY CONTESTS**Proxy Contests: CASE-BY-CASE**

³⁹ SEC Practice Section and AICPA Division for CPA Firms, Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies, April 16, 1992.

⁴⁰ The Conference Board Commission on Public Trust and Private Enterprise, "Corporate Governance: Principles, Recommendations and Specific Best Practice Suggestions." Parts 2 and 3, Jan. 9, 2003.

⁴¹ Max H. Bazerman, George Loewenstein, and Don A. Moore, "Why Good Accountants Do Bad Audits." Harvard Business Review, Vol. 80, Issue 11, Nov. 1, 2002.

⁴² Individual investor Chris Rossi proposed four-year audit firm rotations at Winn-Dixie Stores Inc. and the Great Atlantic & Pacific Tea Co. in 2002.

Votes on proxy contests should be determined on a CASE-BY-CASE basis, considering the following factors:

- Past performance relative to its peers
- Market in which the fund invests
- Measures taken by the board to address the issues
- Past shareowner activism, board activity, and votes on related proposals
- Strategy of the incumbents versus the dissidents
- Independence of directors
- Experience and skills of director candidates
- Governance profile of the company
- Evidence of management entrenchment

When analyzing proxy contests, the policy focuses on two central questions: (1) Have the dissidents demonstrated that change is warranted at the company, and if so, (2) will the dissidents be better able to affect such change versus the incumbent board?

When dissidents seek board control, the dissidents must provide a well-reasoned and detailed business plan, including the dissidents' strategic initiatives, a transition plan that describes how the dissidents will effect change in control, and the identification of a qualified and credible new management team. The SBA compares the detailed dissident plan against the incumbents' plan, and the SBA compares the dissidents' proposed board and management team against the incumbent team.

When dissidents seek minority board representation, the SBA places a lower burden of proof on the dissidents. In such cases, the SBA's policy does not require the dissidents to provide a detailed plan of action or proof that its plan is preferable to the incumbent plan. Instead, the dissidents must prove that change is preferable to the status quo and that the dissident slate will add value to board deliberations, including by considering the issues from a viewpoint different than current management, among other factors.

Shareowner Proposals to Reimburse Shareowners for Expenses Incurred: CASE-BY-CASE

Most expenditure incurred on behalf of incumbents in a proxy contest is paid directly by the company. Reimbursement is generally limited to those expenses deemed reasonable and necessary to inform shareowners. Practically speaking, reimbursement is almost never denied by these limitations; thus, incumbent directors are free to authorize the company to pay the entire cost of their proxy campaign.

By contrast, in most cases dissidents are reimbursed only for proxy solicitation expenses if they gain control of the company. In successful proxy contests, new management will often seek shareowner approval for the use of company funds to reimburse themselves for the costs of solicitation. The courts have supported such actions in ruling that successful dissident groups benefited the company by removing incompetent or dishonest management.

Empirical evidence suggests that the most advantageous solution for shareowners is an intermediate level of compensation, for both incumbents and dissidents.⁴³ Of course, when a proposal for reimbursement is submitted by the dissidents in either a successful or unsuccessful proxy contest, shareowners are usually asked to vote for or against repaying the entire cost of the solicitation.

Voting to reimburse proxy solicitation expenses should be analyzed on a CASE-BY-CASE basis. In cases where the dissident position is supported, believing it to be in the best interests of shareowners, the SBA generally votes FOR reimbursing such proxy solicitation expenses.

Confidential Voting: FOR

The SBA votes FOR resolutions requesting that corporations adopt a policy comprising both confidential voting and the use of independent vote tabulators and inspectors of elections because it is the best way to guarantee confidentiality. However, the SBA does not withhold support for a resolution calling for confidential voting if it lacks an independent inspector requirement.

ANTI-TAKEOVER DEFENSES AND VOTING-RELATED ISSUES

The rise in unfriendly corporate takeover activity in the 1980s spawned various anti-takeover devices designed to make takeovers prohibitively expensive for the bidder, usually called "poison pills." To further entrench management, corporations sought to limit shareowners' ability to vote. In many earlier cases, boards unilaterally enacted such measures without providing shareowners a voice in the process. States also assumed a role by adopting takeover defense laws or statutes, competing with each other to become the most attractive corporate haven. Today, most companies have an array of defenses in place and, in response shareowners are increasingly filing proposals to remove these defenses.

The debate concerning these defenses focuses on whether they enhance or detract from shareowner value. Proponents argue that a company's board, when armed with these takeover protections, may use them to negotiate and obtain higher takeover premiums

⁴³ Lucian Arye Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests," California Law Review. Vol. 78, October 1990, pp. 1073-1135.

from bidders. According to this position, these devices protect the target company and provide it with negotiating flexibility, which benefits shareowners through financially fair tender offers.

Conversely, the opposing viewpoint claims that management afforded such protection are more likely to become insulated than to actively pursue the best interests of shareowners. Such takeover defenses serve as obstacles to the normal functioning of the marketplace, which, when operating efficiently, should replace poorly performing managers.

Advance Notice Requirements for Shareowner Proposals/Nominations: CASE-BY-CASE

The SBA considers shareowner proposals to provide for advanced notice proposals on a CASE-BY-CASE basis, supporting those proposals which allow shareowners to submit proposals as close to the meeting date as reasonably possible and within the broadest window possible. Requests to move advance notice deadlines as early as 150 days or 180 days prior to meetings have been presented by a number of companies in recent years. Such early deadlines may be intended more to protect incumbent directors than to provide early notice to the board.

In addition, many companies now request shareowner approval of “second generation advance notice bylaws”, which require shareowner nominees to submit company-prepared director questionnaires.⁴⁴ While the SBA appreciates increased disclosure of the qualifications of nominees (and incumbents), we reserve the right to disapprove of such requirements if they served to frustrate shareowner-proposed nominees.

Amend Bylaws without Shareowner Consent: AGAINST

The SBA does not support proposals giving the board exclusive authority to amend the bylaws. Conversely, proposals giving the board, in addition to shareowner, the ability to amend the bylaws are supported by the SBA.

Poison Pills: AGAINST

Stock purchase rights plans or shareowner rights plans, otherwise known as poison pills, have enjoyed widespread adoption since their inception in 1983. Poison pills are the most prevalent takeover defense among S&P 500 companies. They also enjoy support among other large companies. According to publicly available data, over 3,000 plans are now in place at major companies, including over two-thirds of all S&P 500 companies and over one-half of all Business Week 1000 companies.⁴⁵ The vast majority of pills were instituted after November 1985, when the Delaware Supreme Court upheld a company’s right to adopt a poison pill without shareowner approval in *Moran v. Household International, Inc.*

Poison pills are corporate-sponsored financial devices that, when triggered by potential acquirers, do one or more of the following: (1) dilute the acquirer’s equity holdings in the target company; (2) dilute the acquirer’s voting interests in the target company; or (3) dilute the acquirer’s equity holdings in the post-merger company. Generally, poison pills accomplish these tasks by issuing rights or warrants to shareowners that are essentially worthless unless triggered by a hostile acquisition attempt.

Empirical studies reveal that firms that adopt poison pills show higher asymmetry between reported earnings and stock returns after the adoption and greater association between reported current earnings and lagged returns. Furthermore, they show that these firms undertake more R&D expenses and long-term investments after poison pill adoptions. While this evidence supports management’s claims that poison pills increase their propensity to make long-term investments, researchers find that these long-term investments result in a decrease in firm value.⁴⁶

Academic research indicates that firms that have removed poison pills have done so due to shareowner activism. In a study of 126 firms that removed their poison pills during the 1990-2004, Akyol and Carroll (2006) found that the removals took place following shareowner proposals to remove the takeover defenses, despite management’s objection. In cases where companies voluntarily removed their pills, the authors found that such action was taken following active negotiations by institutional investors. Poison pill removals have become more frequent in the post-Enron period. The authors also found that board independence and insider shareholdings are positively related to a board’s responsiveness to shareowner activism to remove pills.⁴⁷

Legal arguments have been made to suggest the illegitimacy of poison pill adoptions. Velasco (2002) argues that at the time the poison pill was first considered, corporate law did not authorize corporations to employ poison pills. According to the same legal academic study, even now, Delaware corporate law, fairly interpreted, does not authorize the use of the poison pill against typical contemporary hostile offers.⁴⁸

According to an academic study, poison pills have an impact on earnings management. Poison pills increase the degree of abnormal accruals by 1.9 percent on average, controlling for factors such as firm size, profitability, financial distress, growth opportunities, and information asymmetry.⁴⁹

⁴⁴ Weingarten, Marc and Erin Magnor, “Second Generation Advance Notification Bylaws” Harvard Law School Corporate Governance Forum, March 17, 2009.

⁴⁵ Thomson Securities Data Co.

⁴⁶ Srinidhi, Bin and Sen, Kaustav, “Effect of Poison Pills on Value Relevance of Earnings.”

⁴⁷ Akyol, Ali C. and Carroll, Carolyn A., “Removing Poison Pills: A Case of Shareowner Activism” (September 2006). Available at SSRN: <http://ssrn.com/abstract=935950>

⁴⁸ Velasco, Julian, “The Enduring Illegitimacy of the Poison Pill”. *The Journal of Corporation Law*, Vol. 27, No. 3, pp. 381-423, Spring 2002

⁴⁹ Jiraporn, Pornsit, “An Empirical Analysis of Corporate Takeover Defenses and Earnings Management: Evidence from the U.S.”, *Applied Financial Economics*, Vol. 15, No. 5, pp. 293-303, 2005

Companies are reacting to hostile takeover attempts by adjusting the rules of their antitakeover mechanisms. Louisiana Pacific Corp. and Micrel, Inc. have changed their shareowner rights plans, redefining the calculation of ownership to include derivatives. Typically, a poison pill is triggered when a shareowner exceeds a certain percentage of ownership of voting shares. The new emerging types of poison pills would trigger a defense mechanism when shareowners' economic interests, including derivatives, which do not confer voting rights to the owner, exceed a set threshold.

Poison pill adoptions that include derivatives arose in response to the proxy contest that The Children's Investment Fund (TCI) and 3G Capital Partners (3G) waged against CSX Corporation. TCI and 3G were involved in a proxy contest with CSX, requesting the replacement of 5 members of the total 12 members of CSX's board of directors. In June 2008, a court ruling against TCI and 3G declared that the two investors evaded disclosure of their total interest in railroad operator CSX, as the funds did not disclose their holdings of total return swaps. The ruling in relation to the CSX case and the new types of pills, as those introduced by Louisiana Pacific and Micrel hint to a movement towards new disclosure rules, which would strengthen companies' defenses against activist investors.⁵⁰

A Moody's study finds evidence supporting the view that more takeover defenses are associated with higher levels of credit risk. The report warns that the correlation is weak, and that the impact of takeover defenses on credit risk should be evaluated on a case-by-case basis.

According to a research report by RMG, the percentage of US companies with poison pills has dropped considerably in the post-Enron era. The number of S&P 500 companies with poison pills decreased from approximately 60 percent in 2002 to below 40 percent in 2006. A smaller, but still considerable, decrease was observed in the S&P 1500 companies, from slightly above 60 percent to approximately 45 percent of companies. In contrast to the decrease of poison pills in the US market, takeover defenses are on the rise in Japan and France.

In Japan, the introduction of the defenses comes as a reaction to foreign and domestic shareowners' demands for improved returns. Poison pills have been on the rise in Japan since 2005 when only 21 companies had a poison pill in place. That number rose to 165 in 2006, 266 in 2007, and reached more than 400 in 2008. The increase in poison pills is due to a convergence of factors including: a movement toward investors willing to tender their shares to a hostile acquirer, an emergence of investment funds, and the realization by Japanese managers that their companies are vulnerable to an acquirer. The most common poison pill used in Japan is the advance-warning type. Occasionally shareowners call for such pills to be abolished. A recent White Paper by the Asian Corporate Governance Association cited poison pills and the entrenchment of management as the core issues affecting the development of a robust investment community in Japan [ACGA White Paper, p. 28]. While the White Paper notes that the adoption of poison pills had a negative impact on share price, it also notes that those companies that adopted poison pills also had weak financial performance before adopting the poison pills. With more than half of Japanese companies trading below book value, and chronic overcapacity in many industries, it's hard to see how investors gain by helping underperforming managers resist buyouts.⁵¹

In France, poison pill adoptions appear as expressions of economic nationalism and protectionism. In contrast to France and Japan, Canada has taken steps to emphasize the rights of shareowners to consider and make final decisions on takeover offers with new generations rights plans, which seek to eliminate board discretion in controlling the bid process.⁵²

The SBA supports proposals asking a company to submit its poison pill for shareowner ratification, and votes AGAINST proposals approving or creating a poison pill. "Pills," or shareowner rights plans, have the potential to act as doomsday machines in the event of an unwanted control contest, providing a target board with power (all it has to do is refuse to redeem the pill) over the takeover bid, even if the bid is in the best interest of target shareowners. The power of redemption is the crucial issue for shareowners, because the courts have allowed target company boards great leeway in deciding when a pill must be redeemed, even in the event of bona fide offers. The best defense against hostile takeovers is not necessarily a poison pill, but an effective board making prudent financial and strategic decisions for the company. Since shareowners are rarely afforded the opportunity to vote on the adoption or renewal of poison pills, the SBA will consider voting against boards that adopt or renew a poison pill unless the pill is subject to shareowner ratification within a year of adoption or renewal.

Anti-Takeover Provisions (France): AGAINST

All forms of public offers, whether hostile or not, have been more common in recent years, with one research piece citing an average of approximately 90 takeover offers being made each year ["Takeover in France" Freshfields Bruckhaus Deringer]. Since France's implementation of the European Union Directive on takeover bids in March 2006, there has been a proliferation of proposals specifically related to approving anti-takeover provisions. French law requires companies to disclose whether any proposed capital devices, debt instruments, or other transactions will be used for the purposes of an anti-takeover mechanism. Generally, these proposals are presented as either (i) authority to repurchase shares and trade in company stock during a takeover period; (ii) authority to issue warrants as a takeover defense; (iii) authority to increase capital as a takeover defense; or (iv) authority to prevent a takeover of the company.

⁵⁰ Lemos-Stein, Mara, "Poison Pills Target Derivatives", Wall Street Journal, June 18, 2008.

⁵¹ "Poison Pills in Japan, What You Need to Know" RiskMetrics Group, April 25, 2008.

⁵² "Poison Pills in France, Japan, the U.S. and Canada: Takeover Barriers Rise in Europe and Japan, But Fall in North America." RiskMetrics Group, May 2007.

The SBA votes AGAINST these authorities as they are not conducive to good corporate governance and can reduce investment returns by substantially limiting opportunities for corporate takeovers.

Limit Written Consent: CASE-BY-CASE

The SBA votes AGAINST proposals to restrict or prohibit shareowners' ability to take action by written consent and vote FOR shareowner proposals to allow or make easier shareowner action by written consent. Most states allow shareowners to take direct action such as adopting a shareowner resolution or electing directors through a consent solicitation, which does not involve a physical meeting. Alternatively, consent solicitations can be used to call special meetings and vote on substantive items taking place at the meeting itself.

Limit Special Meetings: CASE-BY-CASE

The SBA votes AGAINST proposals that restrict or prohibit a shareowner's ability to call special meetings. We vote FOR shareowner proposals that make it easier for shareowners to call special meetings. Most state corporate statutes allow shareowners to call a special meeting when they want to present certain matters before the next annual meeting. The percentage of shareowner votes required to force the corporation to call the meeting depends on particular state statutes, as does the corporation's ability to limit or deny altogether a shareowner's right to call a special meeting.

Supermajority Vote Requirements: AGAINST

The SBA does not support shareowner proposals that require supermajority voting thresholds, except where required by law. Supermajority requirements can be particularly significant with resolutions to approve mergers and other significant business combinations. Conversely, we vote FOR shareowner proposals that lower such super-majority vote requirements. As a matter of principle, we think shareowner desires should be carried out with a majority vote of the disinterested shares. Furthermore, we much prefer fair price provisions. Fair price provisions, an alternative to the supermajority vote requirement for mergers, combine a standard super-majority vote requirement with the additional protection of requiring that all shareowners left in the back end of a two stage merger be compensated as well as those in the front end.

A study by three academics from 1999 concludes that supermajority requirements discourage a potential acquirer from launching a takeover process, but only when a rival bidder might contest the offer, which is precisely the situation that could generate the greatest economic gain for shareowners. On the other hand, fair price provisions ensure that rival bidders who place a higher value on the target than the initial bidder will enter the contest, resulting in the prospect of more value being delivered to investors. Hence, the study demonstrates that supermajority clauses are unambiguously poor policy while fair price provisions may not be.⁵³

Adopt Supervoting Rights ("Phased Voting") attached to shares held for longer than some specified period: AGAINST

Under SEC Rule 19c-4, firms are generally prohibited from utilizing several forms of stock that deviate from a one-share, one-vote standard. Such instances include tracking stocks, different stock classes with asymmetric voting rights (e.g. dual class shares), shares with time-phased voting rights as well as shares of stock with capped voting or even no rights whatsoever. However, under an amendment to the Rule made in 1994, most U.S. companies are exempted from such restrictions under particular circumstances. Time phased voting involves the granting of super voting rights to shareowner who have held their stock for some specified period of time, commonly for a period of 5 years, and if so, has the ability upon certification to exercise a disproportionate voting decision. When the SBA has owned equity securities for the required time period, ownership certification will be provided in order to maximize the proxy voting rights offered by time-phased shares.

Additionally, the easiest way for companies to thwart a hostile takeover is to concentrate its voting power in the hands of management or other insiders through the issuance of shares with supervoting rights to members of management. The SBA votes AGAINST the adoption of supervoting rights due to its potential to be used as an anti-takeover instrument.

MERGERS & CORPORATE RESTRUCTURINGS

Mergers/Acquisitions: CASE-BY-CASE

Merging with another company may take place for numerous reasons ranging from vertical integration to capital acquisition. In general, the SBA favors most mergers and acquisitions proposals while considering such factors as business combination or acquisition, the merger's or acquisition's economic merits (synergy), opinion of financial advisor(s), potential conflicts between management's interests and those of shareowners, and impact on corporate governance and shareowner rights. The SBA may vote AGAINST the merger or acquisition if there is a significant lack of information in order to make an informed voting decision.

Appraisal Rights: FOR

In many states, mergers and other corporate restructuring transactions are subject to appraisal rights. Rights of appraisal provide shareowners, who are not satisfied with the terms of certain corporate transactions, the right to demand a judicial review to determine a fair value for their shares. Such rights also serve another important interest. If a majority of shareowners approve a given transaction, the exercise of appraisal rights by a minority of shareowners will not necessarily prevent the transaction from taking place. Therefore, assuming that a small minority of shareowners succeed in obtaining what they believe is a fair value,

⁵³ Ravid, S. Abraham and Matthew I. Spiegel, "Toehold Strategies, Takeover Laws and Rival Bidders." Journal of Banking and Finance, Vol. 23, No. 8, 1999, pp. 1219-1242.

appraisal rights may benefit all shareowners. The downside of appraisal rights is that if enough shareowners dissented and if the courts found a transaction's terms were unfair, such rights could prevent a transaction that other shareowners had already approved.

The SBA votes FOR proposals to restore or provide shareowner with rights of appraisal.

Asset Purchases: CASE-BY-CASE

The SBA evaluates asset purchase proposals on a CASE-BY-CASE basis, considering the following factors:

- Purchase price
- Fairness opinion
- Financial and strategic benefits
- How the deal was negotiated
- Conflicts of interest
- Other alternatives for the business
- Non-completion risk

Asset Sales: CASE-BY-CASE

The SBA examines asset sales on a CASE-BY-CASE basis, considering the following factors:

- Impact on the balance sheet and working capital
- Potential elimination of diseconomies
- Anticipated financial and operating benefits
- Anticipated use of funds
- Value received for the asset
- Fairness opinion
- How the deal was negotiated
- Conflicts of interest

Approve Reorganization of Division or Department/Arrangement Scheme, Liquidation - CASE-BY-CASE

Resolutions approving corporate reorganizations or restructurings range from the routine shuffling of subsidiaries within a group to major rescue programs for ailing companies. Such resolutions are usually standard unless there are clear conflicts of interest among the various parties, shareowners' rights are being negatively affected, or certain groups or shareowners appear to be getting a better deal at the expense of general shareowners. In the case of routine reorganizations of assets or subsidiaries within a group, the primary focus with the proposed changes is to ensure that shareowner value is being preserved, including the effect of the reorganization on the control of group assets, final ownership structure, relative voting power of existing shareowners if the share capital is being adjusted, and the expected benefits arising from the changes. Options are far more limited in the case of a distress restructuring of a company or group as shareowners often have no choice but to approve the restructuring or lose everything. In such cases, the SBA first determines the company's degree of distress by examining whether the company still has a positive net asset value, that is, if realizable assets are greater than liabilities.

In most cases, however, the company has a negative asset value, meaning that shareowners would have nothing left after a liquidation. The SBA seeks to ensure that the degree of dilution proposed is consistent with the claims of outside parties and is commensurate with the relative commitments of other company shareowners. Because ownership of a small percentage of something is worth more than majority ownership of nothing, existing shareowners usually must accept the transfer of majority control over the company to outside secured creditors.

Approve Special Purpose Acquisition Company (SPAC) Transaction: CASE-BY-CASE

A SPAC is a pooled investment vehicle designed to invest in private equity type transactions, particularly leveraged buyouts. Although SPACs have been around since the 1990s, they have experienced a recent resurgence since 2003. SPACs are shell companies that have no operations at the time of their initial public offering, but are intended to merge with or acquire other companies. Normally, most if not all of a SPAC's IPO proceeds are held in trust to use to fund future acquisitions. Most SPACs grant shareowners voting rights, in order to approve proposed business combinations. When an acquisition deal is proposed, a shareowner has three options—the shareowner can approve the transaction by voting in favor of it, elect to sell their shares in the open market, or vote against the transaction and redeem their shares for a pro-rata share of the trust account. The assets of the trust are only released if a business combination is approved by the voting shareowners, or a business combination is not consummated within 24 months of the initial offering. This guarantees a minimum liquidation value per share in the event that a business combination is not effected.

Business transactions by SPAC entities have distinct differences when compared to standard M&A transactions:

Standard M&A	SPAC Merger
<p>Valuation analysis</p> <ul style="list-style-type: none"> · Premium paid for target shares · Fairness opinion – performed by third party 	<p>Valuation analysis</p> <ul style="list-style-type: none"> · Premium is very difficult to calculate as generally the target is a private company

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<ul style="list-style-type: none"> Financials available for both target and the acquirer Post merger ownership 	<ul style="list-style-type: none"> Generally no independent fairness opinion. Most SPACs provide comparable analysis/valuation performed by sponsors. Financials may be limited as target in a private company Conversion value – compare conversion price vs. underlying value of the target company/acquirer’s current market price Post merger ownership – Usually target shareowners become majority owners of the combined entity. Analysts should evaluate the proportionate value of the combined entity attributable to the SPAC IPO shareowners versus the pre-merger value of SPAC. Apply private company discount to the target, if it is a private entity
<p>Market reaction</p> <ul style="list-style-type: none"> 1-day reaction and announcement-to date (acquirer) Stock price – review if trades above offer from announcement to date (public target) 	<p>Market reaction</p> <ul style="list-style-type: none"> 1-day reaction and announcement-to date (SPAC as acquirer) Stock price – not applicable since target is private
<p>Strategic rationale</p> <ul style="list-style-type: none"> Synergies (cost/revenues) 	<p>Strategic rationale</p> <ul style="list-style-type: none"> Generally no synergies, as SPAC is a shell company with no operations Charter requirement – mandate is to complete deal in 18-24 months
<p>Negotiations and process</p> <ul style="list-style-type: none"> Strategic process – full auction, partial auction, no auction, or go-shop period Management track record 	<p>Negotiations and process</p> <ul style="list-style-type: none"> Strategic process – process undertaken to identify potential target companies within specified industry or location specified in charter Management track record – usually none for the SPAC. Mostly, the management of the target is retained to manage the combined entity Sponsors’ background
<p>Conflicts of interest</p> <ul style="list-style-type: none"> CIC Payments Post-transaction management positions/ board seats 	<p>Conflicts of interest</p> <ul style="list-style-type: none"> Founding sponsors usually retain 20 percent of the SPAC equity to find a deal. This causes immediate dilution upon consummation of the transaction. Time frame - deal must get done in an 18-24 month time frame unless an extension is approved by IPO shareowners. Urgency to close deal would increase as it gets closer to the expiration date. Fairness opinion – usually performed by insiders which could pose a conflict 80 percent rule – may cause management to pay higher price for the target.
<p>Governance</p> <ul style="list-style-type: none"> Governance structure – better or worse (target) 	<p>Governance</p> <ul style="list-style-type: none"> Usually not applicable

SPACs may also pursue conversion rights, with distinct differences relative to standard M&A transactions:

<p>Standard M&A</p> <p>Conversion/Voting Rights</p> <ul style="list-style-type: none"> Appraisal rights – depends on state law Voting rights – majority, 67 percent, etc. 	<p>SPAC Merger</p> <p>Conversion/Voting rights</p> <ul style="list-style-type: none"> Conversion rights – IPO shareowners can request money back if they vote against the transaction or if the SPAC is liquidated Two-tiered voting thresholds – majority + not more than 20 percent (or another specified number) exercise conversion rights Some SPAC sponsors enter into voting agreement/tender offer with shareowners who are likely to vote AGAINST the proposed merger.
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The SBA evaluates proposals for SPAC transaction and SPAC conversion rights on a CASE-BY-CASE basis.

Formation of Holding Company – CASE-BY-CASE

The SBA evaluates proposals to create a parent holding company on a CASE-BY-CASE basis, considering the following factors:

- The reasons for the change
- Any financial or tax benefits
- Regulatory benefits

- Increases in capital structure
- Changes to the articles of incorporation or bylaws of the company

The SBA will vote AGAINST a proposal to form a holding company should the formation of a holding company result in increases in common or preferred stock in excess of the allowable maximum or result in adverse changes in shareowner rights.

Approve a “Going Dark” Transaction: CASE-BY-CASE

Deregistration, or “going-dark,” transactions occur whereby companies cease SEC reporting but continue to trade publicly. Such transactions are intended to reduce the number of shareowners below 300 and are typically achieved either by a reverse stock split (at a very high ratio with fractional shares resulting from the reverse split being cashed out), by a reverse/forward stock split (with fractional shares resulting from the reverse split being cashed out), or through a cash buyout of shares from shareowners owning less than a designated number of shares (tender offer or odd-lot stock repurchase). Such transactions allow listed companies to de-list from their particular stock exchange and to terminate the registration of their common stock under the Securities & Exchange Act of 1934, so that, among other things, they do not have to comply with the requirements of the Sarbanes-Oxley Act of 2002. Some empirical study indicates that following the enactment of the SOX there was a significant increase in the number of companies going dark, especially among smaller capitalization firms and those with lower quality financial accounting. Furthermore, on average, firms going dark experience significant declines in market value. There is also some evidence that firms may pursue a de-registration in order to protect private control benefits and decrease outside scrutiny and oversight.⁵⁴

Reasons for “going dark” include:

- A company derives no material benefit from its status as a public reporting company;
- The low trading volume in its common stock has not provided significant liquidity to shareowners;
- A company does not expect that it will use its common shares as consideration for acquisitions or other transactions in the foreseeable future and has no present intention of raising capital through a public offering;
- The low trading volume in the common stock results in an inefficient trading market causing substantial spikes in the trading price when actual trades are made;
- The direct and indirect costs of remaining a public company (principally compliance with section 404 of Sarbanes-Oxley) will be unduly burdensome and costly in relation to a company's size;
- The common stock has attracted only limited market research attention and the company has not enjoyed the appreciable enhancement in image that usually results from having listed company status.

The benefits of de-listing and de-registering include:

- Eliminating the costs associated with filing documents under the Exchange Act with the SEC;
- Eliminating the costs of compliance with Sarbanes-Oxley and related regulations;
- Reducing the direct and indirect costs of administering shareowner accounts responding to shareowner requests;
- Affording shareowners who hold fewer than a designated number of shares the opportunity to receive cash for their shares without having to pay brokerage commissions and other transaction costs; and
- Permitting management to focus its time and resources on the company's long-term business goals and objectives.

Some of the disadvantages of de-listing and de-registration include:

- Shareowners owning less than a designated number of shares immediately before the transaction would not have an opportunity to liquidate their shares after the transaction at a time and for a price of their own choosing. Instead, they would be cashed out and would no longer be shareowners and would not have the opportunity to participate in or benefit from any future potential appreciation in the company's value.
- Continuing shareowners would no longer have available all of the information regarding a company's operations and results that is currently available in filings with the SEC.
- Following the transaction, shareowners would no longer be able to trade their securities, except in the pink sheets (if at all) or in privately negotiated transactions; the effect of this may be a significant reduction in liquidity.
- A company may have less flexibility in attracting and retaining executives and other employees because equity-based incentives (such as stock options) tend not to be viewed as having the same value in a non-listed company.
- A company will be less likely to be able to use its common shares to acquire other companies.

Leveraged Buyout (LBO): CASE-BY-CASE

A leveraged buyout is a takeover of a company using borrowed funds, normally by management or a group of investors. Most often, the target company's assets serve as security for the loan taken out by the acquiring firm, which repays the loan out of cash flow of

⁵⁴ “Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations,” Christian Leuz, Alexander Triantis and Tracy Wang, Finance Working Paper Number 155/2007, European Corporate Governance Institute, March 2008.

the acquired company. The SBA is in favor of LBO's whenever public shareowners receive the customary premium over the current market value of their shares without decimating the target firm's balance sheet.

Net Operating Loss Carry-forward (NOL) & Acquisition Restrictions: CASE-BY-CASE

Companies may seek approval of amendments to their certificate of incorporation intended to restrict certain acquisitions of its common stock in order to preserve net operating loss carry-forwards (or "NOLs"). NOLs can represent a significant asset for the company, one that can be effective at reducing future taxable income. Generally, both the amount and timing of a firm's future taxable income cannot be accurately predicted. Under Section 382 of the Internal Revenue Code of 1986 (the "Code") and other rules promulgated by the IRS, in certain circumstances firms "carry forward" these NOLs to offset any current and future earnings and thus reduce the company's federal income tax liability, subject to certain requirements and restrictions. The benefit comes from offsetting future taxable income dollar-for-dollar by the amount of NOLs, thereby reducing or eliminating the company's taxes on such income.

Section 382 of the Code imposes limitations on the future use of the company's NOLs if the company undergoes an, "ownership change." An ownership change, as defined under Section 382, occurs if one or more shareowners, each of whom owns 5 percent or more of a company's stock, increases its aggregate percentage ownership by more than fifty percentage points over the lowest percentage of stock owned by such shareowner over the preceding 3 year period. All percentage determinations are based on the fair market value of a company's capital stock, including any preferred stock. It is important to recognize that certificate amendment(s) to restrict stock ownership (tied to NOLs) may only be enforceable against shares voted in favor of such amendment(s). Due to this circumscription, shares could be transferred in a manner that would constitute an "ownership change."

Upon an ownership change, the IRS limits the amount of income that NOLs can be offset in any year after the change, regardless of how much income a company earns. If a company experiences an ownership change, the amount of taxable income in any taxable year subsequent to the ownership change that can be offset by NOLs existing prior to such ownership change generally cannot exceed the product of (1) the aggregate value of the company's stock, and (2) the federal long-term tax-exempt rate.

Most certificate amendments restrict any person from transferring common stock if the transfer would result in a shareowner (or a "group" of shareowners under the federal securities laws) owning a certain percentage (e.g. 10 percent) or more of the company's common stock. There are normally no restrictions on stock sales if a shareowner supports such certificate amendments and group thresholds are not triggered. However, there can be convoluted procedural requirements and an impact on liquidity under some circumstances. For example, at some firms, shareowners that violate such NOL based restrictions may not be entitled to any rights, including, without limitation, the right to vote certain shares nor receive dividend payment. Firms often utilize a shareowner rights plan (poison pill) in conjunction with NOL oriented acquisition restrictions.

While stock ownership limitations may allow the company to maximize use of its NOLs to offset future income, they may significantly restrict specific shareowners from increasing their ownership stake in the company. Furthermore, because further purchases of company stock normally requires explicit board approval, such ownership limitations can be viewed as an anti-takeover device. The SBA does not favor ownership limits (or transfer restrictions) for these reasons. However, when firms seek takeover protection in order to solely protect NOLs, a review of the company's control protections and corporate governance structure is conducted and balanced against the financial value of the NOLs (relative to the firm's market capitalization).

Spinoffs: CASE-BY-CASE

While evaluating spin-offs or corporate divestitures on a CASE-BY-CASE basis, the SBA takes the following factors into account:

- Tax and regulatory advantages
- Planned use of the sale proceeds
- Valuation of spinoff
- Fairness opinion
- Benefits to the parent company
- Conflicts of interest
- Managerial incentives
- Corporate governance changes
- Changes in the capital structure

Change of Corporate Form (Germany, Australia, New Zealand): CASE-BY-CASE

This proposal seeks shareowner approval to convert the company from one corporate form to another. Examples of different corporate forms include: Inc., LLP, PLP, LLC, AG, SE. The SBA generally votes FOR such proposals, unless there are concerns with the motivation or financial impact of a change to firm's corporate structure.

Other business affecting company participation in tender offers: CASE-BY-CASE

The SBA considers whether our shareowner interests are promoted or weakened.

OPERATIONAL ITEMS

This section contains proposals that address normal operating procedures of the company, most of which are of the “housekeeping” nature. While many of these management proposals do not require shareowner approval, some boards decide to submit them to shareowners for ratification. The list of operational items includes: changing the name of the company, routine bylaw amendments, changes to the date, time, or location of the annual meeting, adjourning the meeting, transacting other business matters, general meeting procedures and formalities.

Operational issues submitted by management will be supported absent compelling factors to the contrary. Due to its broad term, the SBA will always vote against proposals to transact other business as it is in the best interest of shareowners not to give directors such discretion to influence corporate decisions without shareowner approval. Conversely, the SBA will not support proposals to reduce quorum requirements, proposals to suppress shareowners’ rights, and proposals to adjourn the meeting of shareowners absent compelling reasons to support such proposals.

While many of these proposals are considered to be routine, they are not inconsequential as fiduciaries remain charged with casting their votes. Furthermore, companies may bundle non-routine items with routine items in an attempt to obtain a more favorable outcome, so the SBA must examine these proposals on a case-by-case basis.

Adjourn Meeting: CASE-BY-CASE

The SBA generally votes AGAINST proposals to provide management with the authority to adjourn an annual or special meeting absent compelling reasons to support the proposal.

The SBA votes FOR proposals that relate specifically to soliciting votes for a merger or transaction if supporting that merger or transaction. Additionally, the SBA votes AGAINST proposals if the wording is too vague or if the proposal includes “other business.”

Amend Shareowners’ Meeting Quorum Requirements: AGAINST

The SBA generally votes FOR when requiring a simple majority and AGAINST when requiring a super-majority (except where required by law).

Amend Technical/ Minor Bylaws or Articles of Association: FOR

The SBA votes FOR bylaw or charter changes that are of a housekeeping nature (corrections or updates to comply with law/listing requirements).

Amend Bylaws or Articles of Association (Special): CASE-BY-CASE

The SBA evaluates resolutions to amend bylaw or articles of association on a CASE-BY-CASE basis, considering the merits of the proposed amendment and its potential impact on shareowner value. When several measures, each of which might be approved on a stand-alone basis, are combined (“bundled”) into a single proposal the result may be so restrictive as to warrant opposition.

Amend Business Objectives Clause in Bylaws or Articles of Association: CASE-BY-CASE

Proposals to amend corporate purpose are voted on a CASE-BY-CASE basis, considering how the changes in business lines may affect our interests as shareowners.

Name Change: FOR

Changing a company’s name is a major step that has likely gone through extensive management consideration and/or marketing research. We are generally in favor of these proposals.

Approve General Meeting Formalities: FOR

This item would authorize the holder of a copy of the minutes of the shareowners’ meeting to accomplish any formalities required by respective market laws.

Change Proxy Card to Allow for 2-way (Pro/Con) Voting: FOR

This item allows shareowners to communicate their desires more fully, and it ensures that shareowners may exercise their full voting rights.

Assign to the Usufructuary (beneficiary), instead of the Trustee, the voting rights appurtenant to shares held in trust: CASE-BY-CASE

The SBA votes AGAINST if the company assigns voting rights to a foundation allied to management.

Receive/Approve/Amend Reports and Audited Accounts for Previous Financial Reporting Period(s): CASE-BY-CASE

Generally, we are in favor of these proposals unless we are aware that there are serious concerns about the accounting principles used or doubts about the integrity of the company’s auditor. We support accurate audited financial statements. Additionally, we believe annual audits of a firm’s financial statements should be mandatory and carried out by an independent auditor.

Change Method of Preparing Accounts/Distributing Financial Statements to Shareowners: CASE-BY-CASE

If the changes have been instituted by a nationwide regulation, they will be approved. Otherwise, they will be carefully scrutinized to ensure they are not damaging to our interests. For instance, managers may seek to reclassify accounts to enhance their perceived performance. If this is the case, then managers may earn more in performance-based compensation without adding actual value to the firm.

Authorize Directors to Appropriate Reservas Voluntarias (Spain): FOR**Authorize Directors to Make Transfers in Reserve Accounts: FOR****Adopt/Raise/Lower Stake Disclosure Requirement(s): CASE-BY-CASE**

Generally, we vote in favor of these proposals. Although rare, management proposals may be submitted to conform to recent changes in home market disclosure laws or other regulations. However, proposed levels that are below typical market standards are often only a pretext for an antitakeover defense. Additionally, lower disclosure levels also require a greater number of shareowners to disclose their ownership, causing a greater burden to shareowners and to the company. Positions of more than five percent are significant, however, and this is the standard that the US SEC employs.

Restrict Inter-shareowner Communications: AGAINST

The SEC has established enforceable guidelines that restrict shareowners or other parties from communicating with each other for the purposes of soliciting proxies or pursuing corporate takeover measures. Therefore, we do not feel that it is appropriate for a company to burden its shareowners with additional restrictions. Furthermore, dialogue among shareowners assists all shareowners in seeing each shareowner's perspective, which promotes the pursuit of wealth maximization for all shareowners.

Change Date of Fiscal Year-End: FOR

Companies routinely seek shareowner approval to change their fiscal year end, a decision best left to management. Most countries require companies to hold their AGM within a certain period of time after the close of the fiscal year. While the SBA typically supports this routine proposal, opposition may be considered in cases where the company is seeking the change solely to postpone its AGM.

Change of Stock Listing Exchange: FOR

The SBA believes that voting for a change in stock listing (exchange) may lead to an increase in the value of stock.

Set or Change Date or Place of Annual Meeting Location: CASE-BY-CASE

Flexibility is necessary in both time and location of board meetings. As such, the SBA generally votes in favor of proposals that provide balance relating to a shareowner meeting's location.

Limit Voting Rights: AGAINST

The SBA supports maximization of shareowners' voting rights at corporations. Any attempts to restrict or impair shareowner-voting rights, such as caps on voting rights, holding period requirement, and restrictions to call special meetings, will be strongly opposed.

Improve Meeting Reports: FOR

The SBA believes that meeting reports always have room for improvement. We vote FOR these proposals even though only marginal improvements may be realized.

Abstention Voting Tabulation (unless required by local law): FOR**Tabulating Votes: CASE-BY-CASE**

The SBA supports proposals that allow for independent third parties to examine and tabulate ballots.

Increase/Decrease Majority Required for Passage of Ordinary Resolutions: AGAINST

The SBA votes AGAINST increases in majority requirements and FOR decreases (except where required by law).

Increase/Decrease Majority Required for Passage of Extraordinary Resolution (including requirements for By-law/Article repeal or amendment): AGAINST

The SBA votes AGAINST increases in majority requirements and FOR decreases (except where required by law).

Prohibit Solicitation of Shareowner Consents to Action in Lieu of Meeting: AGAINST**Establish a Distinction Favoring Nominees/Registered Holders/Beneficial Holders: AGAINST****Provide for Equal Treatment of Nominees & Beneficial Holders: FOR****Allow Directors to Vote on Matters in Which They Are Interested: CASE-BY-CASE**

Generally, the vote will be AGAINST unless it is shown that the directors' interests are not material or the proposal conforms to federal regulations or stock exchange requirements.

Allow Directors to Meet Over the Telephone or Via Other Telecommunications Media: CASE-BY-CASE**Change/Set Procedure for Calling Board Meetings: FOR**

The SBA embraces full disclosure regarding the procedures for calling board meetings. Therefore, we typically vote FOR improvements in these procedures and the disclosure of these procedures.

Change Quorum Requirement for Board Meetings: CASE-BY-CASE***Transact Other Business: AGAINST***

This item provides a forum for questions and any other resolutions that may be brought up at the meeting. In most countries, the item is a formality and does not require a shareowner vote, but companies in certain countries include other business as a voting item. "Other Business" is such a broad term that it is probably in the best interest of shareowners not to give directors such discretion to influence corporate decisions without shareowner approval. Additionally, because shareowners who vote by proxy cannot know what issues will be raised under this item, the SBA cannot support this request when asked for a vote.

STATE OF INCORPORATION

The relative rights and powers of management, shareowners, and other company stakeholders can vary significantly from state to state. A company incorporated in one state is entitled to do business and have its governance provisions respected throughout the country. A corporation having no business contacts or connections in a state may nonetheless choose that state as its place of incorporation and that state's laws as those that determine its internal governance structure. The ability of corporations to choose their legal domicile has led many states to compete for revenue from corporate fees and taxes by enacting management-friendly incorporation codes. Additionally, this competition has encouraged states to support an array of antitakeover devices and wide latitude in restricting the rights of shareowners.

Control Share Acquisition Provisions: CASE-BY-CASE

Control share acquisition statutes function by denying shares their voting rights when they contribute to ownership in excess of certain thresholds. Voting rights for those shares exceeding ownership limits may only be restored by approval of either a majority or supermajority of disinterested shares. Thus, control share acquisition statutes effectively require a hostile bidder to put its offer to a shareowner vote or risk voting disenfranchisement if the bidder continues buying up a large block of shares.

The SBA votes FOR proposals to opt out of control share acquisition statutes unless doing so would enable the completion of a takeover that would be detrimental to shareowners. Additionally, the SBA votes FOR proposals to restore voting rights to the control shares.

Conversely, the SBA opposes proposals to amend the charter to include control share acquisition provisions or limit voting rights.

Control Share Cash-Out Provisions: FOR

Control share cash-out statutes give dissident shareowners the right to "cash-out" of their position in a company at the expense of the shareowner who has taken a control position. In other words, when an investor crosses a preset threshold level, remaining shareowners are given the right to sell their shares to the acquirer, who must buy them at the highest acquiring price.

The SBA votes FOR proposals to opt out of control share cash-out statutes.

Disgorgement Provisions: FOR

Disgorgement provisions require an acquirer or potential acquirer of more than a certain percentage of a company's stock to disgorge (or pay back) to the company any profits realized from the sale of that company's stock purchased 24 months before achieving control status. All sales of company stock by the acquirer occurring within a certain period of time (between 18 months and 24 months) prior to the investor's gaining control status are subject to these recapture-of-profits provisions.

The SBA votes FOR proposals to opt out of state disgorgement provisions.

Anti-Greenmail: FOR

Greenmail payments are targeted share repurchases by management of company stock from individuals or groups seeking control of the company. They are one of the most wasteful entrenchment devices available to management. Since only the hostile party receives payment, usually at a substantial premium over the market value of his shares, the practice is discriminatory to all other shareowners of the company. With greenmail, management transfers significant sums of corporate cash, not their own, to one entity for the sole purpose of saving their position and fending off a hostile takeover. This is cash that could be put to use for reinvestment in the company, payment of dividends, or to fund share repurchases, with all shareowners participating on an equal basis.

We vote FOR proposals to adopt anti-greenmail charter or bylaw amendments or otherwise restrict a company's ability to make greenmail payments.

"Fair Price" and similar provisions in two-tiered tender offers: CASE-BY-CASE

Votes will be cast FOR management proposals to adopt a fair price provision as long as the shareowners vote requirement embedded in the provisions is no more than a majority of the disinterested shares. The SBA will vote AGAINST all other management

fair price proposals. In addition, votes will be cast FOR shareowner proposals to lower the shareowners vote requirement embedded in existing fair price provisions.

Fair Price Provision: CASE-BY-CASE

Fair price provisions are a variation on standard supermajority voting requirements for mergers, whereby shareowners vote before a significant business combination can be affected. Fair price provisions add a third option, allowing a bidder to consummate a merger without board approval or a shareowner vote as long as the offer satisfies the price requirements stipulated in the provision. Although the price requirements vary from company to company, the common requirement is that in order to consummate a merger, an offeror must pay minority shareowners at least as much as he/she paid to gain a controlling position in the company. Fair price provisions are normally adopted as amendments to a corporation's charter. The provisions normally include a super-majority lock-in, a clause requiring a super-majority shareowner vote to alter or repeal the provisions itself. We vote FOR management proposals to adopt a fair price provision, as long as the shareowner vote requirement imbedded in the provision is no more than a majority of the disinterested shares. We vote AGAINST all other management fair price provisions and FOR shareowner proposals to lower the shareowner vote requirement imbedded in existing fair price provisions.

Re-incorporation to a Different State: CASE-BY-CASE

Corporations may change the state in which they are incorporated as a way of strengthening their defense(s) against unwanted takeovers. Conversely, the move may also be a way of loosening takeover defenses by moving to a state that has lax takeover laws. Many companies changed their state of incorporation to Delaware in the 1980's because they viewed it as having a legal climate favorable to management. In 2007, North Dakota changed its laws of incorporation in an effort to create an environment of corporate governance best practices and strong shareowner rights. The SBA will consider proposals to shift the state of incorporation to North Dakota on a case-by-case basis. The opportunity to increase shareowner rights will be weighed against the costs and potential disruption of changing the state of incorporation. Significant governance shortfalls, such as a board's lack of responsiveness to a majority-supported shareholder proposal, will increase the likelihood of a vote to reincorporate the company in North Dakota. A company with a combination or history of governance shortcomings also suggests the need for an environment of increased shareowner protections.

The SBA considers the conditions of the new jurisdiction versus those of the old jurisdiction, generally supporting proposals that require the company to reincorporate to a state that is more shareowner friendly.⁵⁵

Offshore Re-Incorporation: CASE-BY-CASE

The SBA believes that in some circumstances the costs of a corporation's reincorporation may outweigh the benefits, primarily tax and other financial advantages. However, reincorporation can also result in the loss of shareowner rights, financial penalties, future detrimental tax treatment, litigation, or lost business. The SBA evaluates reincorporation proposals on a CASE-BY-CASE basis examining the following:

- Economic costs and benefits of an offshore reincorporation
- Comparison of the company's governance provisions prior to and following the transaction
- Comparison of corporation laws of original and destination locations

Non-Financial Effects of Merger: CASE-BY-CASE

Some companies have added provisions to their charters that require or allow their boards of directors to evaluate the impact that a proposed change in control could have on employees, host communities, suppliers and others. Evaluating the impact on non-shareowner constituencies presents a target's board with an explicit basis, approved by the shareowners, which it may invoke to reject a purchase offer that may be attractive in purely financial terms. Some state laws allow corporate directors to consider whether the companies have adopted such a charter or bylaw provision.

Opt Out of Takeover Law: FOR

The SBA does not favor corporations opting into state takeover laws (e.g. Delaware). Such laws prohibit an acquirer from making a well-financed bid for a target, which provides a premium to shareowners without decimating the balance sheet.

Approve Stakeholder Provisions: AGAINST

Stakeholder laws permit directors, when taking action, to weigh the interests of constituencies other than shareowners, including bondholders, employees, creditors, customers, suppliers, the surrounding community, and even society as a whole, in the process of corporate decision making. In other words, such laws allow directors to consider nearly any factor they deem relevant in discharging their duties, giving directors an excuse for any action that may be detrimental to shareowners.

The SBA votes AGAINST proposals that ask the board to consider non-shareowner constituencies or other nonfinancial effects when evaluating a merger or business combination.

CAPITAL STRUCTURE

⁵⁵ Subramanian, Guhan, "The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the 'Race' Debate and Antitakeover Overreaching." Harvard NOM Research Paper No. 01-10, December 2001.

The stewardship of a company's capital structure involves a number of significant issues, including dividend policy, taxes, types of assets, opportunities for growth, ability to finance new projects internally, and the cost of obtaining additional capital. While most of these decisions are best left to company management, many financing decisions have a significant impact on shareowners, particularly when they involve the issuance of additional common stock, preferred stock, or the assumption of additional debt. Additional equity financing, for example, may reduce existing shareowners' interest and can dilute the value of an investment. Additionally, shareowners must be weary of potential anti-takeover mechanisms, which are often embedded in management's chosen financing vehicles.

Subdivision of capital or stock split (reduce nominal/par value, increase # of shares): FOR

Reverse stock split (increase nominal/par value, decrease number of shares): FOR

Increase Common Stock: CASE-BY-CASE

The SBA generally supports common stock increases up to 100 percent of the current number of outstanding shares. We will consider additional increases if management demonstrates a reasonable need. It is important that publicly held corporations have a cushion (i.e., authorization for more shares than what is currently needed) for ordinary business purposes, including raising new capital, funding reasonable executive compensation programs, business acquisitions, and facilitating stock splits and stock dividends. While the SBA recognizes the need for companies to have financial flexibility, these proposals raise two governance issues that should be evaluated. First, the increased share authorization could be used to trigger a company's poison pill. Without enough additional shares to purchase, there is no chance for the rights to be exercised. The second governance issue concerns targeted share placements. In the event of a hostile takeover attempt, a large number of shares could be placed with a white knight (a friendly third party) and defeat a possibly worthwhile offer. The probability of these scenarios is lowered if the board does not have an excess amount of common shares authorized.

Dual Class Stock Authorization: CASE-BY-CASE

Companies with dual class voting plans have two or more classes of voting common stock, with each class having a different number of votes per share. Dual class capitalization plans are not anti-takeover measures, per se, but they may help management deter takeovers when management controls the class of stock with higher voting rights. This can be done when management purchases or is awarded the majority of new issues with super voting rights, thereby reducing the total voting power of public shareowners. Recapitalization proposals have often been introduced at family controlled companies to ensure that the family retains control.

Academic literature on the corporate governance of dual class firms has gained significant popularity over the past several years. Studies mainly focus on the impact of dual class share structure on five main elements of firm and market behavior:

- i) Agency problems
- ii) Firm valuation;
- iii) Earnings management
- iv) Investment decisions
- v) Recapitalization

The following findings provide an overview of the findings in the recent literature.

Bebchuk (2000) examined the relationship between dual class stock and corporate governance from an agency perspective. This analysis showed that the agency costs associated with such structures are higher than the costs associated with controlling shareowners that hold a majority of the cash flow rights in their companies. The authors also found the costs of these structures to be higher than the agency costs of attending highly leveraged capital structures.⁵⁶

Masulis (2006) also contributed to the studies on agency problems, citing that as the divergence between insider voting rights and cash-flow rights widened at dual class companies, corporate holdings were worth less to outside shareowners; CEOs received higher levels of compensation; managers were more likely to make shareowner-value destroying acquisitions, and capital expenditures contributed less to shareowner value.⁵⁷ Also in relation to agency issues, Tinaikar (2006) found that the detachment of control rights from cash flow rights in dual class share firms induced lower levels of voluntary disclosure in addition to higher levels of executive compensation.⁵⁸

A study by Claessens (2002) on East Asian firms suggested a correlation between discount valuation and dual class share structure.⁵⁹ Drawing from the results of Claessens' findings, several studies examined the implications of dual class shares on firm value in several other markets. In an analysis of a large sample of Western European firms, Bennedsen and Nielsen (2006) found evidence

⁵⁶ Bebchuk, Lucian Arye, Kraakman, Reinier H. and Triantis, George G., "Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights". As published in CONCENTRATED CORPORATE OWNERSHIP, R. Morck, Ed., pp. 445-460, 2000 Available at SSRN: <http://ssrn.com/abstract=147590> or DOI: 10.2139/ssrn.147590

⁵⁷ Masulis, Ronald W., Wang, Cong and Xie, Fei, "Agency Problems at Dual-Class Companies" (November 12, 2006). Available at SSRN: <http://ssrn.com/abstract=961158>

⁵⁸ Tinaikar, Surjit, "The Voluntary Disclosure Effects of Separating Control Rights from Cash Flow Rights" (November 2006). Available at SSRN: <http://ssrn.com/abstract=951547>

⁵⁹ Claessens, Stijn & Fan, Joseph P.H. & Lang, Larry, 2002. "The Benefits and Costs of Group Affiliation: Evidence from East Asia," CEPR Discussion Papers 3364, C.E.P.R. Discussion Papers, revised.

supporting the argument that there is a value discount associated with firms of disproportional ownership structures. Their findings strengthened the causal interpretation that the discount is driven by incentive and entrenchment effects. More importantly, the authors found that firms with dual class shares had a significantly higher value discount than did firms with pyramidal ownership.⁶⁰ In a comprehensive study of dual class firms in the U.S., Gompers and Metrick (2008) found that firm value decreased with an increase in insider voting rights.⁶¹ In addition, a 30 year study conducted by Martijn Cremers and Allen Ferrell (2009) found that there is a robust negative association, both economically and statistically meaningful, between poor governance and firm valuation for the period of their study, including the years 1978-2006.⁶² Puttonen (2007) found dual class stock to be the “single most important provision contributing to the negative valuation” of Nordic firms.⁶³

Dual class shares appear to have a significant impact on earnings management as well. Jiraporn (2005) found that dual class stock exacerbated earnings management by increasing the degree of abnormal accruals by 2.6 percent on average. The increase in abnormal accruals was greater compared to the impact of other takeover defenses such as blank check preferred stock (not significant), poison pills (1.9 percent increase) and classified boards (1.5 percent increase). The results were robust even after controlling for firm size, profitability, financial distress, growth opportunities, and information asymmetry.⁶⁴

Dual class share structures influence investment decisions as well. Li (2007) found that after controlling for other determinants of institutional investment, dual class firms had significantly less institutional ownership than did single class firms. Although institutions of all types hold less of the shares of dual-class shares, this avoidance is more pronounced for long-term investors with strong fiduciary responsibilities than for short-term investors with weak fiduciary duties.⁶⁵

However, not all the literature has negative findings on the impact of dual class share structure on shareowner value. In a study on recapitalization of single class stock to dual class stock, Dimitrov and Jain (2004) found that corporate initiatives for dual class recapitalizations enhance shareowner value. The authors found that shareowners, on average, earned significant positive abnormal returns of 23.11 percent in a period of four years following the announcement of a recapitalization. Abnormal returns were even larger (52.61 percent) for dual class firms that issued equity.⁶⁶ One example of a company operating under a dual class share structure is Ford Motor Company, with family control via super voting rights.

Increase authorized share capital where management is given a general mandate to issue shares up to the limit of authorized capital without seeking specific approval (increase requested without reference to specific business purpose): CASE-BY-CASE

Increases not exceeding 100 percent of currently authorized capital will generally be supported. We recommend a CASE-BY-CASE review on increases above this limit. For countries where requests are for fixed pools of capital with a specified life, we will approve requests that do not exceed 100 percent of the sum of currently issued capital and authorized, unissued capital. We will consider a larger increase if a need is demonstrated. We will apply a stricter standard if the company has not stated a use for the additional shares or has previously authorized shares still available for issue. Finally, proposals that include shares with unequal voting rights will likely be opposed.

Increase authorized share capital when a specific business purpose has been specified: CASE-BY-CASE

As indicated above, we generally vote FOR increases not exceeding 100 percent. The SBA will generally vote AGAINST increases above this limit if they could be used as an anti-takeover defense.

Reduce authorized share capital: CASE-BY-CASE

Proposals to reduce capital can cover a variety of corporate actions, ranging from routine accounting measures to reductions pertaining to a significant corporate restructuring in the face of bankruptcy. In addition, proposals to reduce capital can vary significantly from market to market as a result of local laws and accounting standards. Some examples of capital reduction proposals found overseas (e.g. in Germany and Switzerland) include:

- **Reduction in stated capital:**

This proposal asks shareowners to allow the board to reduce the company's deficit and create a contributed surplus by effecting a reduction in the state capital of the company's common shares. If net assets are in danger of falling below the aggregate of a company's liabilities and stated capital, some corporate law statutes prohibit the company from paying dividends on its shares. Other proposals seek to cancel any unused capital (e.g. from the treasury, conditional capital or

⁶⁰ Bennedsen, Morten and Nielsen, Kasper Meisner, "The Principle of Proportional Ownership, Investor Protection and Firm Value in Western Europe" (October 2006). ECGI - Finance Working Paper No. 134/2006 Available at SSRN: <http://ssrn.com/abstract=941054>

⁶¹ Gompers, Paul A., Ishii, Joy L. and Metrick, Andrew, "Extreme Governance: An Analysis of Dual-Class Companies in the United States" (May 1, 2008). AFA 2005 Philadelphia Meetings Available at SSRN: <http://ssrn.com/abstract=562511> or DOI: 10.2139/ssrn.562511

⁶² Cremers, Martijn and Allen Ferrell, "Thirty Years of Corporate Governance: Firms Valuation & Stock Returns" (September 2009). Yale ICF Working Paper No. 09-09. Available at <http://ssrn.com/abstract=1279650>

⁶³ Puttonen, Vesa, Ikaheimo, Seppo and Ratilainen, Tuomas, "External Corporate Governance and Performance - Evidence from the Nordic Countries" (January 30, 2007). Available at SSRN: <http://ssrn.com/abstract=960431>

⁶⁴ Jiraporn, Pornsit, 2005, "An Empirical Analysis of Corporate Takeover Defenses and Earnings Management: Evidence from the U.S.", Applied financial Economics (University of Warwick, U.K.), Vol. 15, No. 5, pp. 293-303.

⁶⁵ Li, Kai, Ortiz-Molina, Hernan and Zhao, Shelly, "Do Voting Rights Affect Institutional Investment Decisions? Evidence from Dual-Class Firms" (November 2007). Available at SSRN: <http://ssrn.com/abstract=950295>

⁶⁶ Dimitrov, Valentin and Jain, Prem C., "Recapitalization of One Class of Common Stock into Dual-class: Growth and Long-run Stock Returns" (September 1, 2004). Available at SSRN: <http://ssrn.com/abstract=422080> or DOI: 10.2139/ssrn.422080

the authorized pool), which are generally deemed to be no longer necessary for covering the company's capital requirements.

- **Reduction in connection with cancellation of repurchased shares:**
A company may also seek a routine reduction in capital corresponding to the cancellation of shares repurchased in connection with an earlier buyback authorization, as typically seen in Scandinavia, Japan, Spain, and some Latin American markets. In most instances, the amount of equity that may be cancelled is usually limited to ten percent by national law.
- **Reduction in connection with dividend payments:**
If income is not sufficient to enable the payment of a dividend, the board may propose to lower the par value of the company's shares and pay the difference in par value back to the shareowners, effecting a corresponding reduction in capital. This routine authority does not involve any material change relative to shareowner value as such reduction is normally effected proportionately against all outstanding capital.
- **Reduction in connection with restructuring:**
Some proposals to reduce capital are sought pursuant to significant corporate restructuring. The SBA generally supports such proposals because opposition could lead to insolvency, which is not in shareowners' interests. Assessment of this type of proposal should take a realistic approach to each company's situation and the future prospects for shareowners.

In all instances, the SBA considers whether the reduction in authorized share capital is for legitimate corporate purposes and not to be used as an anti-takeover tactic.

Approve General Share Issuance with Preemptive Rights: CASE-BY-CASE

General issuance requests under both authorized and conditional capital systems allow companies to issue shares to raise funds for general financing purposes. Approval of such requests gives companies sufficient flexibility to carry out ordinary business activities without having to bear the expense of calling shareowner meetings for every issuance. Issuances can be carried out with or without preemptive rights. Preemptive rights permit shareowners to share proportionately in any new issuances of stock, guaranteeing current shareowners the first opportunity to purchase shares of new issuances of stock in the class they own in an amount equal to the percentage of the class they already own. Corporate law in many international countries recognizes preemptive rights and requires shareowner approval for the disapplication of such rights.

Because excessive issuance, authorities may lead to excessive cash calls on shareowners, the SBA votes FOR general issuance requests with preemptive rights to a maximum of 100 percent over currently issued capital.

Approve General Share Issuance without Preemptive Rights: CASE-BY-CASE

Companies may need the ability to raise funds for routine business contingencies without the expense of carrying out a rights issue. Such contingencies include, but are not limited to, the facilitating of option plans, small acquisitions, or payment for services. Recognizing that shareowners suffer dilution as a result of issuances without preemptive rights, authorizations should be limited to a fixed number of shares or a percentage of capital at the time of issuance. The SBA votes FOR general issuance requests without preemptive rights to a maximum of 20 percent over currently issued capital.

Eliminate Preemptive Rights: AGAINST

Preemptive rights guarantee existing company shareowners the first opportunity to purchase shares or new issues of company stock in the class they own and in an amount equal to the percentage of the class they already own. While shareowners may choose not to exercise their right, preemptive rights at least ensure that existing shareowners will be able to prevent dilution in their relative ownership position when a company issues more stock if they choose to do so. The SBA is generally AGAINST proposals to eliminate preemptive rights, unless the purpose of the issuance is in shareowners' interests, such as to facilitate an acquisition. Conversely, the SBA votes FOR proposals that direct the adoption of preemptive rights.

Approve Issue of Ordinary Shares with No/Limited/Restricted Voting Rights: AGAINST

As stated in this section and in preceding sections, the SBA favors the expansion of shareowner rights. Therefore, we will vote AGAINST any proposal to remove, limit, or restrict shareowner rights.

Specific Share Issuances: CASE-BY-CASE

Specific shares issuances may be requested in connection with an acquisition, fund raising, issuance to a private party, etc. The SBA evaluates all specific share issuance requests on a CASE-BY-CASE basis as such requests should be judged on their individual merits.

Approve Issue of Preferred Shares: CASE-BY-CASE

"Preferred share" typically refers to a class of stock that provides preferred dividend distributions and preferred liquidation rights as compared to common stock; however, preferred shares typically do not carry voting rights. However, preferred shares may carry voting rights in rare circumstances. Therefore, the SBA reviews proposals to issue preferred shares on an individual basis, considering whether the preferred shares carry voting rights. If the preferred shares do have voting rights, then we will likely vote AGAINST the issuance as this dilutes the SBA's voting position.

Likewise, if a company seeks to *amend* its preferred shares to provide for voting rights, we will typically vote AGAINST such a proposal as well because any new shares with voting rights will dilute the SBA's voting position.

If a company wants to issue preferred shares without voting rights and with no conversion rights to common shares, then the SBA will be more likely to vote FOR such an issuance so long as the company issues the preferred shares for legitimate financial needs and not as a tool to entrench management. Conversely, the SBA will likely vote against preferred shares that provide for conversion to common shares as this may dilute our voting position if the conversion is exercised. Furthermore, preferred shares with conversion rights require that the company reserve a sufficient number of common shares in case all of the preferred shareowners exercise all of their conversion rights.

Blank check preferred stock gives the board of directors the power to issue shares of preferred stock at their discretion, with voting, conversion, distribution, and other rights set by the board at the time of issuance. Blank check preferred stock can be used for sound corporate purposes like raising capital, stock acquisition, employee compensation, or stock splits or dividends. However, blank check preferred stock is also perfectly suited for use as an entrenchment device. The company could find a "white knight," sell the knight a large block of shares, and defeat any possible takeover attempt. With such discretion outside the control of common stock shareowners, the SBA typically votes AGAINST proposals to issue blank check preferred stock.

The SBA will vote on a Case-by-Case basis on the proposal to cancel preferred shares. Of course, our decision on a proposal to cancel preferred shares will depend on the status of the preferred shares. If the preferred shares carry voting rights, rights of conversion, or are unissued "blank check" preferred shares, then the SBA will likely vote FOR cancellation of these preferred shares.

In regards to proposals to issue preferred shares, we consider factors other than the dilution of our voting power. For instance, we will consider financial factors, such as the effect that the preferred issuance will have on market capitalization and earnings per share.

Restructure/Recapitalize: CASE-BY-CASE

These proposals deal with the alteration of a corporation's capital structure, such as an exchange of bonds for stock. The SBA is in favor of recapitalizations when our overall investment position is protected during the restructuring process.

Share Repurchase: CASE-BY-CASE

When a company repurchases shares, it is generally using retained earnings to purchase stock. This is one form of distributing retained earnings to shareowners. Additionally, companies may have share repurchase arrangements in their stock option grants to employees. If the repurchase of shares is motivated because management feels the stock is undervalued, we are in favor of the proposal. If repurchase is motivated as an anti-takeover maneuver, the SBA is opposed and votes AGAINST the proposal. Determining a company's motivation may be impossible.

Accelerated Share Repurchases (ASR) is another means in which companies may buy back outstanding shares. Pursuant to this method, the company repurchases its shares from an investment bank that borrowed such shares from shareowners. Subsequently, the investment bank will buy back shares of the company from the market to return to the shareowners. The company then cancels any shares that it may receive in addition to the initial amount. Because ASRs reduce the number of issued shares for a fixed cost while transferring the risk to the participating investment bank for a negotiated premium, it represents an effective method for companies to repurchase shares. Unlike an open market buyback, ASRs allow a company to immediately exchange a fixed amount of money for shares of its stock. However, recent academic studies have suggested that this practice may be used by management to manipulate earnings figures for incentive compensation plans and reporting purposes.⁶⁷

Some voting items seek to provide management the authority to use financial derivatives in connection with share repurchase authorizations. In Germany, for example, the law requires that the use of financial derivatives for share repurchase programs be authorized explicitly by shareowners. In some instances, shareowners have been given the opportunity to vote separately on the underlying share repurchase program and the use of derivatives.

Targeted Share Placement (TSP): CASE-BY-CASE

The SBA votes FOR shareowner proposals requesting that companies first obtain shareowner authorization before issuing voting stock, warrants, rights or other securities convertible into voting stock, to any person or group, unless the voting rights at stake in the placement represent less than 5 percent of existing voting rights. The SBA is in favor of targeted share placements that do not lower our overall return in a takeover situation. We also support TSPs done on a friendly basis where there is minimal dilution.

Declare Dividends: FOR

Declaring a dividend is a very good way to release profits to shareowners. Since it is better to be assured of a return today than at some time in the future, the SBA generally supports dividend declarations unless payout is unreasonably low or the dividends are not covered by reserves and cash flow. Any payouts less than 30 percent for most markets are considered low.

Approve Appropriation of Profits: CASE-BY-CASE

Generally, the SBA is in favor unless the payout is unreasonably low or the dividends are not covered by reserves and cash flow.

⁶⁷ Marquardt, Carol, "Managing EPS Through Accelerated Share Repurchases: Compensation Versus Capital Market Incentives." Baruch College-CUNY, September 2007.

Amend Eligibility for Dividends: CASE-BY-CASE

Attention will be focused on whether the new method is detrimental to our interests.

In addition to the general best practices described above, which are intended for all firms, the Institute of International Finance released its *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations – Financial Services Industry Response to the Market Turmoil of 2007-2008* in July 2008.

Tracking Stock: CASE-BY-CASE

The SBA closely examines the issuance of tracking stock shares, particularly corporate governance rights attached to those shares. Normally, tracking stock is a separate class of common stock that “tracks” the performance of an individual business of a company. Tracking stock represents an equity claim on the cash flows of the tracked business as opposed to legal ownership of the company’s assets. Tracking stock is generally created through a charter amendment and provides for different classes of common stock, subject to shareowner approval. Due to their unique equity structure, we examine closely all of the following issues when determining our support for such proposals: corporate governance features of tracking stock (including voting rights, if any), distribution method (share dividend or initial public offering), conversion terms and structure of stock-option plans tied to tracking stock.

Establish a requirement that shareowners approve new issues of securities: FOR

Establish a percentage limit on capital/number of shares which a single shareowner may own: AGAINST

Allow Board to issue additional voting shares without preemptive rights during a public tender offer for shares of the company: AGAINST

Approve issue of debt securities convertible into ordinary shares or with warrants to purchase ordinary shares: CASE-BY-CASE

Approve issue of bonds, debentures, and other debt instruments: FOR

Generally, we vote in favor of debt issuance for the purpose of financing future growth and corporate needs. However, there is evidence that firms use debt as a surrogate for sound corporate governance practices.

Debt holds managers accountable for corporate performance because if the company does not perform well financially due to managerial behavior, then the company may not be able to meet its financial obligations. When a firm does not meet its financial obligations, managerial reputation and marketability typically suffers. As such, managers, knowing that their capital structure is built on debt, will be inclined to pursue strategies that lead to the firm’s economic growth because they want to meet the financial obligations of the firm, thereby simultaneously protecting their own interests and shareowner interests. A 2009 study by Pornsit Jiraporn, Ph.D., et. al., examined the relationship between firms’ capital structure and the quality of their corporate governance mechanisms, and the study confirmed that corporations use debt in place of corporate governance tools.⁶⁸ The authors found that firms substituted leverage for corporate governance as a means to overcome agency costs. In other words, the authors stated that firms with poor corporate governance mechanisms were highly leveraged.

While the SBA recognizes the need to employ various tools to minimize agency costs and align management interests with shareowner interests, corporations must not abdicate their corporate governance duties solely by expanding their leverage.

Authorize conversion of convertible stock or bonds: CASE-BY-CASE

The SBA considers proposals to convert preferred shares or bonds into common shares on a Case-by-Case basis dependent on the firm’s motivations. If the conversion is predicated on a capital restructuring that will improve the firm’s overall financial performance, then the SBA will vote FOR such a proposal. Alternatively, if the firm submits a conversion proposal as a defensive tactic to entrench management in the face of a corporate takeover, then the SBA will vote AGAINST such a proposal. Additionally, if the conversion will substantially dilute the appurtenant rights of the company’s common stock, then we will likely vote AGAINST such a proposal.

Set limits on conversion rights of convertible securities: FOR

The SBA favors limitations on the conversion rights of convertible securities to prevent the dilution of our holdings.

Modify borrowing limits or debt ceiling: FOR

Issue warrants, options (outside of normal Co. compensation plans) or other types of subscription rights: CASE-BY-CASE

Approve terms for settlement of debt: CASE-BY-CASE

Consider whether the proposal is in our interest.

⁶⁸ Pornsit Jiraporn, et al, “Does Corporate Governance Affect Capital Structure?” available at http://www.fma.org/Texas/Papers/Capital_Governance_FMA.pdf

Modifications to rights appurtenant to or terms of particular classes of securities: CASE-BY-CASE

The modification must be in the best interest of shareowners. For instance, if a company increases the rights of existing common stock shareowners, then the SBA will vote FOR the modification. Conversely, if the company wishes to grant additional rights to preferred shareowners that would dilute existing share rights, then the SBA will vote AGAINST the modification.

Transfer of Shares: CASE-BY-CASE

We will generally vote FOR the repeal or relaxation of restrictions on share transfers and vote AGAINST the tightening of restrictions on share transfer if the transfer may be used to institute or strengthen a takeover defense.

Approve mechanical change in transferring or recording transfers of securities (no effect on ability to transfer): FOR

Several countries have already introduced or may introduce electronic clearing systems and the SBA supports these initiatives.

Authorize Directors to make application for one or more exchange listings for an issue of securities: FOR

Secondary share listings seek to provide a further funding mechanism through which a company can structure and fund opportunities in a secondary market through enhancement of investors' awareness in such market while increasing share liquidity. The SBA supports this favorable resolution.

Authorize directors to dispose of fractional entitlements and to retain the proceeds for the benefit of the company: FOR**Approve private placement of any type of security: CASE-BY-CASE**

Private placement is a method of raising capital through the sale of securities to a relatively small number of investors rather than a public offering. Investors involved in private placement offerings typically include large banks, mutual funds, insurance companies and pension funds.

Because the private placement is offered to a limited number of investors, detailed financial information is not always disclosed and the need for a prospectus is waived. Moreover, in the United States, the authority does not have to be registered with the Securities and Exchange Commission.

The SBA evaluates private placements on a CASE-BY-CASE basis, voting AGAINST it if the private placement contains extraordinary voting rights or if it may be used in some other way as an anti-takeover defense.

Approve bonus issue of shares funded by capitalization of reserves, share permits or other account: FOR

Companies routinely carry out bonus issues of shares or increases in par value to existing shareowners, usually through the capitalization of reserves from either the share premium reserve or the retained earnings account. These issuances essentially function as dividends; however, the distribution of new shares could increase liquidity and marketability, while ultimately expanding the company's shareowner base.

Approve exchange offer made by company to own holders/for another company/by another company: CASE-BY-CASE

The SBA will consider short-term gains of accepting the offer versus benefits achievable over the long-term by rejecting the offer.

International Issues Related to Corporate Structure (India-specific):

The discovery of financial fraud and corporate governance failings at Satyam Computer Services in 2008 led to increased scrutiny of Indian practices in general. Below is an excerpt of the disclosures recommended in the Confederation of Indian Industry's sample code⁶⁹ of corporate conduct:

- A tabular form containing details of each director's remuneration and commission should form a part of the Directors Report, in addition to the usual practice of having it as a note to the profit and loss account.
- Costs incurred, if any, in using the services of a Group Resource Company must be clearly and separately disclosed in the financial statement of the user company.
- A listed company must give certain key information on its divisions or business segments as a part of the Directors Report in the Annual Report. This should encompass (i) the share in total turnover, (ii) review of operations during the year in question, (iii) market conditions, and (iv) future prospects. For the present, the cut-off may be 10 percent of total turnover.
- Where a company has raised funds from the public by issuing shares, debentures or other securities, it would have to give a separate statement showing the end-use of such funds, namely: how much was raised versus the stated and actual project cost; how much has been utilized in the project up to the end of the financial year; and where are the residual funds, if any, invested and in what form. This disclosure would be in the balance sheet of the company as a separate note forming a part of accounts.

⁶⁹ Available at: www.nfcgindia.org/desirable_corporate_governance_cii.pdf

EXECUTIVE COMPENSATION

Stock-based incentive plans are among the most economically significant matters upon which shareowners are entitled to vote. Because the approval of such plans may result in substantial transfers of shareowner equity out of the company to plan participants as awards vest and are exercised, the terms of such plans must be scrutinized carefully in order to properly align directors' interests with those of shareowners.⁷⁰

A 2005 study found that executives that commit fraud generally have greater financial incentives to do so than executives at similar firms have. Executives are more likely to commit fraud if they are faced with incentives from unrestricted stock holdings; however, they are no more likely to commit fraud if they are faced with incentives from restricted stock and unvested and vested options. Executives who commit fraud tend to exercise larger fractions of their vested options, sell more stock, and receive greater total compensation while committing fraud than executives in similar firms. Additionally, the study found evidence that executives commit corporate fraud following declines in company performance. The authors conclude that governance measures need not be consistent across companies, but rather, the measures should depend on executives' financial incentives, especially after declines in performance, and that restrictions on executives' ability to sell shares could help deter fraud.⁷¹

The SBA believes that director compensation has two purposes:

- To align the interests of shareowners and directors
- To provide value to directors for value received

In meeting these purposes, the following five principles should be used by all companies in setting director compensation.

Five Principles

- 1.1. Director compensation should be determined by a completely independent compensation committee and reviewed by the entire board with complete disclosure and approval by shareowners.
- 1.2. Director compensation should be aligned with the long-term interest of shareowners.
- 1.3. Compensation should be used to motivate directors to pursue shareowner interests.
- 1.4. Directors should be adequately and fairly compensated for their time and effort.
- 1.5. Director compensation should be approached on an overall basis, rather than as an array of separate elements.

Based on these principles, the National Association of Corporate Directors' Blue Ribbon Commission on Executive Compensation recommends the Best Practices listed below.

Best Practices

Boards should effectively:

- Establish a process by which directors can determine the compensation program in a deliberate and objective way.
- Set a substantial target for stock ownership by each director and a time period during which the target is to be met.
- Define a desirable total value of all forms of director compensation.
- Pay directors solely in the form of equity and cash – with equity representing 50 to 100 percent of the total; dismantle the existing benefit programs and avoid creating new ones.
- Adopt a policy stating that a company should not hire a director or a director's firm to provide professional services to the corporation.
- Disclose fully in the proxy statement the philosophy and process used in determining director compensation and the value of all elements of compensation.⁷²

In addition to the best practices above, the Institute of International Finance has developed best practices and principles of conduct regarding executive compensation tailored to executives within the financial services industry.⁷³ The IIF states that financial firms should:

⁷⁰ CFA Centre for Financial Market Integrity, "The Compensation of Senior Executives at Listed Companies: A Manual for Investors," 2007.

⁷¹ Johnson, S., Ryan, H.E., Jr., and Tian, Y.S., 2005. Executive Compensation and Corporate Fraud.

⁷² Stobaugh, Robert B., "Principles and Best Practices for Director Pay." National Association of Corporate Directors and The Center for Board Leadership, 2006.

⁷³ See IIF, *supra* note 25.

- Base compensation on risk-adjusted performance, and align incentives with shareowner interests and long-term, firm-wide profitability
- Ensure that compensation incentives do not induce risk-taking in excess of the firm's risk appetite
- Align payout with the timing of related risk-adjusted profit
- Take into account realized performance for shareowners over time in determining severance pay
- Make the approach, principles, and objectives of each firm's compensation policies transparent to stakeholders

To accomplish the above goals, IIF states that firms should implement the following practices:

- Structure a significant portion of incentive pay in the form of deferred or equity-related components
- Use risk-adjusted compensation metrics, including adjustment for the cost of capital
- Distinguish an employee's "alpha" value added to profits from advantages provided by the firm (e.g., a low cost of funding)
- Link a more material portion of pay packages to the risk time horizon;
- Review policies and performance periodically to maintain alignment of compensation policies with the firm's risk appetite
- Ensure effective management oversight to guard against manipulation and arbitrage of the compensation metrics chosen
- Make incentives for risk-takers as comparable as possible across firms' business groups.

Several of the policies above incorporate risk assessment as a factor in determining appropriate compensation practices. The financial crisis of 2008 revealed the critical need for risk evaluation as particular incentives are considered. With this in mind, Pearl Meyer & Partners released a list of considerations relevant for companies as they assess risk within the framework of compensation plans⁷⁴:

- What risks could threaten the institution's value?
- Do incentive plan metrics reflect the institution's business strategy?
- Are the leverage and ratio of incentive compensation appropriate?
- Is the full range of upside/downside payouts under the incentive plans understood?
- Do plans have protection/controls to avoid excessive risk-taking?
- Do plans focus executives on long-term performance that aligns with shareholder interests?
- How does performance compare to industry/peers?
- Do the plans allow the Committee to exercise discretion?

Set/Approve Directors' Fees/Compensation: CASE-BY-CASE

The SBA is generally in favor unless the proposed retainer fees appear out of line with national industry practice in the company's country of incorporation.

Adopt or Amend Stock Awards and/or Option Plan (U.S.): CASE-BY-CASE

The SBA supports compensation structures that provide incentives to directors, managers, and other employees by aligning their economic interests with those of the shareowners while simultaneously limiting the transfer of wealth out of the company. Therefore, we evaluate incentive-based compensation plans on the total cost to shareowners and the incentive aspects of the plan.

The SBA uses independent consultants to model these costs and incentives. For plans to provide proper incentives, executive compensation should be linked directly with the performance of the business. The consultants engaged by the SBA have proprietary pay-for-performance models that evaluate compensation of the top five executives at each company. Additionally, some of our corporate governance research partners review executive compensation practices at foreign companies as well. These proprietary models benchmark the compensation of these executives compared with their performance using three peer groups⁷⁵ for each company: an industry peer group, a smaller sector peer group, and a geographic peer group.

Typically, companies also use peer groups when developing compensation packages for their executives. However, these peer groups may be flawed in that the peer groups will be developed to maximize executive compensation regardless of executive performance. In fact, a 2000 study by Bizjak, Lemmon, and Naveen found that the "vast majority" of firms that use peer groups set their executive compensation at or above the fiftieth percentile of the peer group.⁷⁶ Issuer-developed peer groups may exhibit the following red flags: 1) too many firms listed (more than 15); 2) bias toward "peers" that are substantially larger and/or more profitable; 3) multiple peer groups with unusually high CEO pay, particularly if not direct competitors; 4) too many industries and geographic markets included; 5) peers that do not compete with the issuer for executive talent; and 6) unexplained year-to-year peer group changes. Such red flags are of concern to us and the corporate governance community because of the potential to "game" the pay-setting process. Firms may select a peer group composed of companies that are of a material size difference, which can substantially inflate compensation benchmarking and may be an indication of weak board oversight. A 2007 study found such peer inflation to be the case, noting that "the selection bias towards highly paid companies in the compensation peer groups

⁷⁴ For a more extensive discussion, see Pearl Meyer & Partners, *Trends and Issues, "Top 10 Executive Compensation Issues in the New Economy,"* 2009.

⁷⁵ Moody's Investor Services, "Expanded Disclosure On U.S. Executive Compensation Offers New Clues for Creditors," July 2008

⁷⁶ Bizjak, M. John, Lemmon, L. Michael, and Naveen, Lalitha. 2000 "Has the Use of Peer Groups Contributed to Higher Pay and Less Efficient Compensation?"

appears to contribute to the ratcheting of CEO pay over time.”⁷⁷ The study found that firms chose a median peer with \$470 thousand higher total pay than its best-matched unselected peer. Boston University professor Ana Albuquerque found a similar increase in CEO pay due to peer selection. She also concluded that “firms for which the ‘peer-pay-effect’ reflects higher CEO talent perform better in the future, whereas firms perform worse when it reflects opportunism.”⁷⁸ A 1999 study by Porac, Wade, and Pollock examined the peer groups that firms use to compare their executive compensation packages. They found that companies usually anchor these peer firms in their own primary industry, but if the industry is doing poor, the firms CEO’s are paid excessively, or shareowners are powerful and active, these defined peers could extend beyond the firm’s industry.⁷⁹ This is done to help justify the firm’s own executive compensation structure.

To prevent companies from “gaming” the system with their peer groups, governance research firms score companies on their executive compensation practices. For example, with a forced curve and a school letter-grade system, a company’s pay-for-performance policies are ranked using fundamental performance measures such as stock returns, earnings-per-share (EPS) growth, return-on-assets (ROA), and return-on-equity (ROE). This information is used to guide voting decisions on each compensation issue as well as to evaluate the compensation committee’s performance.

The SBA evaluates equity-based incentive plans using a cost-based analysis. The potential cost of an equity plan is expressed in terms of shareowner value transfer (SVT), which is measured using a binomial model that assesses the amount of shareowners’ equity that will flow out of the company to participants either as options are exercised or restrictions on awards lapse.

When analyzing the potential cost of a new plan or an amendment to add shares to an existing plan, the SBA estimates the potential total cost of a company’s equity compensation program, including: (1) new shares being reserved, (2) shares available under all existing equity compensation plans, and (3) shares subject to outstanding awards (or “overhang”). Note that, for purposes of the binomial model, new shares, available shares, and shares underlying outstanding grants are referred to as A, B, and C shares, respectively, in our analyses. SVT is expressed in dollar terms and as a percentage of the company’s market value. As part of the evaluation protocol for determining a vote decision on a plan proposal, the total potential cost (SVT) of all a company’s equity-based incentive plans is compared to a company-specific cap that is both industry - and performance-based.

A company’s SVT is fueled by three elements - its current share request, plus the number of shares previously reserved under its equity plans that have not yet been granted, plus the number of shares that have been granted and not yet exercised or (in the case of full-value awards) vested.

The SBA’s current approach provides an unbiased dollar cost estimate of a company’s equity compensation program. If the potential cost of the equity compensation program exceeds the company-specific allowable cap, the SBA generally votes against the equity plan proposal because it is too costly for shareowners.

Companies with sustained positive stock performance may exhibit high SVT costs attributable to overhang if option holders retain their options for prolonged periods. Such a combination likely reflects employees’ confidence in their company’s future prospects. However, the SBA may vote against a new share request due to excessive cost that is driven primarily by overhang. Although positive stock performance will typically result in a higher allowable cap for a company, the high cost of overhang may still represent a significant component of SVT. In addition, although most full-value awards (such as time-based restricted shares) fully vest after no more than three or five years, most stock options are granted with 10-year terms, and thus may impact overhang for a longer period than full-value awards if not exercised within five years after they are granted.

Beginning in 2008, the SBA is incorporating a case-by-case policy to the current approach in situations where a company keeps its employees and the employees keep the options. Such a case may represent successful retention of employees, who have a positive outlook on the future performance of the company. Our new approach would entail an evaluation of companies with excessive SVT cost. For these companies, we would examine the company’s: (1) performance, (2) overhang, (3) dilution attributable to equity compensation, and (4) overall compensation practices. For companies with excessive SVT cost, the SBA would consider, on a case-by-case basis, a carve-out of a portion of cost attributable to overhang, considering the following criteria:

1. **Stock performance:**
A company with sustained positive stock performance will merit greater scrutiny. Five-year total shareowner return (TSR), year over year performance, and peer performance could play a significant role in this determination
2. **Overhang and exercise behavior:**
We would assess whether optionees have held in-the-money options for a prolonged period (thus reflecting their confidence in the prospects of the company). Note that this factor would require detailed disclosure regarding a company’s overhang, such as tranches of all outstanding grants with corresponding exercise prices, vesting provisions,

⁷⁷ Faulkender, Michael W. and Yang, Jun, “Inside the Black Box: The Role and Composition of Compensation Peer Groups,” (March 15, 2007). AFA 2008 New Orleans Meetings Paper.

⁷⁸ Albuquerque, Ana M., De Franco, Gus and Verdi, Rodrigo S., “Peer Choice in CEO Compensation,” (July 21, 2009). Available at SSRN: <http://ssrn.com/abstract=1362047>

⁷⁹ Porac, F. Joseph, Wade, B. James, and Pollock, Tim. 1999 “Industry Categories and the Politics of the Comparable Firm in CEO Compensation.”

terms, forfeiture rates, and their distribution with respect to the employee base. We also consider the dividend payment policy on unvested stock and whether, if paid, such dividends are recouped by the company in the event the stock does not vest.

3. **New share request:**

We would evaluate the new share request and calculate the expected duration of the request in addition to the shares currently available under the equity compensation program, based on the company's three-year average burn rate (or a burn-rate commitment that the company makes for future years). For example, an expected duration in excess of five years could be considered problematic.

4. **Overall compensation practices:**

An evaluation of overall practices could include: (1) stock option repricing provisions, (2) liberal share recycling provisions, (3) evergreen provisions, (4) high concentration ratios (of grants to top executives), or (5) additional practices outlined in the independent consultant's current poor pay practices policy.

In addition to these performance and cost calculations, the SBA uses a set of guiding principles to make voting decisions on compensation plans.

The board committee should have discretion to tailor plans to fit individual and company needs at any point in the life of the plans. However, shareowners also need safeguards against possible misuse of plan structures. To avoid conflicts of interest, insiders and affiliated directors should not sit on the board's compensation committee. Additionally, the SBA typically votes against plans which do not limit individual plan dilution levels to a range of 3 percent to 5 percent of a company's outstanding common stock, and simultaneously do not limit the total dilution resulting from all plans to a range of 6 percent to 10 percent of outstanding common stock.

Stock-based incentive plans should require some financial sacrifice and/or risk. Plans that include only restricted stock or other forms of outright grants should be kept to minimal levels due to their higher costs and decreased incentive elements. While each plan is judged primarily on cost and how well the plan will align the goals of management with those of shareowners, the SBA typically votes against plans that permit unrestricted stock or time-lapsing restricted stock awards that fully vest in less than 4 years. When plans include provisions like cashless exercise, no particular strike price, evergreen provisions, payment of dividends on unvested shares, and repricing ability, and the extent to which a plan can effectively align the interests of management is mitigated. Some financial risk on the part of the option holder is important to efficiently achieve this goal.

Option repricing is a serious detriment to the incentive aspect of these plans. If the company has a history of repricing underwater options, or if the plan specifically permits this practice, the plan is doubtful to meet the standards required under the consultant's model. There are very rare instances where repricing is acceptable, but several strict conditions must be met including a dramatic decline in stock value due to serious macroeconomic or industry-wide concerns and the necessity to reprice options in order to retain and motivate employees.

The voting decision of the SBA will take into account any other factors relevant in determining whether a proposed plan is a reasonable way to achieve the ultimate goal of maximizing shareowner value.

Adopt/Amend Executive or Employee Stock Option Plan (International): CASE-BY-CASE

The SBA supports stock option plans, which provide incentives to directors, managers, and other employees by aligning their economic interests with those of the shareowners while limiting the transfer of wealth out of the company. Option plan evaluations are therefore based on the total cost to shareowners and give effect to the incentive aspects of the plan. Specific analysis includes all of the following:

- exercise price (should be \geq 100% market price of shares);
- total dilution (should be \leq 10% of fully-diluted issued capital);
- the plan is to have a disinterested administrator; and
- "repricing" of underwater options is prohibited.

If total dilution exceeds 10 percent, special consideration will be given towards industry practice within the specific foreign capital market, the company's performance relative to its industry, and percentage of stock options awarded to top executives. If proxy disclosure is inadequate to gauge certain aspects of compensation plans, we are not likely to support these option plans.

Adopt Bonus 162(m) Plan (US): CASE-BY-CASE

The SBA reviews proposals to adopt performance-based cash bonus plans for executives on a case-by-case basis. These plans are put to a shareowner vote to preserve the tax deductibility of compensation in excess of \$1 million for the five most highly compensated executives, pursuant to section 162(m) of the Internal Revenue Code. A vote against these plans does not prevent the bonus from being paid, but only precludes the ability to take a tax deduction.⁸⁰ As such, the SBA generally favors these proposals but will vote

⁸⁰ "Section 162(m) Requirements, Implications and Practical Concerns," Exequity, September 2008.

against them when executive compensation is egregious as evidenced by one or more of the following: a gross misalignment of pay and performance, lack of defined performance criteria, or no or excessively high maximum payout.

Authorize Allotment of Share Options to Director(s) Pursuant to an Approved Stock Option Plan: FOR

Authorize Directors to grant stock options to executives or staff of the company or its affiliates (where further information is not known): AGAINST

Authorize Employee Stock Ownership Plans (ESOP's): FOR

Generally vote in favor using similar criteria for stock option plans (i.e. dilution parameters, plan features, etc.)

Establish a requirement that shareowners approve severance pay or other special compensation to company officers or directors: FOR

Ratify or renew management/profit-sharing contract with other companies (in which the company retains or gains management control over the other): FOR

Cancel management/profit-sharing contracts with other companies: FOR

Establish a requirement that directors hold shares in the company: FOR

We encourage stock ownership by directors and believe directors should own an equity interest in the companies upon which boards they are members. However, we do not currently support any type of minimum or absolute ownership levels (e.g. 10,000 shares of stock, \$25,000 of stock, etc.).

Authorize (Revoke Appropriation) Directors to Set Retirement Payment for Retiring Director(s): CASE-BY-CASE

We favor this management proposal only if it clearly states that it affects employee directors. If it is not clear who will be affected by the proposal, we vote AGAINST it.

Approve Retirement Bonus for Directors (Japan): CASE-BY-CASE

The SBA votes on proposals to approve retirement bonus for directors on a CASE-BY-CASE basis. We treat such payouts as routine resolutions provided that retirees have been executives of the company. However, the SBA opposes payment of retirement bonuses to outsider directors as the appointment of affiliated parties as directors, and their subsequent retirement with full benefits, continues to be a problem in Japan. Because this practice transforms key oversight positions into a form of reward to friends and affiliates of management, this is a highly unacceptable practice and a wasteful use of shareowners' funds. Due to the limited level of disclosure provided in Japanese proxies describing the way these payments are calculated, shareowners are not able to assess the true merits of such rewards. As such, the SBA will vote against this resolution when one or more of the individuals to whom the grants are being proposed have been designated as an outsider particularly because the size of these payments is left at the board's discretion.

Approve Deep Discount Stock Option Plan (Japan): CASE-BY-CASE

Deep discount stock option plans act like restricted stock plans, which are not allowed in Japan. The exercise price of the options is set at JY 1 per share, but the recipient is usually not allowed to exercise the options until retirement. These plans are most often adopted as a substitute for the retirement bonus system, and are an explicit attempt to link director compensation with share price performance. Because companies typically seek to reserve very modest size of grants, the SBA is not concerned with dilutive effects associated with such plans. However, when the options may be exercised prior to retirement, with no disclosure of performance hurdles which must be met, or when the conditions for exercise are not clearly specified, the SBA will oppose the resolution. A near-zero exercise price means that grantees do not bear the same downside risks as shareowners who purchase their shares at market price, thereby weakening the alignment of grantees' interests with those of ordinary shareowners.

Set/Amend Exercise Delay (European style options): CASE-BY-CASE

Adopt Compensation Scheme: CASE-BY-CASE

Consider the appropriateness of the compensation scheme.

Approve amendments to employee profit sharing plan: CASE-BY-CASE

Consider potential dilution as compared to potential productivity increases.

Option Exchange Programs/Repricing Options: CASE-BY-CASE

While the SBA is strongly opposed to the repricing of stock options, there are very rare instances where we may accept repricing. In such scenarios, the SBA will evaluate such proposals on a CASE-BY-CASE basis, considering:

- Presence of a dramatic decline in stock value attributed to serious macroeconomic or industry-wide concerns
- Necessity to reprice options in order to retain and motivate employees
- Historic trading patterns, i.e. the stock price should not be so volatile that the options are likely to be back "in-the-money" over the near term
- Rationale for the re-pricing, e.g., was the stock price decline beyond management's control?

- Value of exchange for the company and shareowners
- Plan for surrendered options, e.g., placed in reserve, etc.
- Option vesting, e.g., does the new option vest immediately or is there a black-out period?
- Term of the option, i.e. the term should remain the same as that of the replaced option
- Exercise price, i.e. should be set at fair market or a premium to market
- Participants, i.e. executive officers and directors should be excluded.

If the surrendered options are added back to the equity plans for re-issuance, then we also take into consideration the company's three-year average burn rate.

In addition to the above considerations, we evaluate the intent, rationale, and timing of the repricing proposal. The proposal should clearly articulate why the board is choosing to conduct an exchange program at this point in time. Repricing underwater options after a recent precipitous drop in the company's stock price demonstrates poor timing. Repricing after a recent decline in stock price triggers additional scrutiny and a potential AGAINST vote on the proposal. At a minimum, the decline should not have happened within the past year. Also, we consider the terms of the surrendered options, such as the grant date, exercise price, and vesting schedule. Grant dates of surrendered options should be far enough back, at least two to three years, so as not to suggest that repricings are being done to take advantage of short-term downward price movements. Similarly, the exercise price of surrendered options should be above the 52-week high for the stock price.

The SBA votes FOR shareowner proposals to put option repricings to a shareowner vote.

Options Backdating: AGAINST

Options backdating has had serious implications for companies and shareowners, resulting in financial restatements, the de-listing of companies, and the termination of executives. According to an ISS study on the stock option timing scandal, option timing has allowed some executives to prosper without building long-term shareowner value. In addition, many investors view option -timing as stealing from corporate coffers, especially since many companies expend cash on stock buybacks to counteract the dilutive impact of their executives' option profits.⁸¹

As of November 2007, more than 220 U.S. companies had announced internal or regulatory investigations related to their stock option practices. The revelation of backdating results in an average loss to shareowners of about 8 percent. This translates to about \$500 million per firm. By contrast, the authors estimated that the average potential gain from backdating to all executives in these firms is under \$600,000 per firm annually.⁸²

Since the passage of the Sarbanes-Oxley Act in 2002, companies have been required to report option grants within two business days. While this rule change has made it more difficult for companies to manipulate grant dates, a significant number of firms have missed these deadlines, raising concerns among some investors that option-timing is still occurring.

A 2005 empirical study on the timing of CEO stock option awards found that abnormal stock returns are negative before the award dates and positive afterwards, and the returns around unscheduled awards appear to have intensified over time, suggesting that executives have gradually learned how to better time awards to their advantage or become more aggressive in their timing efforts.⁸³

According to an academic study, backdating can be curtailed in several ways. For instance, if the two-day reporting is strictly enforced, it will substantially reduce the scope of backdating. In 2006, more than 20 percent of the option awards were reported late, with about 10 percent more than one month late. The study empirically found that managers can gain significant economic benefits from grant manipulations both via back- and forward-dating of stock options.⁸⁴

Another academic paper on stock options grants manipulation found that approximately 18.9 percent of grants between 1996 and 2005 have been backdated or manipulated in some fashion. This fraction is highest for unscheduled, at-the-money grants and among firms that are small, operate in the tech sector, and have high stock price volatility. In addition, firms that use smaller auditing firms, i.e. firms outside the Big Four, are more likely to file their grants late. The incidence of backdating was more than halved as a result of the two-day filing requirement that took effect in 2002, but it remains high for grants that are filed late. At the firm level, the authors of the study estimated that 29.2 percent of firms manipulated grants to top executives at some point between 1996 and 2005.⁸⁵

A study by Goldman Sachs found that the stock prices of many companies that have publicly announced investigations into option granting practices have moved notably lower after such announcements. The study revealed that stock underperformance occurs even though stock option backdating may not necessarily be illegal if conducted in accordance with the company's compensation plan, properly disclosed, and properly accounted for.⁸⁶

⁸¹ ISS, 2006, "An Investor Guide to the Stock Option Timing Scandal."

⁸² Narayanan, M.P., Schipani, Cindy A. and Seyhun, Hasan Nejat, "The Economic Impact of Backdating of Executive Stock Options." Michigan Law Review, 2006.

⁸³ Lie, Erik, 2005, "On the Timing of CEO Stock Option Awards", *Management Science*, Volume 51, No. 5, May 2005, pp. 802-812.

⁸⁴ Narayanan, M.P and H. Nejat Seyhun, 2006, "The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?"

⁸⁵ Heron, Randall A. and Erik Lie, 2006, "What Fraction of Stock Option Grants to Top Executives have been Backdated or Manipulated?"

⁸⁶ Goldman Sachs Group, 2006, "ESO Backdating – What a Mess!"

Furthermore, according to a CRS Report for Congress on the backdating of stock options, while corporate executives appear to have profited handsomely from undisclosed backdating, there is, potentially, a significant cost to shareowners. Companies that have backdated their stock options may face costs from earnings hits, reduced executive performance, delisting, actions of bondholders, additional taxes, and probes, fines, and lawsuits; all of these costs can deteriorate shareowner value.⁸⁷

In cases where a company has practiced options backdating, the SBA votes AGAINST or WITHHOLD on a CASE-BY-CASE basis when voting on the members of the compensation committee. Our vote depends on the severity of the practices and the subsequent corrective actions on the part of the board. We vote AGAINST or WITHHOLD from the compensation committee members who oversaw the questionable options grant practices or from current compensation committee members who fail to respond to the issue proactively, depending on several factors, including, but not limited to:

- Reason and motive for the options backdating issue, such as inadvertent vs. deliberate grant date changes
- Length of time of options backdating
- Size of restatement due to options backdating
- Corrective actions taken by the board or compensation committee, such as canceling or repricing backdated options, or recoupment of option gains on backdated grants
- Adoption of a grant policy that prohibits backdating, and creation of a fixed grant schedule or window period for equity grants going forward.

An ISS study on the stock option timing scandal found that the option-timing scandal calls into question the oversight provided by boards and compensation committee members at these companies. When a compensation committee fails to perform its fiduciary responsibilities and provide adequate oversight of the executive pay policies and process, shareowners eventually suffer.⁸⁸

Adopt or Amend Employee Stock Purchase Plan: CASE-BY-CASE

Employee stock purchase plans (ESPP) are normally broad-based equity plans that allow employees to purchase stock via regular payroll deductions, often at a reduced price. Equity-based compensation can be a useful tool in aligning the interests of management and employees with those of the shareowners. ESPPs provide low cost financing for corporate stock and can improve employee productivity, both of which should, in theory, lead to increased shareowner value. Numerous studies favorably link ESPPs with improved corporate performance.⁸⁹ To avoid incurring an expense under Financial Accounting Standard 123R, companies must offer a non-compensatory ESPP. The SBA uses a set of criteria to evaluate ballot items. These criteria include the presence of evergreen provisions, opt-out features, reset features, purchase limits, pay deductions, matching contributions, holding requirements, and tax deductibility. The SBA generally supports ESPP proposals that pass the criteria of a consultant's model based on the size and cost of the plan, as well as the company's overall use of equity compensation. The combined cost of the ESPP plus any other equity-based compensation plans is compared to the average level of the company's peers and several absolute limits, in the same fashion as detailed in the above section, "Adopt or Amend Stock Awards and/or Options Plan". The plan is generally accepted if the combined amount of equity used across all programs is deemed reasonable.

Restrict Executive Pay: CASE-BY-CASE

The SBA supports levels of compensation that are consistent with our goal of aligning management's interests with shareowners' interests. Generally, the SBA believes that shareowners should not be involved in setting or limiting the absolute level of executive compensation, which is a matter for the compensation committee to determine, and if a problem arises with respect to executive pay, providing or withholding support of the individual compensation committee members is the appropriate recourse. Absolute limits that may or may not be tied to certain criteria may inhibit the compensation committee's ability to fulfill its duties, particularly for companies that have a track record of reasonable compensation. When the company's executive compensation and performance have been in line with that of peers, there is no justification for shareowners to require an arbitrary cap.

Disclosure of Executive Compensation: CASE-BY-CASE

It is important that shareowners have the opportunity to review all elements of compensation to senior officials in order to evaluate the performance of the board, specifically the compensation committee, in monitoring management. Proposals for more detail will be evaluated based on the depth of the disclosure required. ***Executive Severance Agreements or Golden Parachutes: CASE-BY-CASE*** Golden parachutes are a special kind of employment contract for directors, officers, and other key employees. This change in control ("CIC")⁹⁰ severance package typically includes a continuation of the individual's base salary for two to three years or a lump sum payment valued at two to three times the base salary rate, plus retirement and other benefits guaranteed in the contract following termination. In some cases, these periods and multiples can be significantly longer than three years and greater than three times. In fact, payments have escalated so high that a provision has been outlined in the Internal Revenue Code to try to curb parachute payments. This provision calls for a 20 percent excise tax to be levied on excess parachute payments. Unfortunately, it has had the opposite affect and has caused companies to gross-up the parachute payments to executives. According to an analysis by the RiskMetrics Group, 66.2 percent of companies would provide excise tax gross-ups to executives in connection with a change in

⁸⁷ Congressional Research Services, 2007, "Stock Options: The Backdating Issue."

⁸⁸ ISS, 2006, "An Investor Guide to the Stock Option Timing Scandal."

⁸⁹ 2006 Employee Stock Purchase Plan Report, Equilar, Inc., 2006.

⁹⁰ Within employment agreements and executive compensation plans, a CIC is typically defined as an occurrence of one or more of the following: 1) a certain percentage of the company's stock is acquired outright (or via a merger); 2) a sale of all or a substantial amount of the company's assets; 3) a liquidation of the company; or 4) a certain percentage of the board of directors is replaced. CIC's are also defined in the tax code within IRC Section 280G and 490A.

control.⁹¹ The SBA supports initiatives to reduce the time frame of severance agreements, to tie them to executive performance, and for outside executives, to sunset agreements after an initial “honeymoon” period. The SBA also supports and votes FOR shareowner proposals requiring shareowner ratification of golden parachutes unless the proposal requires shareowner approval prior to entering into employment contracts. Shareowners should allow the compensation committee to set benefit levels, provided that shareowner approval is sought when benefits will exceed 2.99 times salary plus bonus to allow for tax advantages.

Similarly, the SBA believes that there are certain criteria that can be included in severance agreements that would prevent excessive and undue compensation from being awarded. Specifically, severance agreements should be structured so that executives are not awarded full payments in the event of poor performance. Executive compensation should be based on a solid foundation of pay for performance, and if an executive has not performed, severance packages should afford the company leniency to reduce payouts. Companies should not be required to pay for work that has not been performed. Further, executives should not receive severance payments under a broad executive plan if they are also eligible for severance payments under their employment contract. A double trigger standard for severance payouts to executives following a change in control event is fast evolving into a governance best practice. Advocates of a double trigger argue that companies that enter into severance (golden parachute) agreements that allow for payments to departing senior executives upon a change in control, should be subject to a double trigger that makes payouts contingent upon both a) an actual change in control and b) the termination of an executive (or a substantial diminution of the executive's duties). The proponents of the proposal also argue that by allowing the accelerated vesting of equity awards or the easing of restrictions on stock upon a change in control, departing executives receive windfalls from awards that may not vest for several additional years and that such unearned payouts have no real benefit to shareowners as they are not aligned with the principle of pay for performance. The SBA supports the adoption of compensation policies that require any future senior executive severance agreements that provide for payments made upon a change in control to be double triggered and not allow for accelerated vesting of unvested equity awards.

Since shareowners are not afforded the opportunity to vote on the adoption of a golden parachute itself, the SBA will consider voting against compensation committee members for approving the adoption of excessive or egregious golden parachutes such as those with payouts exceeding 2.99 times salary plus bonus and those that would be paid in addition to contractual severance payments. The SBA will also consider voting against compensation committee members for approving the adoption of “tin parachutes,” which are paid to a broad class of employees and serve as a takeover deterrent.

Posthumous Executive Compensation or Golden Coffins: CASE-BY-CASE

Some executives may receive provision for severance packages, vested shares, salary, bonuses, perquisites and pension benefits even after death.⁹² Most public companies include death benefits with other types of termination-related pay due their CEOs, with variations for whether the person is fired, becomes disabled or dies in office. Death benefits may be layered on top of pensions, vested stock awards and deferred compensation, which for most CEOs already amount to large sums. Though not all companies provide it, the most common posthumous benefit is acceleration of unvested stock options and grants of restricted stock—accelerated vesting provisions are not supported by SBA proxy voting guidelines. According to compensation consultant Equilar, as of 2006, 17.2 percent of Fortune 100 companies disclosed that their CEO is entitled to receive death benefits. Death benefits are defined as termination payments triggered by death. Typically, these payments are structured in a similar fashion to severance and change-in-control benefits where basic payments are set as a multiple of base salary and/or bonus. Death benefits structured in this manner may be a form of poison pill (anti-takeover device), and are likely to result in compensation levels that contradict performance. Companies often claim that pay packages that include death benefits are designed for executive retention, but death clearly severs any retention rationale. Because golden coffin provisions may pay out significant long-term compensation that is unrelated to performance after the death of the executive, the SBA supports their removal from compensation frameworks at any firm that does not provide similar benefits to its other managers or does not require such compensation to be approved by shareowners.

Link Executive Compensation to Social Performance: CASE-BY-CASE

These types of resolutions ask companies to compensate executives on the basis of their progress on various social issues. Generally, the SBA does not support such proposals. While it is important for corporations to be socially responsible and ethical, shareowners should not enforce a social mandate through the manipulation of compensation levels. Shareowners have the right to address any social issue on an individual basis with their companies. The SBA believes executives should be compensated based on numerous factors and that linking pay matters with social issues is generally inappropriate.

Link Pay to Performance: CASE-BY-CASE

The SBA supports executive compensation plans that align management interests with those of shareowners and reward executives based on good long-term performance. The SBA generally endorses shareowner proposals advocating the use of performance-based equity awards (e.g., indexed options, premium-priced options and performance-vested awards), unless the proposal is overly restrictive (e.g., all awards to top executives must be structured in a certain way, such as only in the form of indexed options). Some advocates, largely in response to compensation requirements tied to the Troubled Asset Relief Program (TARP) and Capital Purchase Program (CPP) of the Economic Emergency Stabilization Act of 2008, have proposed various reporting and award restrictions to executive compensation practices. Some investors may urge board of directors to adopt more rigorous executive compensation reforms in order to improve the pay-for-performance features of the companies' plans and help restore investor confidence,

⁹¹ “Gilding Golden Parachutes, The Impact of Excise Tax Gross-Ups” RiskMetrics Group November 2008.

⁹² “Companies Promise CEOs Lavish Posthumous Paydays,” *Wall Street Journal*, June 10, 2008.

stipulating the benefits afforded to companies participating in the TARP program justify these more demanding executive compensation reforms.

Ken Hugessen, an expert on executive compensation, proposes evaluating compensation packages by comparing the total compensation relative to other executives, financial performance, and other companies along several dimensions, including total shareowner return, company growth, returns, and profits.⁹³

A 2005 study investigated the link between CEO pay and skill, defined as the ability to continue positive company performance and reverse poor performance. For small firms, the link was found to be strong when the CEO receives high incentive pay, when there was a large monitoring shareowner, and when environmental constraints on managerial decisions were absent; for large firms, there is no such evidence. The study also found that the performance of firms that experienced CEO turnover was related to differences in pay between the departing CEO and the incoming CEO. If the compensation package has a high incentive component, new CEOs receiving higher pay are more likely to reverse prior poor performance than CEOs receiving the same pay or lower pay than the departing CEO. The authors estimated that when pay and skill are linked, highly paid CEOs earn abnormal annual returns that are eight percent higher than poorly paid CEOs. Additionally, the mean return of companies in which pay and skill are related is nearly eight percent higher than companies in which pay and skill are not related.⁹⁴

Mandatory Holding Periods: CASE-BY-CASE

The SBA supports shareowner proposals asking companies to adopt a holding period for their executives, which means to hold stock after option exercise. The SBA will take a CASE-BY-CASE approach on these proposals based on these factors:

- Whether the company has any holding period or officer ownership requirements in place
- Actual officer stock ownership and how that compares to the shareowner proponent's suggested holding period or the company's own stock ownership or retention requirements

*For further information on the SBA's model on stock ownership, please see discussion on Minimum Stock Ownership on page 19.

Supplemental Executive Retirement Plans (SERPs): CASE-BY-CASE

SERPs are non-qualified, executive-only retirement plans under which the company provides an additional retirement benefit to supplement what is offered under the employee-wide plan where contribution levels are capped.

SERPs are different from typical qualified pension plans in two ways. First, they do not receive the favorable tax deductions enjoyed by qualified plans. The company pays taxes on the income it must generate in order to pay the executive in retirement. Therefore, some critics contend that the executive's tax obligation is shifted to the company. Second, SERPs typically guarantee fixed payments to the executive for life. Unlike defined contribution plans, SERPs transfer the risk of investment performance entirely to the firm. Even if the company or its investment performs poorly, the executive is entitled to receive specified stream of payments.⁹⁵

In the face of rising executive pay in the past decade, companies have not kept pace with modifying their SERP formula. The typical SERP formula not only includes base salary, but may also include variable compensation like bonus or equity compensation. Furthermore, most SERP formulas largely depend on the highest level of compensation received in the years preceding an executive's retirement. Some companies even provide additional years of service not worked for a newly hired executive to account for pension forfeited at the previous company. All of these enhancements create substantial lifetime costs to the company and its shareowners.

Generally, we support shareowner proposals if there is evidence of abuse in the SERP program or post-employment benefits that indicate the company should not have broad discretion in administering such plans. The SBA supports the limitation of SERP policy to base compensation, rather than the extension to variable compensation or other enhancements, since this may significantly drive up the costs to the company and its shareowners due to the inefficiencies of SERPs. Otherwise, we give the compensation committee latitude in this decision.

Pension Plan Accounting for Executive Compensation: FOR

These shareowner proposals ask companies not to include the impact of company pension fund income in the calculation of earnings used in determining executive bonuses and performance compensation. The SBA supports shareowner proposals to exclude pension fund income in the calculation of earnings used in determining executive bonuses and compensation plans.

Expensing Stock Options: FOR

The SBA supports the general principle of stock option expensing. Stock options should be expensed along with other forms of compensation given that the exercise of options results in a transfer of shareowner value. Expensing options should provide additional discipline against overuse. Expensing stock options, as with other forms of compensation, also increases the clarity of a company's true earnings. The SBA believes stock options have a cost and should be included as an expense on the company's income statement.

⁹³ Hugessen, K., 2006 (Mar 30). Pay Without Performance: What Went Wrong and What We're Going to Do About It. Presentation to Toronto CFA Society.

⁹⁴ Daines, Robert, Nair, Vinay B. and Kornhauser, Lewis A., "The Good, the Bad and the Lucky: CEO Pay and Skill" (August 2005). Univ. of Pennsylvania Institute for Law and Economics, Research Paper Series, Forthcoming Available at SSRN: <http://ssrn.com/abstract=622223> or DOI: [10.2139/ssrn.622223](https://doi.org/10.2139/ssrn.622223).

⁹⁵ Bebchuk, Lucian Arye and Fried, Jesse M., "Pay without Performance: Overview of the Issues". Journal of Corporation Law, Vol. 30, No. 4, pp. 647-673, 2005.

A Bear Sterns research report on the acceleration of stock options identified 759 U.S. firms, which accelerated their stock options in 2006, up from 439 companies in 2005. The 73-percent increase occurred in anticipation of adopting FAS No. 123(R), which requires the expensing of stock options. The study estimates that over \$6 billion of employee stock option expense has vanished from future income statement recognition through vesting acceleration.⁹⁶

In accordance with the passing of FAS 123(R) in 2005, all companies are now required to expense stock options. That being the case, it is possible to restrict the right of transferability until after the vesting of a transferable stock option (TSO), as well as to subject an employee's proceeds from the sale of their TSOs to separate vesting requirements, which suggests further restrictions can be placed on these options to protect the plan from overuse. According to a study completed by Citigroup, Citi-Issued Options (CIOs) can be used to help clarify a company's true earnings as an alternative method to TSOs. CIO's possess two key features that eliminate the need to analyze the exercise and forfeiture behavior of the company's employees in pricing the options: transferability and reversion to company upon forfeitures, which in turn creates the cleanest method for expensing stock options.⁹⁷

Recoup Bonuses or Incentive Compensation through "Clawback" Provisions: CASE-BY-CASE

When companies or shareowners propose provisions discussing the recoupment of executive bonuses or incentive compensation, these provisions are referred to as "clawback" provisions. In other words, a company's board of directors may claw back, or recoup, an executive's bonus or incentive compensation after it has been paid to the executive. Most commonly, these provisions address situations where the company's restated financial statements show that an executive did not achieve the performance results necessary for the executive to receive a bonus or incentive compensation. For instance, if a company with a clawback provision is forced to restate its financial statements and the restated financial statements reveal that an executive did not achieve the performance necessary to receive a bonus or incentive compensation, then the company may recoup the bonus or incentive compensation, especially if the executive misstated the financial statements through fraud, misconduct, or negligence just to receive his or her bonus or incentive compensation.

Clawback provisions are a relatively new tool, but they are receiving much press in light of the U.S. recession that began in December 2007 as a result of the crisis in the U.S. financial sector. The meltdown in the U.S. financial sector brought numerous financial restatements with it, which showed in some instances that executive bonuses and incentive compensation payments were unjustified. This led shareowners to propose clawback provisions to recoup some or all of these payments.

In addition to shareowners, the U.S. government has experimented with clawback provisions. Section 304 of the Sarbanes-Oxley Act of 2002 states that the CEO and the CFO of an issuer must reimburse the issuer for bonuses or incentive compensation received if the issuer had to restate its financial statements as a result of misconduct. When the U.S. government became a proxy shareowner for the U.S. public under the Troubled Asset Relief Program, it enacted broader, more stringent clawback provisions than what SOX contained. With TARP, the U.S. government predicated monetary assistance on the condition that companies receiving TARP funds claw back executive bonuses or incentive compensation "if the payment was based on materially inaccurate financial statements or performance metrics."

In the February 2009 edition of "Executive Compensation Trends", Equilar noted that the prevalence of clawback policies at publicly traded Fortune 100 companies grew from 17.6 percent in 2006 to 64.7 percent in 2008. In addition, even companies outside the financial services sector are increasingly adding or expanding clawback provisions.

For instance, Dell's clawback proposal states:

"If Dell restates its reported financial results, the Board of Directors will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and to the extent practicable, Dell will recover or cancel any such awards based on having met or exceeded performance targets that would not have been met under the restated financial results." Definitive Proxy, p. 30 (filed June 2, 2008)."

The SBA adopts the position that clawback provisions are essential to performance-based compensation plans. To align executive interests with the interests of shareowners, executives should be compensated for achieving performance benchmarks. Equally, an executive should not be rewarded if he or she does not achieve established performance goals, and if restated financial statements reveal that the executive was falsely rewarded, then he or she should be forced to repay any unjust compensation received.

Specifically, the SBA considers clawback proposals on a CASE-BY-CASE basis. If it is later determined that fraud, misconduct, or negligence significantly contributed to a restatement of financial results that led to the awarding of unearned incentive compensation, the SBA will evaluate these proposals, taking into consideration:

- If the company has adopted a formal recoupment bonus policy, or
- If the company has chronic restatement history or material financial problems.

Compensation Consultants - Disclosure of Board or Company's Utilization: FOR

⁹⁶ McConnell, Pat et al, 2006, "Employee Stock Options: 749 Companies Accelerate Stock Options Vesting", Bear Sterns Equity Research – Accounting and Tax Policy.

⁹⁷ Ortner, William et al, 2006, "Equity Compensation and the Capital Markets", Citigroup – Corporate Equity Derivatives Research.

External compensation consultants should be independent to ensure that advice is unbiased and uncompromised. Multiple business dealings or significant revenue from the company may impair the independence of a pay consultant's opinions, advice, or recommendations to the compensation committee.

The following policy is typically used by compensation consultants to ensure that conflicts of interest are mitigated when the consultant provides other services to a company in addition to executive pay advice:

- The consultant establishes a Code of Conduct, which articulates a commitment to providing impartial services.
- Senior consultants have the responsibility to review and resolve all potential conflicts of interest before the engagement proceeds.
- A senior consultant not on the team performing the work reviews the executive pay recommendations.
- The consultant has a policy in place, which precludes consultants who advise the company on executive pay to engage with the company on any other services provided by the consultant.

Such safeguards and procedures are designed to separate compensation consultancy work from other services provided from the consultant to company.⁹⁸

In a study examining the effect of compensation consultants on CEO pay of 880 firms from the S&P 1500 for fiscal year 2006, the authors found evidence of greater compensation in the presence of a compensation consultant, consistent with a rent extraction role, as suggested by critics. However, the study found no evidence proving that the potential conflicts of interest between the firm and compensation consultants as the primary driver of excessive CEO pay.⁹⁹

Additionally, another study found that while there was no direct relationship between potential conflicts of interest and executive pay, there was some evidence that directors and executives may use compensation consultants to legitimize unusually high levels of executive pay. According to the authors' results, executive pay was highest when a company engages three or more compensation consultants [Murphy, Kevin and Tatiano Sandino, "Executive Pay and 'Independent' Compensation Consultants," June 2008].

In December 2007, the United States House of Representatives Committee on Oversight and Government Reform issued a report examining whether the compensation consultants hired by large publicly traded companies meet the required standards of independence. The report is based on nonpublic information provided to the Committee by the leading compensation consultants in the United States. For each consultant, the Committee requested and received data on the value of the executive compensation services and other services provided to the 250 largest publicly traded companies as determined by *Fortune* magazine. The report revealed that compensation consultant conflicts of interest were widespread. Fees earned by compensation consultants for providing other services often far exceeded those earned for advising on executive compensation. Moreover, many Fortune 250 companies do not disclose their compensation consultants' conflicts of interest. Finally, the report also suggested that there appeared to be a correlation between the extent of a consultant's conflict of interest and the level of CEO pay.¹⁰⁰

An article written by founder and managing director of compensation consulting firm James F. Reda & Assoc. suggested that boards needed to consider following a number of criteria when seeking outside advice for executive compensation. First, consultants must maintain independence from management, which also allows for visibility and good reputation. Second, the compensation consultants must have expertise in the industry the company operates, as well as direct and relevant experience. More importantly, the consultants must have a wealth of executive compensation resources, which are seamlessly integrated and includes proficiency with all pay elements and performance measurement analytical techniques. Fourth, the consultant must strive to align the company's business goals and its executive pay strategy. Finally, nationwide and worldwide coverage is a key component, which combined with the above, allows for the consultants to demonstrate greater creativity and have the capability to create custom designs.¹⁰¹

The SBA generally votes FOR shareowner proposals seeking disclosure regarding the Company, Board, or Compensation Committee's use of compensation consultants, such as company name, business relationship(s), fees paid, and identification of any potential conflicts of interest.

Pension Plan Income Accounting: FOR

We generally vote FOR shareowner proposals to exclude pension fund income in the calculation of earnings used in determining executive bonuses and compensation as pension assets may provide potential for manipulation and help boost companies' reported earnings.

Pre-Arranged Trading Plans (10b5-1 Plans): FOR

The SBA generally votes FOR shareowner proposals calling for certain principles regarding the use of prearranged trading plans (10b5-1 plans) for executives. These principles include:

⁹⁸ Waxman, Henry A. (prepared for), 2007, "Conflicts of Interests among Executive Compensation Consultants", U.S. House of Representatives, Committee on Oversight and Government Reform, available at: <http://www.eriari.com/PDF/Executive-Consultant-Conflicts.pdf>

⁹⁹ Brian Cadman, Mary E. Carter and Stephen Hillegeist: "The Role and Effect of Compensation Consultants on CEO Pay", March 2008.

¹⁰⁰ United States House of Representatives Committee on Oversight and Government Reform: "Executive Pay: Conflict of Interest Among Compensation Consultants." December 2007.

¹⁰¹ James Rada: "How 'Independent' Is Your Compensation Adviser?", *The Corporate World*, March/April 2008.

- Adoption, amendment, or termination of a 10b5-1 Plan must be disclosed within two business days in a Form 8-K.
- Amendment or early termination of a 10b5-1 Plan is allowed only under extraordinary circumstances, as determined by the board.
- The plan must provide that ninety days must elapse between adoption or amendment of a 10b5-1 Plan and initial trading under the plan.
- Reports on Form 4 must identify transactions made pursuant to a 10b5-1 Plan
- An executive may not trade in company stock outside the 10b5-1 Plan.
- Trades under a 10b5-1 Plan must be handled by a broker who does not handle other securities transactions for the executive.

A study by Stanford’s Alan Jagolinzer reveals that trades executed within 10b5-1 plans were more lucrative for the insiders than trades executed by insiders at the same firms who had not adopted such plans, and that early terminations of 10b5-1 plans are associated with impending disclosures of negative corporate news. 10b5-1 plans are intended to eliminate executives’ flexibility over transactions in company stock so that they are able to diversify their financial portfolio. However, Jagolinzer’s study seems to suggest that the 10b5-1 plans may have been abused. The SBA believes that 10b5-1 plans, with proper safeguards and controls, can be an effective tool for executives.

A related issue of concern is the use of “prepaid variable forward contracts” by company management. These contracts are stock sale arrangements whereby an executive agrees to sell, at some point in the future, a specified number of shares and receives immediate payment of cash (from a brokerage firm or other third party) for a portion of the sale price. If the stock price falls, the brokerage takes the loss; if it goes up, the executive shares in at least some of the profits with no downside risk.¹⁰² The SBA discourages such arrangements as they go beyond the ability to diversify an executive’s company holdings.

Share Buyback Holding Periods: AGAINST

Because a share buyback is often an indication of the company’s confidence in its own stock, the announcement of a share buyback may increase a company’s stock price. However, share buyback may occur in stages and not all at once. Also, companies may not actually repurchase shares if market conditions are not attractive even though they have made prior announcement of share buyback.

The SBA generally votes AGAINST shareowner proposals prohibiting executives from selling shares of company stock during periods in which the company has announced that it may or will be repurchasing shares of its stock. Conversely, we vote FOR the proposal when there is a pattern of abuse by executives exercising options or selling shares during periods of share buybacks.

Tax Gross-Up Shareowner Proposals: FOR

Tax gross-ups are reimbursements to senior executives paid by the company to cover an executive’s tax liability. Tax gross-ups are a costly benefit to shareowners, since it generally takes at least \$2.50 and as much as \$4 to cover each \$1 of excise tax that must be “grossed-up.”¹⁰³ Providing gross-ups to executives has become widespread and represents a clear disconnect between pay and performance. A recent study found that approximately two-thirds of the S&P 500 index disclosed they would provide excise tax gross-ups to one or more top executives. At 80 percent of those companies, tax gross-ups would have been triggered if the executives had received change-in-control (“CIC”) severance at the end of the prior fiscal year—with the aggregate potential gross-up payments for all named executive officers at those companies averaging \$13.9 million.¹⁰⁴ Influential executive compensation consultant Ira Kay of Watson Wyatt recommends, “...eliminating full tax gross-ups for new executives and fazing them out of existing agreements.”¹⁰⁵ Anti-tax gross-up shareowner proposals ask the board to adopt a prospective policy that forbids the payment of tax gross-ups to executives unless such payments are provided to other managers at the firm. The SBA generally votes FOR proposals calling for companies to adopt a policy of not providing tax gross-up payments to executives, except in situations where gross-ups are provided pursuant to a plan, policy, or arrangement applicable to management employees of the company, such as a relocation or expatriate tax equalization policy.

Advisory Vote on Executive Compensation (Say-on-Pay), Management Proposals: CASE-BY-CASE

Background and Overview

High levels of investor concern about escalating levels in executive pay have prompted a number of developments this decade, including the implementation of shareowner votes on pay programs in a growing number of markets. These include the U.K., Australia, the Netherlands, Sweden, Norway, and Spain.

A 2007 study examined the effect of 2002 legislation in the UK requiring publicly traded companies to submit reports on executive compensation to a non-binding shareowner vote at the annual general meeting. The authors found that, as a result of the legislation, CEO cash compensation and CEO total compensation became more sensitive to negative operating performance.¹⁰⁶

¹⁰² Hodgson, Paul, “Investing in Corporate Governance: Forward Sales – Sharing the Gain, Avoiding the Pain,” The Corporate Library, July 2009

¹⁰³ “New Study on Tax Gross-ups,” *Risk & Governance Weekly*, 12/5/08.

¹⁰⁴ Papadopoulos, Kosmas, “Gilding Golden Parachutes: the Impact of Excise Tax Gross-Ups,” *RiskMetrics Group*, 11/24/08.

¹⁰⁵ Kay, Ira, and Steven Seelig, “A Reasonable Approach to Severance and Change-in-Control Payments,” *Watson Wyatt Insider*, August 2007.

¹⁰⁶ Balachandran, S., Ferri, F., and Maber, D., 2007. Solving the Executive Compensation Problem Through Shareowner Votes? Evidence From the U.K.

Another study indicates that the UK requirement to require shareowner voting on compensation practices has produced markedly fewer rewards for underperforming senior executives and lowered CEO compensation at those companies with poor operating performance.¹⁰⁷

A 2007 Millstein Center Policy Briefing reviewed the UK's experience with "say on pay" rights. The author asserted that advisory shareowner votes on executive pay could be adapted to the US and other markets and would be a step in the right direction for aligning corporate pay with performance as part of a package of accountability reforms, including legislation and adaptation of market practices.¹⁰⁸ The findings of such studies, along with investor discontent regarding executive compensation levels, have resulted in increasing demand for advisory votes in the U.S. Legislation has been introduced in the U.S. Senate, raising the possibility that these resolutions will be required of all U.S. public companies. The earliest U.S. companies to provide shareowners with a say-on-pay vote were TIAA CREF in 2007, followed in 2008 by Aflac, RiskMetrics, H&R Block, Jackson Hewitt, Zale, and Littlefield. The number of companies facing say-on-pay proposals jumped to approximately 100 in 2009. A report in 2008 indicates that future shareowner votes on executive compensation are likely to create value for firms with overpaid CEOs and firms more likely to respond to the shareowner votes.¹⁰⁹

Current Policy

The SBA votes on management proposals for an advisory vote on executive compensation on a CASE-BY-CASE basis. Further, the SBA votes AGAINST these resolutions in cases where boards have failed to demonstrate good stewardship of investors' interests regarding executive compensation practices. The following principles and factors should be considered:

1. The following five global principles apply to all markets:
 - Maintain appropriate pay-for-performance alignment with emphasis on long-term shareowner value: This principle encompasses overall executive pay practices, which must be designed to attract, retain, and appropriately motivate the key employees who drive shareowner value creation over the long term. It will take into consideration, among other factors: the linkage between pay and performance; the mix between fixed and variable pay; performance goals; and equity-based plan costs;
 - Avoid arrangements that risk "pay for failure": This principle addresses the use and appropriateness of long or indefinite contracts, excessive severance packages, and guaranteed compensation;
 - Maintain an independent and effective compensation committee: This principle promotes oversight of executive pay programs by directors with appropriate skills, knowledge, experience, and a sound process for compensation decision-making (e.g., including access to independent expertise and advice when needed);
 - Provide shareowners with clear, comprehensive compensation disclosures: This principle underscores the importance of informative and timely disclosures that enable shareowners to evaluate executive pay practices fully and fairly;
 - Avoid inappropriate pay to non-executive directors: This principle recognizes the interests of shareowners in ensuring that compensation to outside directors does not compromise their independence and ability to make appropriate judgments in overseeing managers' pay and performance. At the market level, it may incorporate a variety of generally accepted best practices.
2. For U.S. companies, the SBA votes CASE-BY-CASE considering the following factors in the context of each company's specific circumstances and the board's disclosed rationale for its practices:

Relative Considerations:

- Assessment of performance metrics relative to business strategy, as discussed and explained in the CD&A
- Evaluation of peer groups used to set target pay or award opportunities
- Alignment of company performance and executive pay trends over time (e.g., performance down: pay down)
- Assessment of disparity between total pay of the CEO and other Named Executive Officers (NEOs)

Design Considerations:

- Balance of fixed versus performance-driven pay
- Assessment of excessive practices with respect to perks, severance packages, supplemental executive pension plans, and burn rates

¹⁰⁷ Ferri, Fabrizio and David Maber, "Solving the Executive Compensation problem through Shareholder Votes? Evidence from the U.K.," November 2007.

¹⁰⁸ Davis, S. (2007), Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable, Policy Briefing No. 1, Millstein Center for Corporate Governance and Performance, Yale School of Management.

¹⁰⁹ Cai, Jie and, Ralph A. Walking, "Shareholders' Say on Pay: Does it Create Value?," December 8, 2008, Drexel College of Business Research Paper No. 2008-06.

- Vesting provisions and dividend payment on earned shares

Communication Considerations:

- Evaluation of information and board rationale provided in CD&A about how compensation is determined (e.g., why certain elements and pay targets are used, and specific incentive plan goals, especially retrospective goals)
 - Assessment of board's responsiveness to investor input and engagement on compensation issues (e.g., in responding to majority-supported shareowner proposals on executive pay topics).
3. For international companies, the SBA vote's recommendations for annual "say-on-pay" resolutions put forward by management on a case-by-case basis in each market where such proposals routinely appear on proxy ballots. As noted, these currently include the U.K., Australia, the Netherlands, Sweden, Norway, and some companies in Denmark. Evaluations take into account specific proposal wording, local market regulations and prevailing practices, and local governance and best practice codes. The key factors influencing evaluations generally fall into the following categories:
- Pay in relation to performance, usually based on the design of programs and actual grants (e.g., the use of rigorous performance hurdles)
 - Equity-based awards, which should not exceed levels recommended under local best practice codes
 - "Pay for failure" arrangements, such as long-term contracts that could lead to multiple-year severance packages;
 - The quality of pay disclosures (e.g., specifying incentive goals that generated past-year rewards and/or forward-looking targets)
 - In some markets, aspects of non-executive directors' pay (e.g., codes in several markets discourage stock-based grants to non-executive directors)
 - Voting recommendations typically look to the preponderance of evidence, i.e. an AGAINST recommendation may result when a preponderance of negative features outweighs the positive features presented in a remuneration report.

Advisory Vote on Executive Compensation (Say-on-Pay), Shareowner Proposals: FOR

Generally, the SBA votes FOR shareowner proposals that call for non-binding shareowner ratification of the compensation of the Named Executive Officers and the accompanying narrative disclosure of material factors provided to understand the Summary Compensation Table. The SBA supports a granular assessment of executive compensation at any given company, rather than an all-or-nothing vote. Preferably, this would allow for separate votes on one-time compensation awards, CEO pay, and senior executive compensation.

Director Compensation: CASE-BY-CASE

The SBA votes CASE-BY-CASE on compensation plans for non-employee directors, based on the cost of the plans against the company's allowable cap.

Occasionally, director stock plans that set aside a relatively small number of shares when combined with employee or executive stock compensation plans will exceed the allowable cap. The SBA votes FOR the plan if ALL of the following qualitative factors in the board's compensation are met and disclosed in the proxy statement:

- Director stock ownership guidelines with a minimum of three times the annual cash retainer
 - Vesting schedule or mandatory holding/deferral period
 - A minimum vesting of four years for stock options or restricted stock; or
Deferred stock payable at the end of a four-year deferral period.
- Mix between cash and equity:
 - A balanced mix of cash and equity, for example 40% cash/60% equity or 50% cash/50% equity; or
 - If the mix is heavier on the equity component, the vesting schedule or deferral period should be more stringent, with the lesser of five years or the term of directorship.
- No retirement/benefits and perquisites provided to non-employee directors
- Detailed disclosure provided on cash and equity compensation delivered to each non-employee director for the most recent fiscal year in a table. The column headers for the table may include the following: name of each non-employee director, annual retainer, board meeting fees, committee retainer, committee-meeting fees, and equity grants.

Director Retirement Plans: AGAINST

The SBA votes AGAINST retirement plans for non-employee directors. Conversely, the SBA votes FOR shareowner proposals to eliminate retirement plans for non-employee directors.

Non-Employee Director Compensation Plan: CASE-BY-CASE

Non-employee director compensation should be composed of a mix of cash and stock awards. Although some board members may already own considerable amounts of stock, the SBA believes that directors should not be compensated solely in cash. Director compensation plans will be evaluated by comparing the cash compensation plus the approximate value of the equity-based compensation per director to a peer group with similar size and enterprise value. The initial compensation that is provided to new directors is also considered. Plans are generally approved when the per-director total cost falls within one standard deviation of the mean pay for the peer group. In most cases, non-employee directors have full-time employment elsewhere, making it unnecessary to offer retirement benefits for serving on the board. The cash retainer and equity compensation are generally adequate compensation for board service. Therefore, the SBA typically supports shareowner proposals requesting the limitation or elimination of retirement benefits for non-employee directors.

Stock Options to Non-Executive Directors (International Markets): CASE-BY-CASE**Background and Overview**

Granting options to non-executive directors is currently an accepted practice in the U.S. and Canada. However, in the U.K., Australia and some Continental European countries, such as Belgium and the Netherlands, local codes of best practice recommend against the granting of stock options to non-executive directors. French law even takes this a step further by limiting the grant of options strictly to corporate officers or employees.

As indicated below, the codes advocate the principle that option grants do not necessarily align non-executive directors' interests with those of shareowners, as stock options arguably confer potential upside to directors but none of the downside that shareowners face. In addition, such exposure to a company's financial performance may make non-executives either less or more risk averse from a strategic point of view, taking the focus away from oversight of management processes and accountability.

The Netherlands (Tabaksblat Code): "The remuneration of a supervisory board member should not be dependent on the results of the company". "A supervisory board member shall not be granted any shares and/or rights to shares by way of remuneration" and "Any shares held by a supervisory board member in the company on whose board he sits are long-term investments".

Belgium (Lippens Code): "Non-executive directors should not be entitled to performance-related remuneration such as bonuses, stock related long-term incentive schemes, fringe benefits or pension benefits."

France (Bouton Code): "Directors who are neither corporate officers nor employees are barred by law from receiving options."

Review of Current Policy

In most markets, stock option plans featuring potential grants to non-executive directors are generally considered acceptable. In the U.K., the SBA's policy is consistent with local best practice, as articulated by the National Association of Pension Funds (NAPF) on the basis of the Combined Code. According to the ABI (Associations of British Insurers)/NAPF guidelines on executives' remuneration, "participation in share incentive schemes should be restricted to bona fide employees and executive directors." A similar policy applies in Australia, where stock options for non-executives are not accepted either.

In international markets, the SBA will vote on plans that include option grants to non-executives on a CASE-BY-CASE basis. Country-specific opposition to options grants will be taken into consideration.

Pay-for-Superior Performance: FOR

The SBA generally votes FOR shareowner proposals based on an individualized analysis that requests the board establish a pay-for-superior performance standard in the company's executive compensation plan for senior executives. The proposal has the following principles:

- Sets compensation targets for the Plan's annual and long-term incentive pay components at or below the peer group median
- Delivers a majority of the Plan's target long-term compensation through performance-vested, not simply time-vested, equity awards
- Provides the strategic rationale and relative weightings of the financial and non-financial performance metrics or criteria used in the annual and performance-vested long-term incentive components of the plan
- Establishes performance targets for each plan financial metric relative to the performance of the company's peer companies
- Limits payment under the annual and performance-vested long-term incentive components of the plan to when the company's performance on its selected financial performance metrics exceeds peer group median performance.

The following factors are considered when evaluating this proposal:

- What aspects of the company’s annual and long-term equity incentive programs are performance-driven?
- If the annual and long-term equity incentive programs are performance driven, are the performance criteria and hurdle rates disclosed to shareowners or are they benchmarked against a disclosed peer group?
- Can shareowners assess the correlation between pay and performance based on the current disclosure?
- What type of industry and stage of business cycle does the company belong to?

Recent research by Ertimur, Ferri, and Muslu shows greater success for shareowner proposals that focus on the pay setting process, such as subjecting certain compensation items to shareholder approval, rather than proposals seeking specific pay limits.¹¹⁰ The study showed an average reduction of \$2.3 million in CEO in firms targeted by proposals sponsored by institutional proponents and calling for greater link between pay and performance.

Shareowner Proposal to Require Supermajority of Independent Board Members to Approve CEO Compensation: AGAINST

The SBA generally votes AGAINST shareowner proposals to seek approval of an amendment to the bylaws in order to provide that a company’s CEO’s compensation must be approved by two-thirds of all independent directors of the board. “Independent director” shall mean any director who is not a present or former employee or officer of the Corporation, and who meets criteria for qualifying as an “independent” director under the applicable listing requirements of the New York Stock Exchange.

Proponents of this proposal argue that approval of this proposal would ensure that the company provides a CEO pay package that is widely supported by its independent directors; increase the likelihood that the company’s independent directors are kept informed of, and feel shared responsibility for, CEO compensation decisions; and would not prevent a small committee or subcommittee to study, examine and determine CEO compensation. Instead, it would only require that decisions made by such a committee or subcommittee to be subsequently ratified by additional independent directors to meet the bylaw’s requirements.

The SBA believes that shareowners should not be involved in setting executive compensation, particularly where a company has a track record of reasonable executive compensation. Such matters should be left to the board’s compensation committee, which has the ultimate responsibility of examining all aspects of the compensation program for the company’s executive officers. In addition to being unnecessarily restrictive, this proposal would establish procedures that could usurp the role of this committee. The SBA believes that shareowners would be better served through a shareowner advisory vote on executive compensation, which would provide shareowners with a more effective mechanism to voice their concerns over a company’s executive compensation practices. However, the SBA does encourage the company’s board of directors to review the work of the compensation committee to ensure that best practices are followed.

**CORPORATE SOCIAL RESPONSIBILITY (CSR)
VOTING ON ENVIRONMENTAL, SOCIAL AND POLITICAL ISSUES**

The SBA acknowledges that many beneficiaries are concerned about the social, political, and moral implications of investment decisions within the Florida Retirement System. As part of the SBA’s asset management responsibilities, investments are undertaken with a strong focus on maximizing long-term returns, controlling costs, and achieving appropriate diversification in order to minimize risk. Historically, the SBA has been proactive on many corporate governance issues, emphasizing those factors that directly impact investment values. Increasingly, investors are incorporating emerging issues, such as the environment, into their investment calculus. As a result, many companies are intensifying their approach to corporate responsibilities and expanding the scope of their disclosures related to burgeoning risk factors. The SBA is a leading advocate for full and transparent disclosures across a broad spectrum of corporate governance issues.

In the December 2006 issue of the *Harvard Business Review*, Michael Porter and Mark Kramer discussed the link between competitive advantage and corporate social responsibility. Their starting point was a forceful critique of current CSR trends, which, they argued, are misinformed by the idea that business and society were in tension, when in fact they are interdependent. They contended that the prevailing justifications for CSR, namely moral obligation, sustainability, license to operate, and reputation create at best generic rationales that fail to help companies identify the social issues where they can have the biggest positive impact. As a consequence, CSR in practice is unfocused and not coordinated among different business units, often even excluding a company’s core operations. CSR activities are thus driven by external audiences instead of the internal needs and opportunities of businesses. The authors proposed that companies should abandon this reactive perspective of CSR and instead, incorporate CSR into their strategic planning. Strategic CSR will focus on a company’s operations by focusing on cost control and better customer service, thereby increasing competitiveness. Companies need to take a tactical, proactive approach regarding CSR. For Porter and Kramer, the essential test to guide CSR is not whether a cause is worthy, but whether it presents an opportunity to create a meaningful mutual benefit for society and business, which will lead to corporate social integration.

¹¹⁰ Yonca Ertimur, Fabrizio Ferri, and Volkan Muslu, “Shareholder Activism and CEO Pay” August 7, 2009.

Whereas U.S. companies in the past viewed sustainability as something between goodwill utopianism and a public relations exercise, today's younger CEOs see sustainability issues as an upper echelon agenda item, says McKinsey's Lenny Mendonca. One of the firms at the forefront of identifying and quantifying how specific environmental and social practices improve corporate performance is Innovest Strategic Value Advisors. Matthew Kiernan, CEO of Innovest, argues that sustainability strategies are a good proxy of management quality. Many major investment banks now share this point of view. For instance, Goldman Sachs, Deutsche Bank Securities, UBS, Citigroup, Morgan Stanley, and other brokerages have formed research teams addressing sustainability. The evidence is still scarce that addressing social and environmental sustainability will help with short-term financial performance goals. Nevertheless, there is an emerging consensus within the financial community that sustainability is a long-term imperative, even for corporate survival.

Recently, factors such as environmental, social, and governance (ESG) issues have been incorporated in the valuation of companies due to the increased awareness of the implications of these issues on the financial position of companies. The evaluation of ESG risks can be used to understand the strategic direction of a company, or industries as a whole, as well as allow for the prediction of future costs or burdens to the company due to these factors. Understanding these issues may allow investors to develop a competitive advantage, by recognizing industry patterns. It has been determined by the United Nations Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact Principles for Responsible Investment (PRI) that ESG factors can affect the long-term performance of investments, and by July 2007, more than 200 international corporations, representing over \$9 trillion in assets, had endorsed the PRI.¹¹¹ Furthermore, researchers have made great strides recently in quantifying ESG issues. For instance, a CFO.com article revealed that finance Professor Anant Sundaram and the Allwin Initiative for Corporate Citizenship at Dartmouth's Tuck School of Business has developed a Fossil Fuel Beta (FFB) for determining fossil fuel prices and green house gas emission liabilities throughout the value chain. As such, the metric may provide the market with a method of quantifying a firm's sustainability reports, thereby, allowing sustainability to be factored into a firm's market value.

Accordingly, the SBA may vote AGAINST shareowner initiatives to ban precatory proposals as it would eliminate the proper exercise of shareowner rights, especially as it relates to these issues.

Consumer Issues

Background and Overview

The recent wave of recalls and warnings from products produced in China has ignited concerns about the complex risks associated with product safety, including the potential management of certain global supply chains. Companies operating in the global economy are increasingly called upon to assume greater responsibility for social and environmental compliance in their supply chain operation, in particular as it relates to toxic chemicals risks in the workplace or consumer human exposure to toxic chemicals in products.

According to ISS Governance Services' 2007 Policy Survey, 62 percent of respondents felt it was important for U.S. companies to report to shareowners on the environmental and social practices of the supply chain as a part of routine filings and disclosure. Over seventy-eight percent of respondents felt that workplace safety performance was an important disclosure criterion.

Toxic chemical and product safety concerns may pose substantial challenges to both manufacturing and retail companies. In the short term, companies may face supply shortages. In the long term, companies may be challenged by persistent supply-chain disruptions and legislative, legal, and reputational risk, which affect companies' political and social costs. As a result, long-term institutional investors may face significant risk exposure at companies that fail to properly manage product safety in their supply chain.

Review of Current Policy

The SBA evaluates a number of shareowner proposals each season on the issue of toxic chemicals. In past years, proponents have focused on the phase-out of certain high profile chemicals by eliminating, or evaluating the feasibility of eliminating, persistent and bioaccumulative toxic (PBT) chemicals, brominated flame retardants (BFRs), polyvinyl chloride (PVC) plastics, bisphenol-A, lead, and mercury, and have requested that companies use safer materials. These proposals have also asked for what new initiatives management can or will take to respond to these toxic chemical public policy challenges beyond those initiatives or actions already required by law.

The SBA will continue to evaluate such shareowner proposals on a case-by-case basis, weighing issues such as: current regulations, recent significant controversy/litigation/fines stemming from toxic chemicals, and the current level of disclosure by the company on this topic. Resolutions requiring that a company reformulate its products are unlikely to be supported by the SBA.

The SBA will generally support resolutions requesting that a company disclose its policies related to toxic materials unless substantial information is already provided by the company. This existing policy works appropriately for manufacturers but falls short of addressing companies further down the supply chain, notably retailers. Consistent with the mounting concerns over product recalls and our client survey results, the intent of the SBA's approach on product safety is to expand the scope of the current toxic chemicals policies to be more applicable to issues related to product safety and global supply chain management. This would essentially imply that companies beyond manufacturers would be evaluated individually and relative to industry peers to determine

¹¹¹ CFA Centre for Financial Market Integrity, "Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors," 2008.

if their policies and disclosure provide shareowners with the necessary information to consider the company's management of the potential risks associated with toxic chemicals and product safety.

Product Safety: FOR

Product recalls due to safety hazards or the inclusion of toxic materials reiterate the importance of high safety standards and secure manufacturing processes throughout the supply chain network. Company failure to implement effective safety standards, and to enforce them throughout the supply chain, creates risk beyond the obvious consumer hazards. Shareowners face the potential for substantial loss in the event of product recalls, class action liability, damage to brand reputation, or supply chain failures and supply shortages due to substandard safety practices or the use of toxic materials. Therefore, proposals for increased disclosure in this context are generally appropriate, provided the request is not duplicative of currently available company reports or practices.

- Generally, the SBA votes FOR proposals requesting increased disclosure regarding oversight procedures, product safety risks, or the use of toxic materials in the manufacturing of company products.
- Generally, the SBA votes FOR proposals requesting increased disclosure regarding oversight procedures, product safety risks, or the use of toxic materials in the company's global or domestic supply chain network.

Genetically Engineered (GE) Organisms: CASE-BY-CASE

Genetically engineering organisms involves the introduction of new genes into plant and animal organisms in order to spawn new traits in animals or produce exceptional growth in agriculture. The U.S. Department of Agriculture (USDA), the Food and Drug Administration (FDA), or the Environmental Protection Agency (EPA) currently regulates engineered or genetically modified organisms. Shareowner proposals in this area generally request the removal of genetically engineered food (animals), ingredients from crops (products), changes in product labeling, or their related study.¹¹² The SBA votes on such shareowner proposals on a CASE-BY-CASE basis. For those proposals that request changes to a company's business strategy or operations, the SBA generally votes AGAINST since we do not attempt to mandate business strategies for the companies we own.

Community Reinvestment: FOR

Equality in mortgage lending is the basic motivation behind these proposals. The Community Reinvestment Act (CRA) of 1977 was developed to encourage banks to improve their lending practices in the communities from which they receive deposits; however, since the law's introduction, the banking business has changed significantly. Now, more than half of mortgage lending is done by non-depository financial institutions such as mortgage companies, insurance companies, or a corporate subsidiary. Also, these financial institutions are not affected by the CRA because they are non-depository. Critics of the CRA contend that the legislation lacks teeth; however, given the projected pace of banking consolidation, the CRA's only sanction has found new importance. The only sanction for poor CRA performance is for regulators to deny an institution's request for expansion, including applications to open new branch offices, as well as for its mergers or acquisitions of other institutions. The law's regulations allow individuals or groups to protest the expansion and merger applications of a specific lender if they believe that institutions are not meeting the credit needs of its local community. Proponents of these proposals request the board of directors to develop a policy which includes all financial subsidiaries of the corporation (both depository and non-depository) under a general program for community reinvestment similar to that required of individual depository subsidiaries under the CRA and to report annually to shareowners on its achievements. The SBA supports shareowner initiatives aimed at promoting fair and open lending standards.

Tobacco Production, Marketing, & Health Issues: CASE-BY-CASE

Shares should be voted in a manner designed to enhance shareowner benefit while at the same time respecting the regulations and legal structures relevant to the tobacco industry. We do not believe that shareowners are responsible for instructing management on business strategies or tactics. However, in cases of negligence on the part of management, the SBA has a responsibility to protect shareowner value and will support shareowner proposals aimed at maintaining or restoring shareowner value.

Educational Plan on Abortifacient Effect of Drugs: ABSTAIN

This proposal asks for an education plan that would inform "literate and non-literate" women of the possible abortifacient effects of the company's products. Due to the complex and sensitive nature of these proposals, the SBA ABSTAINS from voting on these issues.

Pharmaceutical Pricing Policy: AGAINST

These resolutions ask companies to adopt price restraint policies and report to shareowners. The SBA supports unfettered prices dictated only by the forces of a free market. Therefore, we will not support shareowner initiatives seeking to restrain a company's ability to charge what the market will bear.

Pharmaceutical Product Reimportation: CASE-BY-CASE

The SBA generally supports proposals requesting that companies report on the financial and legal impact of their policies regarding prescription drug reimportation unless such information is already publicly disclosed. However, the SBA generally votes AGAINST proposals requesting that companies adopt specific policies to encourage or constrain prescription drug reimportation.

Consumer Lending: CASE-BY-CASE

¹¹² Fetter-Degges, Jan, "Environment: Bioengineering." Social Issues Service, 2007 Background Report – J1. 6 March 2007.

Requests for reports on the company's lending guidelines and procedures, including the establishment of a board committee for oversight, are voted on a CASE-BY-CASE basis by the SBA, taking into account:

- Whether the company has adequately disclosed mechanisms in place to prevent abusive lending practices
- Whether the company has adequately disclosed the financial risks of the lending products in question
- Whether the company has been subject to violations of lending laws or serious lending controversies
- Peer companies' policies to prevent abusive lending practices.

Climate Change and the Environment

Investor Network on Climate Risk

The Investor Network on Climate Risk (INCR) is a network of institutional investors and financial institutions that promotes better understanding of the financial risks and investment opportunities posed by climate change. INCR is coordinated by Ceres, a coalition of investors and environmental groups working to advance sustainable prosperity.

The Investor Network on Climate Risk was launched at the first Institutional Investor Summit on Climate Risk at the United Nations in November 2003. INCR's membership has since grown from 10 investors managing \$600 billion in assets to more than 50 investors managing nearly \$4 trillion of assets. Members include asset managers, state and city treasurers and comptrollers, public and labor pension funds, including the SBA, foundations, and other institutional investors. INCR leverages the collective power of these investors to promote improved disclosure and corporate governance practices on the business risks and opportunities posed by climate change. INCR has achieved dramatic results, including the following:

- INCR brought together 500 investors, Wall Street and corporate leaders at the United Nations in 2005 for the second Institutional Investor Summit on Climate Risk to address the growing financial threats and opportunities posed by climate change.
- Launched a 10-point action plan, endorsed by 28 investors, which seeks deeper analysis, disclosure and action from Wall Street firms, securities regulators and companies on the business risks and opportunities of climate change.
- INCR members have invested over \$1.2 billion of their assets in renewable energy and other clean technology ventures in the past 18 months. The investments cover such technologies as hydrogen fuel cells, ethanol, geothermal facilities and advanced materials.
- Persuaded more than two-dozen Fortune 500 companies to improve their climate policies, practices and disclosure, including leading oil, auto and insurance companies.
- Produced research reports to help investors better understand the implications of global warming. Prominent reports included: an August 2006 report, "From Risk to Opportunity: How Insurers Can Proactively and Profitably Manage Climate Change"; and the March 2006 report entitled, "Corporate Governance and Climate Change: Making the Connection", which analyzed how 100 of the world's largest companies are addressing the business challenges of climate change.
- Published the Global Framework for Climate Risk Disclosure, a standardized set of guidelines for improving corporate disclosure on the risks and opportunities for climate change. The framework was developed in collaboration with investors worldwide.

SEC Climate Risk Disclosure

Recent weather events, such as Hurricane Katrina, suggest to some observers that climate change is inevitable and have caused a series of debates on ways to prevent further climate evolution. More specifically, it has been argued that further climate change due to greenhouse gas emissions threatens national security, and could cause danger to civilians, damage infrastructure, and require costly deployment of the military. Therefore, companies have begun to develop policies targeting adoption, as well as risk-reduction and preparedness, which could minimize costs for policy development and implementation in the future and provide economic benefits. Investing in infrastructure firms, for example, would provide an economic benefit, while providing a small way to help avoid the dangers of an evolving climate.¹¹³

Securities and Exchange Commission (SEC) rules stipulate that "specific known trends, events, or uncertainties that are reasonably likely to have a material effect on a company's financial condition or operating performance" must be discussed as part of a company's SEC filings. Still, SEC rules do not clearly require such disclosure on global warming and carbon dioxide emissions. This

¹¹³ Busby, Joshua, 2007, Mixed Sources, "Climate Change and National Security."

results in non-disclosure and uneven disclosure by companies, making it extremely difficult for investors to assess climate risk in their investments.

In April 2004, in coordination with Ceres, 15 leading institutional investors with nearly \$800 billion in assets, including eight state treasurers and comptrollers, four labor pension fund leaders, the New York City Comptroller, and the California State Teachers' Retirement System (CalSTRS), called on the SEC to eliminate any doubt that publicly traded companies should be disclosing the financial risks of global warming in their securities filings. In two separate letters to SEC Chairman William Donaldson, the pension fund leaders said that climate change poses material financial risk to many of their portfolio companies and that those risks should be analyzed as a matter of routine corporate financial disclosure to the SEC. While several oil and gas companies have agreed in recent months to include such information in their reports with the SEC, the SEC has not made a formal change in its policy.

In October 2004, in partnership with the Wirth Chair in Environmental and Community Development Policy at the University of Colorado, Ceres convened a leadership forum on "Climate Change Risks and the SEC: Problems and Opportunities" at the Aspen Institute in Washington, DC. Four-dozen participants from public pension funds, businesses, nonprofits, governments, foundations, the United Nations, and academia considered the risks climate change poses to companies and investors, the quality of existing climate risk disclosure, and measures the SEC could take to improve it. Participants agreed that companies' lack of rigorous analysis and reporting of climate risk stems from strategic failures at the highest level, top management and the board room, and too much emphasis on short-term results, a trend reinforced by financial markets. Participants also concluded that the SEC should apply its existing requirements for disclosure of material risks to climate risk and make this clear in an interpretive release. More information is available here: [Climate Change Risks and the SEC: Summary Report](#).

Ceres Principles: FOR

Ceres, formerly known as the Coalition for Environmentally Responsible Economics Principles, is a 10-point environmental code of conduct drafted by environmental groups and investor advocates to be adopted by companies in any industry. The issues stressed are protection of the biosphere, prevention of environmentally harmful accidents, conservation of natural resources, proper reduction and disposal of waste, marketing of safe products and services, and appointments of environmental experts to corporate boards. The SBA supports the Ceres Principles consistent with prudent fiduciary standards.

Energy and Environment: CASE-BY-CASE

In conjunction with the Ceres Principles, we are in favor of companies taking actions toward energy conservation and environmental solutions. We generally vote in favor of proposals that ask companies to disclose historical, current, or projected levels of pollutants emitted into the environment and to disclose any control measures to shareowners. The SBA evaluates such proposals, taking into account whether the company has clearly disclosed the following in its public documents:

- **Physical Risk Analysis:**
Estimates for potential damage to company assets, operations, and supply chain due to climate risk should be provided. Climate risk assessment should include an overview of current climate and weather impacts on company operations, as well as specific risks to operations in the event that climate change results in more extreme weather conditions. In addition, company analysis should include possible means of adapting to such climate risks and the potential costs of adaptation.
- **Regulatory Risk Analysis:**
Any expected increase in governmental environmental regulation should be evaluated with attention to company-specific impacts. The approximate cost of complying with current or proposed environmental laws, particularly those related to the regulation and reduction of greenhouse gas emissions should be disclosed.¹¹⁴

Emissions Disclosure should include the following: 1. Historical, current, and projected greenhouse gas emissions, 2. Company actions to reduce greenhouse gas emissions or other environmental pollutants, and 3. Targets and goals for the reduction of emissions and environmental pollutants.

Environmental and Sustainability Disclosure: FOR

With rising awareness of climate risk scenarios, there is increasing shareowner interest in full company disclosure of environmental and sustainability issues. Such issues are now seen as factors likely to impact a company's long term growth and profitability. Therefore, analysis of a company's environmental positioning and related risk exposure is increasingly a required component of the investment decision making process. The 2007 Carbon Disclosure Project provided an appreciation of corporate concern regarding climate risk as 81 percent of S&P 500 respondents considered climate change to present commercial risks for their businesses, compared to only 69 percent that saw climate change as presenting commercial opportunities.¹¹⁵ A recent study evaluated corporate disclosure of climate change and the likelihood that companies would respond to the Carbon Disclosure Project's request for information. The empirical evidence supports the conclusion that companies that have already been targeted by shareowners, through a shareowner proposal, are more likely to respond to requests for information.¹¹⁶ This underscores the importance of active shareowner engagement to encourage companies to bolster disclosure regarding sustainability risk management.

¹¹⁴ Ceres Global Framework for Climate Risk Disclosure, October 2006.

¹¹⁵ <http://www.riskmetrics.com/pdf/CDP5.pdf>

¹¹⁶ Reid, Erin and Michael Toffel, "Responding to Public and Private Politics: Corporate Disclosure of Climate Change Strategies," August 2008

The Global Reporting Initiative (GRI) was developed by CERES and the United Nations Developments Programme (UNEP). The GRI allows companies to increase disclosure relevant information to shareowners. The SBA encourages companies to support GRI disclosure standards:

- Generally, the SBA votes FOR shareowner proposals seeking greater disclosure of a company’s environmental practices and contingency plans.
- Generally, the SBA votes FOR shareowner proposals which seek greater disclosure of a company’s environmental risks and liabilities, as well as company opportunities and strengths in this area.
- Generally, the SBA votes FOR shareowner proposals asking companies to report in accordance with the GRI.

For each proposal, the SBA considers whether such information is already publicly provided by the company. Redundant information requests should be avoided. As such, the SBA may consider voting AGAINST requests for reporting if the company has already disclosed reports to the public, and has responded to the Carbon Disclosure Project.

Global Warming and Greenhouse Gas Emissions Disclosure: FOR

Global warming and greenhouse gas emissions create the potential for the most imposing and widespread environmental dangers. Specific recognition and disclosure of a company’s preemptive actions in this category are therefore appropriate. Such disclosure allows shareowners to more effectively quantify the company-specific risk, and to assess management’s ability to position the company appropriately.

- The SBA votes FOR shareowner proposals seeking disclosure of liabilities or preparation of a report pertaining to global warming and climate change risk.
- The SBA votes FOR shareowner proposals seeking disclosure of how a company will respond to increasing social and regulatory pressures around climate change.

Energy Efficiency: CASE-BY-CASE

It has been argued that the green movement is not strictly public sector-driven, and an increased number of companies are beginning to increase their efforts to become more environmentally friendly. While some have implemented mandatory LEED certification, others have provided economic incentives for engaging in energy conservation. In addition, there is no doubt that there are initial economic barriers to this process, but many corporations have begun to voluntarily take part in energy consumption reduction, which will reduce the economic burden in the future. This process can be achieved through better market transparency and measurement standards globally, which will lead to changes in behavior.¹¹⁷

Proposals addressing environmental and energy issues generally seek greater disclosure on an issue or seek to improve a company’s environmental practices in order to protect natural resources. The negative financial implications for companies with poor environmental practices include liabilities associated with site clean-ups and lawsuits, while proponents argue that energy efficient products and clean environmental practices are sustainable business practices that will contribute to long-term shareowner value. Shareowners claim that the majority of independent atmospheric scientists agree that global warming poses a serious problem to the health and welfare of this country, citing the findings of the Intergovernmental Panel on Climate Change. Shareowners argue that companies can report on their greenhouse gas emissions within a few months at reasonable cost.

The SBA votes on proposals requesting a company report on its energy efficiency policies on a CASE-BY-CASE basis, considering:

- The current level of disclosure related to energy efficiency policies, initiatives, and performance measures;
- The company’s level of participation in voluntary energy efficiency programs and initiatives;
- The company’s compliance with applicable legislation and/or regulations regarding energy efficiency; and
- The company’s energy efficiency policies and initiatives relative to industry peers.

Water Supply, Utilization and Conservation Disclosure: FOR

As a vital natural resource and a key input to operations, sustainable water supply is a critical social and corporate issue. Company disclosure should include crucial water supply issues, as well as contingency planning to ensure adequate supply for anticipated company demand levels.

- Vote for shareowner proposals seeking disclosure of water supply dependency or preparation of a report pertaining to sustainable water supply for company operations.

¹¹⁷ Florance, Miller and Spivey, 2007, “Does Green Pay Off?”

Environmental and Sustainability Directives: AGAINST

Proposals that request a company engage in specific environmental actions are evaluated on the potential to contribute to long-term shareowner value. However, the SBA applies a stricter standard of approval for any proposal which would compel directors to adopt a particular strategic, social, or environmental initiative. Ideally, proposals would be designed to create a meaningful mutual benefit for society and business, leading to improved corporate performance and social integration.¹¹⁸ The decision to implement such directives is most appropriately made by company management, but shareowner input should assist management in choosing a mutually beneficial path. The SBA generally votes against proposals which compel environmental action. However, proposals which reflect the following criteria would be given additional consideration and may be voted on a CASE-BY-CASE basis:

- The potential to lower costs, increase customer satisfaction, create additional competitive advantages, and increase shareowner value.
- Synergy of the proposal with a company’s strategic initiatives and underlying competitive advantage.
- Adaptability of the proposal to a company’s current or proposed cost-cutting or emissions-reducing initiatives.
- The degree to which a company’s labor and capital resources would be diverted from revenue-generating activities.
- The degree to which additional capital and labor would be required in order to fulfill any proposed mandate.
- Whether the proposal was binding or advisory, with a lesser degree of scrutiny for advisory proposals.
- A clearly defined net environmental benefit once all resource costs of engagement are taken into account.

Concentrated Area Feeding Operations (CAFO): FOR

Concentrated animal feeding operations are livestock feeding operations generally defined as facilities containing more than 1,000 animal units (AUs) and/or facilities that allow pollutants associated with animal feeding to enter the local water sources. Environmental advocacy groups have been critical of these operations, citing that the discharge of nitrogen and phosphorus from these facilities pollutes local water sources, ground water, and the soil resulting in significant damage to the ecosystem. Additionally, animal welfare and community groups have also accused these “factory farms” of inhuman treatment of the animals and the displacement of local livestock farmers. Proponents of CAFOs generally argue that these methods are the safest, least costly, and most efficient approach to animal feeding and processing.

Certain shareowner organizations have requested that companies report on the impact of the CAFOs that they source from on the environment and consider the potential financial and legal implications of sourcing from such facilities. Poultry and livestock companies that have received criticism of their CAFO operations note that the facilities are owned and operated by independent entities that are not required to comply with policies dictated by the company. Certain legal decisions have established the precedent that a company can be held liable for the actions of the contract farms it sources from. Fines and remediation expenses stemming from these cases have been significant and could have a notable impact on the companies’ operations and shareowner value.

The SBA generally supports resolutions requesting that companies report to shareowners on the risks and liabilities associated with CAFOs unless:

- The company has publicly disclosed guidelines for its corporate and contract farming operations, including compliance monitoring; or
- The company does not directly source from CAFOs.

Facility Safety (Nuclear and Chemical Plant Safety): CASE-BY-CASE

Resolutions requesting that companies report on risks associated with their operations and/or facilities are examined on a case-by-case basis, considering:

- The company’s compliance with applicable regulations and guidelines;
- The level of existing disclosure related to security and safety policies, procedures, and compliance monitoring; and,
- The existence of recent, significant violations, fines, or controversy related to the safety and security of the company’s operations and/or facilities.

Operations in Protected Areas: FOR

Shareowner proposals seeking additional disclosure on a company’s operations in regions protected or established under national or international categorization guidelines can be an important mitigating factor when addressing increased risk and oversight. Such areas, which include wildlife refuges, national forests, and IUCN categorized areas, expose companies to increased oversight and the

¹¹⁸ From Porter, Kramer, Harvard Business Review, December 2006

potential for associated risk and controversy. Therefore, restrictions to the company's operations, damaging public opinion, and costly litigation resulting from failure to comply with the requirements associated with protected or categorized regions could have a significant impact on shareowner value. Such proposals will be favored if a company operates in such regions, but fails to provide a level of disclosure comparable to industry peers or accepted standards.

The SBA generally supports requests for reports outlining potential environmental damage from operations in protected regions unless:

- Operations in the specified regions are not permitted by current laws or regulations;
- The company does not currently have operations or plans to develop operation in these protected regions; or;
- The company provides disclosure on its operations and environmental policies in these regions comparable to industry peers.

Recycling: CASE-BY-CASE

A coalition of socially responsible investors, environmentalists, and religious groups has promoted the concept of extended product responsibility, a responsibility shared by industry, consumers, and the government for the environmental impact of a product over its life cycle. Producers were encouraged to prevent pollution and reduce resource and energy use in each stage of the company's product life cycle, including the end of the life cycle. The campaign originated with the beverage industry and in 2002 was extended to the computer industry.

The SBA votes on proposals to adopt a comprehensive recycling strategy on a case-by-case basis, taking into account:

- The nature of the company's business and the percentage affected;
- The extent that peer companies are recycling;
- The timetable prescribed by the proposal;
- The costs and methods of implementation; and
- Whether the company has a poor environmental track record, such as violations of applicable regulations.

Renewable Energy: CASE-BY-CASE

Requests for reports on the feasibility of developing renewable energy sources are generally supported unless the report is duplicative of existing disclosure or irrelevant to the company's line of business. However, the SBA generally votes against proposals requesting that the company invest in renewable energy sources as such decisions are best left to management's evaluation of the feasibility and financial impact that such programs may have on the company.

Animal Testing and Welfare Policies: CASE-BY-CASE

Currently, the SBA generally ABSTAINS from voting on these types of proposals.

Equal Employment: FOR

The SBA believes proposals that promote and attempt to enhance or improve equal employment should be supported.

Corporate Board Diversity: FOR

Shareowners should encourage companies to diversify the make-up of their boards of directors. Proponents of board diversity ask that the company's board of directors or nominating committee make a greater effort to seek out qualified women and minorities for the board. In addition, most resolutions ask that the company report back to the shareowners on its efforts and issue a public statement of commitment to board inclusiveness.

Sexual Orientation and Domestic Partner Benefits: CASE-BY-CASE

The SBA generally votes in favor of proposals seeking to amend a company's equal employment opportunity (EEO) statement in order to prohibit discrimination based on sexual orientation, unless the change would result in excessive costs for the company. However, proposals to extend company benefits to, or eliminate benefits from domestic partners, are typically opposed given that benefits decisions should be left to the discretion of the company.

International Issues, Labor Issues and Human Rights

China Principles: AGAINST

The U.S. Business Principles for Human Rights of Workers in China are designed to commit companies to human rights and labor standards defined by the International Labor Organization (ILO) and the United Nations Covenants on Economic, Social and Cultural Rights, and Civil and Political Rights.

1. No goods or products produced within our company-owned facilities or those of our suppliers shall be manufactured by bonded labor, forced labor, within prison camps, or as part of reform-through-labor or reeducation-through-labor programs.

2. Our facilities and suppliers shall adhere to wages that meet workers' basic needs, and to fair and decent working hours, at a minimum adhering to the wage and hour guidelines provided by China's labor laws and policies.
3. Our facilities and suppliers shall prohibit the use of corporal punishment, as well as any physical, sexual, or verbal abuse or harassment of workers.
4. Our facilities and suppliers shall use production methods that do not negatively affect the occupational safety and health of workers.
5. Our facilities and suppliers shall not call on the police or military to enter their premises to prevent workers from exercising their rights.
6. We shall undertake to promote the following freedoms among our employees and the employees of our suppliers: freedom of association and assembly, including the rights to form unions and to bargain collectively; freedom of expression, and freedom from arbitrary arrest or detention.
7. Employees working in our facilities and those of our suppliers shall not face discrimination in hiring, remuneration, or promotion based on age, gender, marital status, pregnancy, ethnicity, or region of origin.
8. Employees working in our facilities and those of our suppliers shall not face discrimination in hiring, remuneration, or promotion based on labor, political, or religious activity, or on involvement in demonstrations, past records of arrests or internal exile for peaceful protest, or membership in organizations committed to non-violent social or political change.
9. Our facilities and suppliers shall use environmentally responsible methods of production that have minimum adverse impact on land, air, and water quality.
10. Our facilities and suppliers shall prohibit child labor, at a minimum complying with guidelines on minimum age for employment within China's labor laws.

Eight ILO conventions have been identified by the ILO's Governing Body as being fundamental to the rights of human beings at work irrespective of levels of development of individual member states.

The ILO Core Conventions and the dates of their adoption are:

- Forced Labour—1930
- Freedom of Association and Protection of the Right to Organize—1948
- Right to Organize and Collective Bargain—1949
- Equal Remuneration—1951
- Abolition of Forced Labour—1957
- Discrimination (Employment and Occupation)—1958
- Minimum Age Convention—1973
- Elimination of the Worst Forms of Child Labour—1999

Furthermore, companies are expected to work cooperatively with human rights organizations both to ensure that their enterprises and suppliers are in compliance with these principles. They will also issue an annual statement to the Human Rights for Workers in China Working Group (CWG) detailing their efforts to uphold these standards and to promote these basic freedoms. Proponents of this resolution claim that making all lawful efforts to implement or increase activity on each of the China Principles will help address poor working conditions and human rights abuses at Chinese factories that produce goods for U.S. firms. It is also beneficial as companies can avoid being blacklisted by states and municipalities, many of whom have limited their contracts with companies that fail to adopt strict labor standards in countries recognized for committing gross human rights violations.

However, companies generally argue against having to join another initiative or adopting separate codes of conduct for every country in which they conduct business. Some also fail to see any benefit of CWG participation in terms of membership fees or in needing any guidance from the organization on how to address labor and human rights issues in China. Traditionally, firms in the retail and extractive industries are most commonly scrutinized by advocates of the China Principles in light of poor working conditions and the use of sweatshop labor.

The SBA generally votes AGAINST proposals to implement the China Principles unless there are serious controversies surrounding the company's operations in China and if the company does not have a code of conduct with standards similar to those declared by the International Labor Organization (ILO).

Codes of Conduct: CASE-BY-CASE

Workplace codes of conduct are designed to safeguard workers' rights in the international marketplace. Advocates of workplace codes of conduct encourage corporations to adopt global corporate standards that ensure minimum wages and safe working conditions for workers at U.S. companies that operate factories in developing countries. Furthermore, U.S. companies that outsource portions of their manufacturing operations to foreign companies are expected to ensure that the products received from those contractors do not involve the use of forced labor, child labor, or sweatshop labor. A number of companies have implemented vendor standards, which include independent monitoring programs with respected local human rights and religious organizations to

strengthen compliance with international human rights norms. Approximately 20 percent of large capitalization companies in global equity markets have adopted some form of labor code for its suppliers, covering forced (child) labor, workplace discrimination, worker safety, and freedom of association.^{119, 120}

Recent evidence shows how sourcing from overseas vendors with labor problems can lead to significant public relations problems for U.S. companies. In addition, more companies have faced consumer boycotts and legal fines as consumers have focused on human rights and labor standards. Studies have shown that 75 percent of respondents would avoid shopping in stores that sold goods produced in sweatshops.¹²¹ Another study found that 76 percent of Americans would pay more for sweatshop-free and child labor-free clothing.¹²²

Several organizations, including Amnesty International, the Fair Labor Association (FLA), and the Ethical Trading Initiative (ETI), have developed labor codes and related principles which have been adopted by several multi-stakeholder initiatives and used in their evaluation of supply chain management. Generally, Amnesty International principles are not as comprehensive in some areas, relative to the FLA and/or ETI. The SBA favors incorporation of operational monitoring, code enforcement, and robust disclosure mechanisms.¹²³ The SBA prefers to see companies with supply-chain risks proactively engage an independent monitoring organization to provide objective oversight, and publicly disclose such evaluation. Although there is no generally recognized standard for companies to use, a very good starting point is participation and membership in the FLA.

Proposals to implement certain human rights standards and policies at company facilities are evaluated by the SBA on a CASE-BY-CASE basis. In examining these proposals, the following should be considered:

- The degree to which existing human rights policies and practices are disclosed
- Whether or not existing policies are consistent with internationally recognized labor standards
- Whether company facilities are monitored (and how)
- Company participation in fair labor organizations or other internationally recognized human rights initiatives
- The company's primary business model and methods of operation
- Proportion of business conducted in markets known to have higher risk of workplace labor right abuse
- Whether the company has been recently involved in significant labor and human rights controversies or violations
- Peer company standards and practices
- Union presence in company's international factories

Community Impact Assessments: CASE-BY-CASE

Community impact assessment proposals ask companies to evaluate and report on their policies and practices on a range of issues that may include requests to review potential environmental and public health damage resulting from a certain regional operation or requests for companies to study and develop a report on the potential environmental and public health damage of its operations.

Because companies find themselves operating in markets where stakeholders have competing interests, the possibility of social, cultural, and environmental impacts resulting from operations is a credible risk that many companies face. As social and environmental controversies, fines, and litigation can have a significant negative impact on a company's financials, public reputation, and license to operate in developing markets, many companies that operate in such markets develop internal controls aimed at mitigating their exposure to these risks by enforcing, supplementing, and in many cases, exceeding local regulations and laws. Many companies also establish outreach programs to the community, stakeholders, and government to promote a collaborative approach to public health and sustainable development.

The SBA employs a case-by-case approach on requests for reports outlining the potential community impact of company operations in specific regions, considering:

- Current disclosure of applicable risk assessment report(s) and risk management procedures
- The impact of regulatory non-compliance, litigation, remediation, or reputational loss that may be associated with failure to manage the company's operations in question, including the management of relevant community and stakeholder relations
- The nature, purpose, and scope of the company's operations in the specific region(s)
- The degree to which company policies and procedures are consistent with industry norms

Internet Privacy and Censorship: CASE-BY-CASE

¹¹⁹ RiskMetrics Group, Corporate Social Issues Reporter, April 2008. Study encompassed over 1,800 companies within the S&P 500 index, the Toronto Stock Exchange 300 index, and the MSCI EAFE index ex-Japan. Study identified that the highest risk industries included Retailing, Food & Staples Retailing, Consumer Durables & Apparel, Household & Personal Products, and Food, Beverage & Tobacco.

¹²⁰ "Factory Labour Standards in Emerging Markets: An Investor Perspective," F&C Asset Management, REO Research Series, January 2009.

¹²¹ PepsiCo 2002 proxy filing, and PepsiCo's April 21, 2002 letter to RiskMetrics Group (RMG). As You Sow Foundation and Walden Asset Management March 31, 2002 letter to Coca-Cola shareowners.

¹²² Marymount University Center for Ethical Concerns, 1999 National Survey: The Consumer and Sweatshops. Arlington, VA, November 1999.

¹²³ "Incorporating Labor and Human Rights Risk into Investment Decisions." Aaron Bernstein, Harvard Labor and Worklife Program, Occasional Paper Series No. 2, September, 2008.

Proposals seeking to adopt policies to protect freedom of access to the internet are fast becoming a social issue garnering the attention of shareowners. Resolution sponsors argue that the Chinese government is using IT companies' technologies to track, monitor, identify, and, ultimately, suppress political dissent. In the view of proponents, this process of surveillance and associated suppression violates internationally accepted norms outlined in the U.N. Universal Declaration of Human Rights. Such restrictions not only violate human rights, but they also decrease the quality of service provided by companies in the industry and threaten the integrity and viability of the industry as a whole. As such, proponents believe that companies like Yahoo, Google, Microsoft, Cisco Systems and Oracle, with operations in such markets should develop adequate standards that can be used when conducting business in countries with authoritarian governments.

The difficulty for IT firms is that the capabilities cited, monitoring, interception, keyword searches, and recording of Internet traffic are inherent in a wide range of products that companies sell to government agencies, state-owned communications or IT entities, or resellers throughout the world. They are designed to protect the integrity of Internet communications networks against theft, sabotage, viruses, and unlawful intrusion, especially in an age where governments face constant attacks against their national IT infrastructure.

Active measures to address these concerns are generally aimed at government policy makers as well as the major Internet and technology companies that operate in these markets. On one hand, the companies suggest that by providing their products, they are providing access to information that would not otherwise be available. Furthermore, management at these companies suggest that they are bound to respect the laws and policies of the countries in which they operate, and that failure to defer to such regulations could lead to the loss of license to operate in a country. As such, while industry dialogue on how to address these issues is taking place, management at most companies in the private sector believe that this issue would be better addressed by a more universal, public policy approach.

Conversely, some human rights advocates and organizations believe that it is incumbent on private companies to use their technological and economic influence to encourage such governments to relax censorship policies and increase freedom of expression. Moreover, these organizations believe that generally accepted international agreements protect such freedoms, and assert that private industry has a moral imperative to develop explicit policies for operating in these markets that would protect human rights or at least inform the public of instances where legal agreements require a company to allow forms of censorship or monitoring. In the event that such policies are not feasible or cannot be implemented, some stakeholders have suggested that companies should cease business relationships with government agencies that are unwilling to protect these basic human rights. Finally, many of the advocates who support more stringent human rights protections related to Internet access believe that companies that fail to develop appropriate policies for operating in challenging markets are actually limiting their long-term opportunities by "fragmenting" technology in such a manner that would restrict the growth of universal communication and technology standards globally in favor of market specific solutions. Such market specific solutions, advocates contend, could lead to ethically unsound practices and financially unsustainable over the long term.

Various measures have been suggested to discourage companies from abetting Internet censorship abroad. Rep. Christopher Smith (R-N.J.) introduced the Global Online Freedom Act in the 109th and 110th Congress, most recently in January 2007. Much like the resolution proposed at Yahoo, the act would require U.S. companies doing business abroad to take steps to protect their users from government retaliation and to alert users of instances of censorship. The bill has been assigned to a committee. Human Rights Watch, a global human rights advocacy organization, has also proposed a voluntary code for companies doing business in nations that censor the Internet.

The SBA generally votes in favor of disclosure-based resolutions relating to Internet policies unless the company has already taken proactive steps to address the issue in question. In evaluating the merits of the proposal, the SBA examines the level of current applicable disclosure on the topic, the level of stakeholder engagement, nature and scope of the company's operations as well as the scope of the proposal, applicable legislation, and the company's past history of controversy and litigation as it pertains to human rights. These guidelines will seek to encourage disclosure that is not overly costly or burdensome to the company, while including pertinent information for shareowners to evaluate the potential risks associated with the management of these emerging human rights concerns.

Operations in High-Risk Markets: CASE-BY-CASE

In recent years, concerned shareowners of companies operating in regions that are politically unstable, including terrorism-sponsoring states, have requested both a withdrawal of operations in a high-risk market as well as having requested a report on operations in a high-risk market. Such concerns are focused over how their investment may, in truth or by perception, support potentially oppressive governments. Operations in these regions, proponents contend, may lead to potential reputational, regulatory, or supply chain risks as a result of operational disruptions.

Countries determined by the U.S. Secretary of State to have repeatedly provided support for acts of international terrorism are designated pursuant to three laws: the Export Administration Act, the Arms Export Control Act, and the Foreign Assistance Act. Taken together, these laws can lead to the four categories of sanctions. These authorities may also penalize persons and countries engaging in certain trade with state sponsors of terrorism. Currently, there are five countries designated under these authorities: Cuba, Iran, North Korea, Sudan, and Syria.

The SBA votes on a CASE-BY-CASE basis when evaluating requests to review and report outlining the company's potential financial and reputation risks associated with operations in "high-risk" markets, such as a terrorism-sponsoring state or otherwise, taking into account:

- The nature, purpose, and scope of the operations and business involved that could be affected by social or political disruption
- Current disclosure of applicable risk assessment(s) and risk management procedures
- Compliance with U.S. sanctions and laws
- Consideration of other international policies, standards, and laws
- Whether the company has been recently involved in significant controversies or violations in "high-risk" markets.

Outsourcing/Offshoring: CASE-BY-CASE

Foreign outsourcing, the transfer of work from a domestic facility to a foreign market to achieve greater efficiencies, has developed into one of the most contentious shareowner action issues in recent years. Also known as "off-shoring," foreign outsourcing first gained hold in manufacturing industries as management at toy, apparel, and other production-heavy companies found that they could increase profit margins by assigning manufacturing contracts to facilities in markets where labor costs were a fraction of those in the United States. However, in the last few years, this approach has become more prevalent in the service and technology industries, prompting the question: Is foreign outsourcing beneficial to the economy in general, and shareowner value in specific, over the long term? While thorough disclosure is an important part of sound corporate governance policy and serves to protect shareowner interests, there are also certain costs and considerations associated with reporting.

As such, the relevance of the proposal to the company's core business shall be considered and the SBA shall ensure that the requested report is not duplicative of existing disclosure. This approach to policy and analysis of outsourcing proposals allows the SBA to independently consider the risks and opportunities of foreign outsourcing at a specific company, and to provide a vote recommendation consistent with leading corporate governance standards and considering the long-term impact on shareowner value.

Proposals calling for companies to report on the risks associated with outsourcing shall be voted on a CASE-BY-CASE basis, considering the risks associated with certain international markets, the utility of such a report to shareowners, and the existence of a publicly available code of corporate conduct that applies to international operations.

Northern Ireland (MacBride Principles): FOR

The MacBride Principles call on U.S. companies with operations in Northern Ireland to promote fair employment practices there. Signatories of the MacBride Principles must make reasonable, good faith efforts to abolish all differential employment criteria whose effect is discrimination on the basis of religion.¹²⁴ The situation in Northern Ireland continues to reflect religious discrimination in employment.

The SBA supports the MacBride Principles as part of Section 121.153, F.S. and feels the principles should be adopted and implemented. The SBA is in favor of firms reporting their relationships in and with Northern Ireland.

High-Performance Workplace: FOR

A "high-performance workplace" can be described as one that provides workers with the information, skills, incentives, and responsibility to make decisions essential for innovation, quality improvement, and rapid response to change. The SBA believes that high-performance workplaces are correlated with both productivity and long-term financial gain. Empowering workers makes employees more productive and their companies more competitive, hopefully enhancing shareowner value in the process. The SBA votes FOR these resolutions.

Military Production: CASE-BY-CASE

These resolutions focus on asking defense contractors to report on the export of military goods and services. Such disclosures may involve sensitive and confidential information. Foreign military sales (FMS) constitute a considerable portion of the business conducted by major U.S. defense contractors. Military arms exports may be accompanied by "offset" agreements, in which companies rebate a portion of the purchase price back to the purchasing country. These agreements are known as offsets because they help offset the cost of the purchase itself and may take a variety of forms, both direct and indirect offsets. Direct offsets are those that involve defense articles or services as part of the military export, such as subcontracting to businesses in the purchasing nation, transfers of technology, financial assistance, and joint ventures. Indirect offsets can involve goods and services unrelated to the military export. Supporters of military production shareowner proposals have noted that a U.S. Commerce Department study reported that between 1993 and 2006, U.S. companies reported export sales of \$84.3 billion and that related offset agreements were \$60 billion, or 71.2 percent of export sale value.¹²⁵

¹²⁴ Northern Ireland Statistics and Research Agency, Source Book 2001 and 2000 Labour Force Survey Religion Report, March 2001.

¹²⁵ According to the U.S. Department of Commerce - Bureau of Industry and Security's report, "Offsets in Defense Trade: Twelfth Report to Congress", released in December 2007, U.S. companies entered into 582 offset agreements with 42 countries related to export sales totaling \$84.3 billion between 1993 and 2006. In 2006 alone, U.S. defense contractors reported 44 new offset agreements with 20 countries, with a total value of approximately \$3.4 billion. These agreements equaled 70.9 percent of the \$4.8 billion in related export contracts.

Shareowner proponents typically argue that taxpayers incur the costs of these agreements, especially when they exceed the dollar value of a foreign military sale itself—because they finance the original research and development of the military equipment whose technology or manufacturing license is subject to transfer or grant. Information about offset agreements is closely guarded by companies participating in such deals. Defense manufacturers are required to submit annual summaries of all offset agreements to the U.S. Department of Commerce, and to provide itemized details regarding new offset agreements they enter into on a yearly basis. The Department of Commerce uses this information to prepare an annual report for Congress.

Weapons sales by U.S. defense contractors to other governments are subject to a number of regulatory frameworks. U.S. defense contractors have two avenues to pursue foreign sales of weapons-related products and services. First, they may sell weapons to foreign countries indirectly through foreign military sales (FMS), a process by which weapons manufacturers sell to the U.S. Department of Defense (DOD), which subsequently negotiates agreements with foreign governments. Under the FMS system, DOD contractors do not negotiate with DOD clients. Alternatively, U.S. defense contractors can apply for export licenses through the U.S. Department of State in order to participate in direct commercial sales (DCS). In doing so, companies negotiate directly with a purchasing agent or country and must register with the U.S. State Department and apply for an export license. To prevent illegal defense exports and technology transfers, the U.S. State Department works with other governmental bodies to implement end-use monitoring checks. From a regulatory perspective, the U.S. Department of State's Directorate of Defense Trade Controls (DDTC), in accordance with the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR), is charged with controlling the export and temporary import of defense articles and defense services covered by the United States Munitions List (USML).

Proponents of foreign military sales resolutions generally argue that weapons sales by U.S. defense contractors create unintended conflicts worldwide. Proponents maintain that military contractors have an obligation to weigh the ethical dimensions of their sales, in some cases above the effect of these sales on shareowner value, in order to increase global security. These proposals may ask companies to establish a board committee to develop ethical criteria for their military contracts and to report to shareowners on those criteria and on details of the company's foreign military sales.

Defense contractors claim that defense and foreign policy decisions, including those pertaining to arms sold abroad, fall within the purview of the legislative and executive branches of government, which are responsible for determining and advancing the United States' security interests. Moreover, the kind of information typically sought by shareowner proponents is, in their opinion, highly sensitive and confidential. Disclosure of such information could put the company at a disadvantage in the competitive bidding process and also could breach contractual and confidentiality agreements.

Nuclear Proliferation: CASE-BY-CASE

Some shareowners are concerned about profitability and safety of operating nuclear power plants, storage and disposal of spent nuclear fuel, depleted uranium, and plant decommissioning. Nuclear utilities are concerned about deregulation and the fact they may not generate enough cash flow to justify their continued operations.

There have been an increasing number of shareowner-sponsored resolutions asking a company to cease production or report on the risks associated with the use of depleted uranium munitions or nuclear weapons components and delivery systems, including disengaging from current and proposed contracts. Such contracts are monitored by government agencies, serve multiple military and non-military uses, and withdrawal from these contracts could have a negative impact on the company's business.

Depleted uranium is a heavy metal considered to be a low-level nuclear waste metal comprised of what is left after most of the fissile radioactive isotopes of uranium are used. The material is relatively inexpensive; however, because of its extremely high density, it has been used for certain military and industrial applications.

There has been some scientific concern over the long-term health effects of exposure to depleted uranium. Some peer reviewed studies have suggested that exposure to depleted uranium can result in birth defects and complications, difficulty breathing, kidney damage, and some types of cancer. Exposure to depleted uranium can be through inhalation, ingestion, or exposure to fragments of the metal.

Due to its relatively short history, scientific research does not find a consensus on depleted uranium's long-term health and environmental effects. Some, including the Pentagon, assert that there is a minimal link, if at all, between depleted uranium exposure and illnesses among veterans exposed to depleted uranium weapons; others assert depleted uranium radiation and toxicity can/may cause detrimental long-term health damage. Conversely, opponents of depleted uranium usage argue that its use should be postponed until scientific data can validate its safety. Meanwhile, the military argues that no other metal can be as effective in warfare as depleted uranium.

Political Contributions and Expenditure Reporting: CASE-BY-CASE

These resolutions address the issue of corporate non-partisanship and disclosure of contributions related to political campaigns, political action committees (PACs), and other special interest organizations. We believe companies should provide data on the amount and rationales for making such donations. Some organizations, primarily labor unions, are addressing "soft dollar" policies and some are requesting shareowner approval of campaign contributions.

The SBA typically evaluates proposals to improve the disclosure of a company's political contributions and trade association spending on a CASE-BY-CASE basis, considering the following factors:

- Recent significant controversy or litigation related to the company’s political contributions or governmental affairs; and
The public availability of a company policy on political contributions and trade association spending including information on the types of organizations supported, the business rationale for supporting these organizations, and the oversight and compliance procedures related to such expenditures of corporate assets.

Political Nonpartisan: CASE-BY-CASE

These resolutions call for companies to maintain scrupulous political neutrality to avoid entanglements detrimental to its business. They ask that the appearance of coercion in encouraging its employees to make political contributions be avoided.

The SBA examines proposals requesting the company to affirm political nonpartisanship in the workplace on a CASE-BY-CASE basis. We will generally not favor such resolutions provided that:

- The company is in compliance with laws governing corporate political activities; and
The company has procedures in place to ensure that employee contributions to company-sponsored political action committees (PACs) are strictly voluntary and not coercive.

Prepare Additional Reports: CASE-BY-CASE

These resolutions ask companies to prepare additional reports to shareowners such as equal employment. The SBA favors such proposals when they are worthy of management’s attention and not disclosed to shareowners.

Sweatshop Labor: CASE-BY-CASE

These resolutions usually ask for a report on supplier standards that the company uses when purchasing goods abroad or to adjust the salaries of contract workers to “ensure adequate purchasing power and a sustainable community wage.” The SBA evaluates such proposals in a similar manner to Codes of Conduct (please see above policy narrative).

U.S. Business and Health Care Reform: CASE-BY-CASE

Shareowners may at times ask companies to evaluate and report on the impact of various health care reform proposals. These resolutions ask the board of directors to examine the company’s position on the important public policy issue of national health care and to report how the company’s health care position will affect the economic, social, and personal welfare of shareowners, employees, customers, suppliers, communities and the nation as a whole. The scope of these shareowner proposals as well as future legislation is very broad. The other relevant issues generally examined include the company’s exposure to health care costs, its industry, its disclosure about its costs, its responsiveness to the issue and its lobbying activities regarding health care.

Frequently, proposals for healthcare reform rely on the principles stated in a 2004 Report of the Institute of Medicine (IOM), which in part recommended that healthcare should be universal, continuous and affordable to families.¹²⁶ It is accepted that employee health has a positive relationship with productivity and employee morale, making this issue an important one for companies to consider. Healthcare costs have risen dramatically in recent years as well, making it harder for companies and individuals to pay escalating premiums and attracting attention at the federal level, including calls for government intervention and reform. The rate of increase of healthcare costs has greatly exceeded those of inflation and wage growth. Companies are faced with the dilemma of rising costs of providing health care coverage or declines in worker health and productivity, as well as problems with employee morale, if provision of such coverage is reduced.

In evaluating proposals to adopt Health Care Reform policies, we consider the information that is publicly available from a company to determine whether the company has given due consideration to the issue and has been transparent in its deliberations on the issue. Given the complex nature of the costs and benefits of health care and the national importance level attached to this issue, the health care principles proposed by a shareowner or recommended by the IOM may be overly restrictive to set upon any one company. We acknowledge the negative effect uninsured workers can have on a company’s productivity and morale, but believe that company management and boards are better informed in most cases to judge the appropriate level of coverage to offer. We note that the Institute of Medicine’s report was a call specifically to the policy leaders of the nation, specifically the President and Congress, to act immediately in finding a solution to this widening crisis. This issue is vexing to all companies alike, and in general we refrain from imposing specific solutions with uncertain benefit to shareholders upon individual companies, particularly while the issue is being scrutinized at the state and federal level.

U.S. Business and Human Rights Guidelines: CASE-BY-CASE

Shareowners have asked companies to adopt guidelines for determining how management will make decisions on investing in or withdrawing from countries where there is a pattern of ongoing and systematic violations of human rights. These proposals target specific companies because of business operations most recently in Burma (brutal military regime) and China (“laogai” forced prison labor). While observers may condemn any nation found guilty of unfair human rights practices, the SBA currently abstains from voting on these resolutions.

¹²⁶The IOM report and summary can be found here: <http://www.iom.edu/CMS/3809/4660/17632.aspx>

MUTUAL FUND PROXIES

Like shareowners of publicly held corporations, shareowners of mutual funds are allowed a voice in fund governance. While some funds proscribe annual meetings in their charter documents, all funds must call special meetings of shareowners to amend substantive governance matters such as board composition, investment advisory agreements, distribution agreements, and changes to fundamental investment restrictions. To this end, mutual fund managers issue and solicit proxies similar to the way that stock corporations do. Voting the SBA's mutual fund proxies is an integral component of the SBA's corporate governance program.

It is important that shareowners exercise care when voting their proxies. In more practical terms, mutual fund proxies raise issues that differ substantially from those found in the proxies of public companies. Though mutual fund proxy holders are also frequently asked to elect trustees and ratify auditors, most of the other agenda items are related to the special nature of this type of security. For example, mutual fund investors are asked to vote on changing fundamental investment policies and restrictions and approving or amending investment advisory and subadvisory agreements. As with elections of directors of corporations, it is preferable to see mechanisms that promote independence, accountability, responsiveness, and competence in regards to the mutual fund.

The investment objectives of mutual funds vary significantly. While some funds seek to maintain a stable net asset value per share, others focus on generating a continuous flow of income through dividends or capital appreciation. Therefore, the risk borne by shareowners of mutual funds varies, with those funds offering the chance of the highest return typically also involving the greatest potential for loss.

Fund Investment Objectives and Fundamental Policies

The investment objectives of mutual funds vary significantly and are expressed in rather general terms. Examples from currently authorized FRS Investment Plan mutual funds include:

- Seeks to obtain as high a level of current income as is consistent with preservation of capital and liquidity
- Seeks maximum total return consistent with preservation of capital and prudent investment management
- Seeks long-term growth of capital and income without excessive fluctuations in market value
- Seeks long-term growth of capital and future income rather than current income
- Seeks long-term capital growth.

A mutual fund's investment process is typically identified in its declaration of principal investment strategies and risks and fundamental policies and restrictions. The principal investment strategy identifies the financial market asset class or sub-sector in which the fund typically invests, e.g. the fund normally invests at least eighty percent of its assets in stocks included in the S&P 500. Conversely, a fundamental investment restriction identifies prohibited activities, e.g. the fund may not invest more than twenty-five percent of the value of its total assets in the securities of companies primarily engaged in any one industry.

Fund Structure

Beyond a fund's investment objectives and fundamental policies, fund structure may also affect shareowner value. The majority of investment funds are open-end investment companies, meaning that they have no set limit on the number of shares that they may issue.

Share Structure

A change in fee structure or fundamental investment policy requires the approval of a majority of outstanding voting securities of the fund, which under the Federal Investment Company Act of 1940 is defined as the affirmative vote of the lesser of either sixty-seven percent or more of the shares of the fund represented at the meeting, if at least 50 percent of all outstanding shares are represented at the meeting, or fifty percent or more of the outstanding shares of the fund entitled to vote at the meeting. Failure to reach this "1940 Act majority" subjects the funds to additional solicitation and administrative expenses.

Election of Directors: CASE-BY-CASE

Similar to the election of directors of corporations, it is preferable to see mechanisms that promote independence, accountability, responsiveness, and competence within the mutual fund. The SBA generally votes FOR directors up for election. However, votes on director nominees should be determined on a CASE-BY-CASE basis, considering the following factors:

- Director independence and qualifications
- Board structure
 - Attendance at board and committee meetings
- Number of mutual funds' boards and/or corporate boards (directorships) upon which a nominee sits

The SBA WITHHOLDS VOTES FROM DIRECTORS WHO:

- Attended less than 75 percent of the board and committee meetings without a valid reason for the absences
- Ignored a shareowner proposal that was approved by a majority of the votes cast for two consecutive years
- Ignored a shareowner proposal that was approved by a majority of the shares outstanding

- Are interested directors and sit on the audit or nominating committees
- Are interested directors and the full board serves as the audit or nominating committee OR the company does not have one of these committees

Converting Closed-end Fund to Open-end Fund: CASE-BY-CASE

The SBA evaluates conversion proposals on a CASE-BY-CASE basis, considering the following factors:

- Past performance as a closed-end fund
- Market in which the fund invests
- Measures taken by the board to address the discount
- Past shareowner activism, board activity, and votes on related proposals.

Proxy Contests: CASE-BY-CASE

The SBA votes on proxy contests on a CASE-BY-CASE basis, considering the following factors:

- Past performance relative to its peers
- Market in which fund invests
- Measures taken by the board to address the issues
- Past shareowner activism, board activity, and votes on related proposals
- Strategy of the incumbents versus the dissidents
- Independence of directors
- Experience and skills of director candidates
- Governance profile of the company
- Evidence of management entrenchment.

Investment Advisory Agreements: CASE-BY-CASE

Votes on investment advisory agreements should be determined on a CASE-BY-CASE basis, considering the following factors:

- Proposed and current fee schedules
- Fund category/investment objective
- Performance benchmarks
- Share price performance as compared with peers
- Resulting fees relative to peers
- Assignments (where the advisor undergoes a change of control)

When considering a new investment advisory agreement or an amendment to an existing agreement, the proposed fee schedule should be compared with those fees paid by funds with similar investment objectives. Proposed fees that are significantly higher than fees for similar funds may be justified if the fund in question has performed admirably or if management explicitly states other factors that contribute to the higher rate. Any increase in advisory fees of more than 10 percent of the prior year's fees are judged on a CASE-BY-CASE basis to determine its long-term impact on shareowner value, and management must offer a detailed, specific and compelling argument justifying such a request.

Approve New Classes or Series of Shares: FOR

The SBA generally votes FOR the establishment of new classes or series of shares.

Boards often seek authority for a new class or series of shares for the fund to grow the fund's assets. The ability to create classes of shares enables management to offer different levels of services linked to the class or series of shares that investors purchase. Also, fee structures can be varied and linked to the series of shares, which allows investors to choose the purchasing method best suited to their needs. The board can use separate classes and series of shares to attract a greater number of investors and increase the variety of services offered by the fund.

Change Fundamental Restriction to Non-fundamental Restriction: CASE-BY-CASE

Proposals to change a fundamental restriction to a non-fundamental restriction should be evaluated on a CASE-BY-CASE basis, considering the following factors:

- The fund's target investments
- The reasons given by the fund for the change
- The projected impact of the change on the portfolio

Change Fundamental Investment Objective to Non-fundamental: AGAINST

The SBA generally votes AGAINST proposals to change a fund's fundamental investment objective to a non-fundamental investment.

The SBA maintains that shareowners should maintain control over this aspect of a fund because a fund's fundamental investment objective represents its *raison d'être*, which often is the very reason that the shareowners originally invested in the fund. Formal shareowner approval should not be difficult to obtain in the event that the original investment objective of the fund proves unfeasible.

Change in Fund's Sub-classification: CASE-BY-CASE

Votes on changes in a fund's sub-classification should be determined on a CASE-BY-CASE basis, considering the following factors:

- Potential competitiveness
- Current and potential returns
- Risk of concentration
- Consolidation in target industry

Disposition of Assets/Termination/Liquidation: CASE-BY-CASE

Votes on dispositions of assets/terminations/liquidations should be determined on a CASE-BY-CASE basis, considering the following factors:

- Strategies employed to save the fund
- The fund's past performance
- Terms of the liquidation

Authorize the Board to Hire or Terminate Sub-advisors without Shareowner Approval: AGAINST

The SBA generally votes AGAINST proposals authorizing the board to hire or terminate sub-advisors without shareowner approval. Typically, the management company will seek authority, through the investment advisor, to hire or terminate a new sub-advisor, modify the length of a contract, or modify the subadvisory fees on behalf of the fund. These investment decisions are normally made with majority shareowner approval, as determined by Section 15 of the Investment Company Act of 1940. However, funds may apply to the SEC for exemptions to this rule, and the SEC often grants these exemptions. These exemptions are usually structured so that they do not apply to the investment sub-advisory agreement that is in place at the time, but apply to any future subadvisory agreement into which the fund enters.

Distribution Agreements: CASE-BY-CASE

Votes on distribution agreements should be determined on a CASE-BY-CASE basis considering the following factors:

- Fees charged to comparably sized funds with similar objectives
- The proposed distributor's reputation and past performance
- Competitiveness of the fund in the industry
- Terms of the agreement

As long as a proposed distribution agreement does not call for an excessive fee rate, such agreements may be supported as a means of increasing asset size and realizing economies of scale.

Master-Feeder Structure: FOR

The SBA generally votes FOR the establishment of a master-feeder structure. The master-feeder fund structure achieves economies of scale from sharing fixed expenses of portfolio management among a larger asset base. In addition, this structure can facilitate fund administration and greater diversification by means of a larger portfolio of securities than could be achieved by individual funds.

Mergers: CASE-BY-CASE

The SBA generally evaluates mergers and acquisitions on a CASE-BY-CASE basis, determining whether the transaction enhances shareowner value by giving consideration to:

- Resulting fee structure
- Performance of both funds
- Continuity of management personnel
- Changes in corporate governance and the impact on shareowner rights

Change the Fund's Domicile: CASE-BY-CASE

The SBA votes on fund reincorporations on a CASE-BY-CASE basis, considering the following factors:

- Regulations of both states
- Required fundamental policies of both states
- Increased flexibility available

When changing the domicile of a fund, the SBA considers the corporate laws of the state in which the fund is seeking to reincorporate as they apply to management investment companies. Shareowner rights can be particularly limited in certain states, including Delaware, Maryland, and Massachusetts.¹²⁷

¹²⁷ Lucian Bebchuk and Alma Cohen, "Firms' Decisions Where to Incorporate." National Bureau of Economic Research Working Paper 9107, August 2002.

1940 Act Policies: CASE-BY-CASE

Votes on 1940 Act policies should be determined on a CASE-BY-CASE basis, considering the following factors:

- Potential competitiveness
- Regulatory developments
- Current and potential returns
- Current and potential risk

The SBA generally votes FOR these amendments as long as the proposed changes comply with the current SEC interpretation and do not fundamentally alter the investment focus of the fund.

Name Change Proposals: CASE-BY-CASE

The SBA votes on name change proposals on a CASE-BY-CASE basis, considering the following factors:

- Political and economic changes in the target market
- Consolidation in target market
- Current asset composition

Changes to the Charter Document: CASE-BY-CASE

The SBA votes on changes to the charter document on a CASE-BY-CASE basis, considering the following factors:

- The degree of change implied by the proposal
- The efficiencies that could result
- The state of incorporation
- Regulatory standards and implications

The SBA generally votes AGAINST any of the following changes:

- Removal of shareowner approval requirement to reorganize or terminate the trust or any of its series
- Removal of shareowner approval requirement for amendments to the new declaration of trust
- Removal of shareowner approval requirement to amend the fund's management contract, allowing the contract to be modified by the investment manager and the trust management, as permitted by the 1940 Act
- Allow the trustees to impose other fees in addition to sales charges on investment in a fund, such as deferred sales charges and redemption fees that may be imposed upon redemption of a fund's shares
- Removal of shareowner approval requirement to engage in and terminate subadvisory arrangements
- Removal of shareowner approval requirement to change the domicile of the fund

Shareowner Proposals to Establish Director Ownership Requirement: CASE-BY-CASE

The SBA generally favors the establishment of a director ownership requirement and considers a director nominee's investment in the company as a critical factor in evaluating his or her candidacy. This decision should be made on an individual basis and not according to an inflexible, across-the-board standard. As a related matter, if the director has invested in one fund of the family, he is considered to own stock in the fund.

Shareowner Proposals to Terminate Investment Advisor: CASE-BY-CASE

Votes on shareowner proposals to terminate the investment advisor should be determined on a CASE-BY-CASE basis, considering the following factors:

- Performance of the fund.
- The fund's history of shareowner relations.
- Performance of other funds under the advisor's management.

Shareowner Proposals to Reimburse Shareowners for Expenses Incurred: CASE-BY-CASE

Voting to reimburse proxy solicitation expenses should be analyzed on a CASE-BY-CASE basis. In cases where the dissident position is supported, believing it to be in the best interests of shareowners, the SBA generally votes FOR reimbursing such proxy solicitation expenses.

Shareowner Proposals to Adopt a Policy to Refrain from Investing in Companies that Substantially Contribute to Genocide or Crimes against Humanity: CASE-BY-CASE

The SBA will evaluate such proposals with an adherence to the requirements and intent of the Protecting Florida's Investments Act (the PFIA, §215.473 of the Florida Statutes), which prohibits investment in companies involved in proscribed activities in Sudan or Iran.