

## PRE-AGM SEASON INVESTOR SURVEY 2010

As we emerge from the worst global recession since 1930, a number of governments and industry bodies have called for institutional shareholders to adopt a more active and long-term approach to their investments. HQB Partners' annual pre-AGM season survey therefore takes place within an environment of enhanced engagement with issuers.

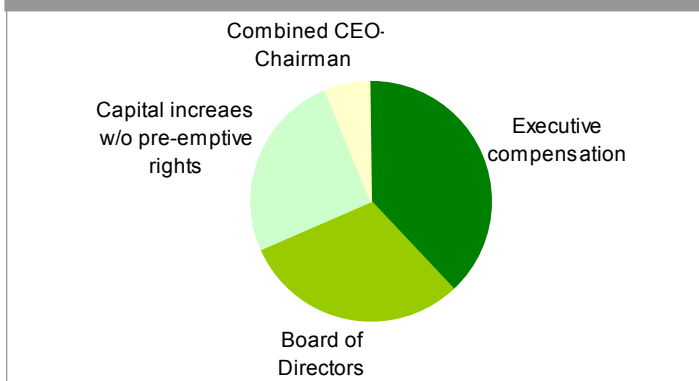
The primary aim of the survey is to ascertain the issues institutional investors will be addressing at the Annual General Meetings of issuers (AGMs) in 2010. Governance and/or proxy voting teams at 23 leading institutional investors in the United States, the United Kingdom, France and the Netherlands, managing assets in excess of €8 trillion (US\$ 11.1 trillion), took part in the survey. All are active in the consideration of corporate governance-related issues surrounding their investments and in questions related to the voting of equity holdings.

The results are summarised in two sections. The first presents the issues which investment institutions expect to be of significance during the 2010 AGM season. The second presents trends regarding voting behaviours and related decision-making processes. Both sections provide intelligence for listed companies to take into consideration when drafting AGM resolutions, as well as when developing effective and targeted shareholder communication campaigns.

### I. TOPICS OF CONCERN TO INVESTORS AT AGMS

According to the survey results and as illustrated (Graph 2), three issues were identified by more than half of the respondents as being areas of focus during the upcoming AGM season. These are executive remuneration, aspects relating to the Board of Directors, and capital increases.

GRAPH 1: TOPICS OF CONCERN (NUMBER OF SHAREHOLDERS)



#### a. Executive Compensation

As in the 2009 survey, remuneration continues to dominate the concerns of institutional investors, with 19 out of 23 investors highlighting it as an area of concern. To some extent, this may be attributed to the considerable media and political controversy regarding bankers' bonuses, but also reflects the growing concern that companies' remuneration policies may not have appropriately aligned the interests of executives with those of shareholders.

In 2010, the most important challenge for investors in relation to remuneration is ensuring that the management teams of investee companies are correctly incentivised and that challenging and transparent performance criteria are in place, particularly in relation to variable pay and other incentive plans. The focus is increasingly on promoting medium to long-term growth while avoiding "pay for failure" scenarios.

Importantly, for remuneration-related resolutions, all survey participants required that companies disclose transparent and verifiable performance criteria before the AGM, the absence of which would likely result in a negative vote. This is particularly significant for remuneration reports and stock plans, which are more or less detailed depending on the markets companies operate in. In these areas, investors are looking for information regarding group and individual targets, the maximum amounts available for payouts under the plans, and justifications for the particular performance criteria chosen.

With regard to the nature of the performance criteria investors are looking for companies to employ, nine respondents indicated they believed companies should have the freedom to choose the most appropriate measures for their company and sector, provided they were transparent and "challenging". In addition, slightly over half of the participants, 13 out of 23, identified company-specific performance indicators as their first preference.

Total Return to Shareholders (TSR), either versus a peer group or an index, was the choice for seven out of 23 participants. However, an additional two participants indicated they had developed misgivings regarding the adoption of the TSR criteria in the past as the preference is now moving towards the adoption of relevant company-specific indicators instead. Another indicator preferred by six of the participants was either cash flow or return on equity, as these were believed to be a more appropriate measure of a company's performance.

The varying preferences of investors reflect the growing awareness that no "one size fits all" approach to performance criteria is suitable. Ultimately, the conclusion appears to be that companies should adopt measures specific to their company and industry. They should also be in a position to justify to investors why these specific criteria are relevant, and how they will incentivise management to ensure long-term performance.

The length of time performance is measured against is also an issue of concern for investors. While three years is generally considered to be best practice in terms of adopting a longer-

term approach to performance management, there is increasing interrogation over whether or not the three-year time frame is in fact truly “long-term”. This concern is of particular relevance to pension fund clients of institutional investors who, by definition, have a much longer-term outlook. HQB Partners has already noted that some companies have started to address this concern by adding holding periods of up to five years for shares awarded under long-term incentive plans. This trend is expected to increase, given investors’ desire for long-term growth in shareholder value. Accompanying these holding periods, investors are also expecting companies to introduce longer and more effective clawback provisions to avoid payouts where performance was illusory or short-term.

Another emerging trend was the inclusion of non-financial criteria in long-term incentive plans. A small number of Dutch companies, for example, are starting to partially link executives’ bonuses to sustainability, including employee safety and human rights issues. Two other respondents echoed this trend, requesting that climate change targets be included as part of the performance criteria for management. HQB Partners expects this trend to increase in the future, as investors further develop their risk mitigation strategies.

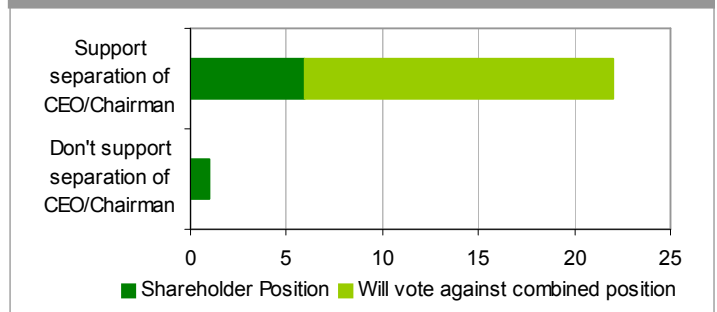
## b. Boards of Directors

The effectiveness and composition of the Board of Directors was the second most important issue for investors, with 15 citing it as a source of concern. In the past, when voting on director elections and re-elections, many institutional investors simply focused on Board independence. This year’s survey would indicate that investors have moved beyond this “box-ticking” approach and are much more concerned about substantive issues.

This is reflected by the responses of 12 participants, who indicated that their views on the effectiveness of non-executive directors had been adversely impacted by the financial crisis primarily because highly independent Boards at financial institutions did not prevent the crisis. Consequently, many investors will be taking elements other than independence into account when deciding on whether to approve director candidates. For example, five respondents indicated they would increase their focus on the experience that current and potential Board members bring to the company, as well as how the Board is structured in terms of diversity. Overall, investors want to see that Board members are dedicated to the companies they serve (with an increased emphasis on the avoidance of “over-Boarding”), that they have relevant experience, and that the Board as a whole is comprised of members who can address strategic issues at the company.

Additional focus will also be placed on the effectiveness of how Boards operate. Investors are increasingly looking for evidence of formal annual Board evaluations with a push toward external evaluations. Publication of the results of such evaluations, which is still weak in many markets, is drawing particular attention as investors wish to gain more insight into Board processes and how effectively the Board is functioning.

GRAPH 2: SEPARATION OF THE ROLES OF CEO AND CHAIRMAN



Another element of concern for investors is the combination of the roles of Chief Executive Officer (CEO) and Chairman. This is evidenced by 22 of the 23 respondents, indicating they support the separation of the functions. Importantly, 16 institutions indicated their willingness to vote against individuals who hold both roles, particularly when companies intend move from separate to combined roles. This trend towards voting against combined roles appears to be increasing and should be noted by relevant issuers, due to its potentially destabilising consequences. Companies intending to combine these roles will need to explain and justify why they have chosen to do so.

Finally, when evaluating Board elections, respondents indicated that they were interested in ensuring appropriate steps had been taken to address risk management, either by establishing a risk management committee or having the Board as a whole address risk management issues. These concerns apply not only to financial firms, but also to companies in other sectors where risks relating to climate change, water scarcity, reputation and other non-financial risks are relevant.

## c. Capital increases

Capital issuances were the third most important aspect raised during the survey, with 13 respondents indicating they were concerned over the volume of rights issues launched to improve the cash reserves and liquidity of the companies involved. Investors, particularly in the UK, raised concern over the preservation of pre-emptive rights, which they consider a vital tool to prevent dilution of their interests. In fact, the accepted levels of capital increase authorisations with and without pre-emptive rights varied greatly among the investors interviewed: increases of between 5% and 20% of capital without pre-emptive rights were considered to be within an acceptable range, while this grew to between 33% and 100% with pre-emptive rights. This reinforces the need for companies to analyse their shareholder bases before drafting their resolutions in order to mitigate the risk of negative votes.

## II. TREND IN INVESTOR VOTING BEHAVIOUR

In addition to the issues shareholders will be scrutinising in 2010, companies should also be aware of the voting behaviour and decision-making processes of their investors in order to

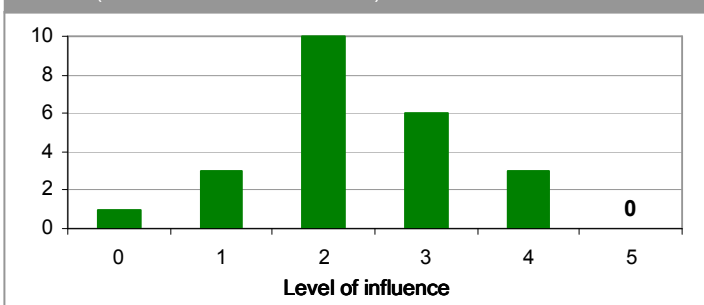
develop effective and targeted shareholder communication campaigns. This section of the report therefore presents the survey results in relation to shareholder voting behaviour.

Perhaps not surprisingly, given that the institutions surveyed are actively involved in corporate governance issues, all of the respondents indicated they were willing to engage with companies during the AGM season, although some indicated they would prefer to be contacted prior to the season where possible.

With respect to engagement, 20 of the respondents have an active engagement policy in place and of these, 17 expected their level of engagement with companies to increase in 2010. This trend is likely to continue given the call for greater involvement on the part of institutional shareholders by public figures, such as the UK's City Minister, Lord Myners, and as evidenced by the soon-to-be launched Stewardship Code in the UK. Institutional investors are being encouraged to be active owners, not "absentee landlords". The call for more engagement is also echoed or implied by numerous national and supra-national measures being taken to simplify cross-border voting, and to encourage shareholder democracy in general.

With respect to proxy advisor agencies (PAAs), all of the respondents use one or more of these research providers. However, all of the investors indicated they also employ their own internal voting policies. When queried as to the extent of their reliance on the PAA vote recommendations or similar AGM-related research, ranked from one to five (with one being not at all and five being significantly), the average across all respondents was only 2.3, with responses ranging from zero to four. 14 respondents indicated that they used PAAs primarily or exclusively for background research.

GRAPH 3: INFLUENCE OF PAA RECOMMENDATIONS ON INVESTOR VOTING (NUMBER OF SHAREHOLDERS)



These results would seem to highlight the need for companies to engage not only with PAAs but also with their investors directly. The rationale is that a PAA with no objections to AGM resolutions does not necessarily equate to wholesale support from the company's shareholders. This is particularly true in the

area of capital increases without pre-emptive rights, where many shareholders have much more stringent guidelines than those of most PAAs.

Finally, it is important to note the recent move away from stock-lending activities. Nine of the 23 participants no longer lend stock (although their clients may continue to do so) and of the 14 who continue to do so, ten indicated that they recall stock prior to the AGM season. In theory therefore, it is becoming easier for issuers to identify stock and thus to identify which institution stock is being voted by at the AGM.

### III. CONCLUSION

There are a number of conclusions that may be drawn from the 2010 Pre-AGM season survey. Perhaps the most important is that corporate governance and engagement with companies is starting to come of age for investors. These are taking an increasingly sophisticated look at governance issues within their portfolio companies and are also taking additional information about non-financial aspects into account. Such aspects include the effectiveness of Boards as well as the entire spectrum of risks facing companies, including climate change and other non-financial risks. Given the concerns raised by investors, particularly in relation to compensation, the Board of Directors and capital increases, companies will need to enhance their disclosure and communication in these areas.

Within this context, there are a number of steps companies can take to mitigate the risk of contentious resolutions at their AGM:

- First, while many investors have their own voting policies, the recommendations of PAAs continue to have an impact on AGM results. Therefore taking into account their policies when drafting resolutions remains important.
- Second, we recommend that discussions with major shareholders take place prior to the publication of the meeting agenda in order to take into account their feedback and to enable a fine-tuning of resolutions.
- Third, proactive shareholder communication in the weeks prior to the AGM plays an important role in maximising shareholder participation, while also providing an opportunity to explain resolutions and thus reduce the risk of negative votes.
- Finally, analysing the results of the AGM and ascertaining the source of any negative votes provides vital intelligence and enables enhanced preparation of subsequent AGMs.

As institutional investors continue to take an increasingly proactive stance on governance issues, effective shareholder communication will remain an essential step in risk mitigation and the AGM preparation process.

### CONTACT US

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