CORPORATE GOVERNANCE IN THE ELECTRIC UTILITY INDUSTRY:

AN ASSESSMENT OF INVESTOR PERCEPTIONS

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By

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Key Conclusions

The following section offers a summary of the main points made by respondents during the interviews conducted to determine their respective views on the role corporate governance (CG) plays in the investment decision-making process. While the conversations didn't focus on practices related to electric utilities *per se*, all but two of the analysts interviewed were industry specialists, and the non-specialists had extensive knowledge of and an intense focus on CG. It also bears mention that some of the respondents had limited knowledge about their firms' CG-related positions and behavior. The discussion included some general topics: the degree to which CG is an emphasis in investments; whether a separate proxy group exists and its role; the use of CG firms' rankings; shareholder activism. As well, specific areas were explored: management issues (compensation and severance caps; limit, recalibration, and mandatory holding periods of options; splitting the chairman/CEO role); board of director issues (independence; limiting other board memberships; apparent conflicts of interest; election frequency; D&O insurance); and auditor issues (rotation; conflicts of interest).

While the interviews touched on a wide range of topics, one key and dominant theme appeared consistently in the analysts' comments: ***a desire for an independent corporate governance structure characterized by checks and balances that leads to long-term value creation for investors***. A related message frequently shared was that ***true independence in corporate governance is what is critical, rather than the structure that brings about that independence.*** In the respondents' views, these notions are what reside at the heart of good CG, and companies that embody them are desirable investments. Specific commentary follows.

- ***<u>Corporate governance is not a new focus area for most investors</u>***. Almost two-thirds of the respondents acknowledged a heightened awareness of and sensitivity to the topic, though only a few (11%) indicated it had newly become a major issue in the decision-making process. Most of remaining analysts (26%) said both their firms' and their own attitudes were largely unchanged toward CG, because it had historically been an important factor in choosing investments. Although CG is often only one of a number of considerations reviewed when choosing an investment, the bad market experiences of late have prompted some investors to pay more attention to CG issues. Roughly one-third of the analysts indicated they approach the subject on an active basis in terms of investment decision-making, while another 28% view it as only one of a number of factors for consideration, and the balance of respondents place a lower priority on CG.

- ***<u>Separate proxy groups are the norm rather than the exception, and many of them exert considerable influence.</u>*** At those firms—75% of the total survey sample—having separate entities, 42% have that group vote the proxies. Another 19% of analysts at firms with separate proxy groups replied that the investment group does the voting; in some cases, there is interaction between the two areas. The remaining 15% of respondents with separate proxy groups noted that the voting was a joint effort between the investment and proxy areas. Regardless of who did the voting, it was quite apparent from the analysts' comments that many proxy groups are in a position of power: "They're responsible for voting the proxy. They sit in on our investment meetings." "We have internal policies, and the analyst has to submit an explanation to them." "They review our proxy voting." And one respondent noted, "For voting proxies, we use ISS. They vote for you, make recommendations. It keeps the analyst out of the process." These observations suggest that, while some firms involve analysts and portfolio managers in the proxy effort, the individuals not directly connected with the investment process are the ones who frequently have that final and important say.

- ***<u>While it is clear that outside corporate governance firms have some influence within the investment community, their power is mixed in swaying decisions.</u>*** Almost three-quarters of respondents don't incorporate the outside firms' rankings in their investment-decision making. The primary complaint against the ratings is that they're rigid, and that real life doesn't fit into an easy model. As well, analysts noted their own exercise of qualitative judgment in the investment process, and that other trouble signs would be evident if the rankings were poor. The 30% of interviewees who did utilize the outside rankings typically didn't follow the recommendations blindly. Rather, the ratings were used as initial screening tools, sources of information, and as assistance in clarifying certain factors. Despite the seemingly benign influence of the outside ranking firms on the surface, a deeper look reveals a different picture. For instance, it was apparent that Institutional Shareholder Services (ISS) enjoys a near-monopoly position within the CG domain; one analyst remarked that his firm votes with ISS because it represents the "gold standard" of CG opinion. ISS was mentioned repeatedly in the discussions, with only occasional references made to other CG entities. Further, while investors might not aggressively utilize the outside rankings, the opinions are at least a first stop for proxy groups, and often serve as the final dictum. It would appear prudent for corporations to ensure they have a clear understanding of (in particular) ISS' positions on issues, and, if possible, work to alter those views in controversial instances.

- ***<u>A number of corporate governance issues set off alarm bells for the respondents.</u>*** In priority order, these included: compensation, poison pills, board of directors (independence, experience, structure), related party transactions, and risk controls. In a nutshell, the responses were centered on a desire for companies to be run in a fashion consistent with shareholder interests; practices running counter to those interests attracted the investors' negative attention. However, the vast majority of analysts said that CG issues don't preclude their owning a stock. Those that are impeded by such factors pointed variously to having discomfort with a company's situation, legal issues, and dysfunctional board composition as reasons for why they might not own a stock.

- ***Shareholder activism has one key intent: by focusing on shareholder issues, to improve value for investors.*** The group of interviewees was split pretty evenly between those characterizing themselves or their firms as activists (56%) and non-activists (44%) on corporate governance issues. The vast majority (85%) of the self-described activists cited shareholder interests and improving shareholder value as the reason for their proactive involvement. Those respondents who aren't shareholder activists said, variously, they work behind the scenes with management on issues of concern and sell their shares if unhappy. Further, overt or potential conflicts of interest held back some investors from publicly taking a stand on CG issues. These dilemmas include a reluctance to jeopardize prospective pension clients because of activism, and investment organizations operating within the structure of investment banks.

- ***Imposing a cap on management compensation wasn't championed by anyone in the survey sample, while more support was expressed for placing a ceiling on severance packages.*** The major reasons offered against ***capping compensation*** included the need to be able to provide proper incentive to management; correlating compensation to performance; and having a hands-off attitude toward management. Providing the ability to attract good people through competitive compensation and the structure of compensation being more important than the level were also mentioned. But some reservations were expressed about not having a pay cap; to wit, recent examples of egregious compensation levels in the wake of poor performance and the associated need to tie remuneration to performance. Disclosure of payment packages' details was also mentioned as being important. As to ***severance deals***, just under half the respondents said they weren't opposed to caps, while another one-third is against them. In the words of some of those supporting ceilings, "severance packages are rewards for failure"; "I have no interest in overpaying someone who's leaving who should be leaving"; and "It's absolutely ridiculous that managements who've run companies into the ground walk out with their pockets stuffed full." Several offered suggested levels for the caps: ~3x total compensation. The views of those analysts against caps were pretty consonant with opinions regarding capping management compensation: providing incentives to ensure good performance, and attracting strong talent. Commentary from the remaining analysts opined that severance packages aren't needed in this day and age, and that they should be decided on a case-by-case basis.

- ***<u>There is little doubt that stock options are a controversial and complex issue to investors.</u>*** As the discussions of options ensued, it became increasingly apparent that this is a subject with which most analysts didn't have a deep understanding or had some commonly held prejudices that were born of the market bubble's collapse. Some investors did acknowledge that options aren't as troublesome an issue with utilities as it is with other industries. Respondents expressed a clear desire for management to have "skin in the game," and some two-thirds believe that the issuance of restricted stock is a better means of accomplishing that than are options. In terms of whether a ***limit*** should be placed on the number of options granted, roughly one-quarter supported the notion (with a few suggesting numbers—3% of shares outstanding or resulting in no greater than 5% dilution), while only 12% did not want a limit (free market concept, proper compensation for management). More of a consensus was evident on the topic of ***recalibrating*** options. Two-thirds of the analysts opposed the practice, saying it is a reward for bad management or performance, that managements shouldn't receive a reward that shareholders don't, and repricing is an attempt to make up for past losses. It was noted, though, that recalibration would be appropriate in the event of underperformance by the broad market; in that instance, the repricing would be totally unrelated to management's actions. Regarding having a ***mandatory holding period*** after options are exercised, two-thirds of the investors were in support but had varying opinions of what the duration should be. Suggestions included 3 years, 3-5 years, an infinite period, and equal to the holding periods of investors. Those 12% of respondents opposed to a mandate pointed out that management might have to exercise for personal reasons, and that could result in a decrease in one's ownership position in the stock. Analysts with mixed views (15%) pointed out variously that management philosophy should be the dictate regarding holding periods, and that it differs by company and industry.

- ***<u>That over half the interviewees supported a separation of the chairman and CEO roles is additional evidence that independence in corporate governance is highly valued by investors.</u>*** Those favoring a separation commented that problems with combining the roles include a concentration of power; the potential for a shaky board structure; no checks and balances; diminution in the ability for each role to be performed well; and lack of independent thought. The handful of respondents opposing splitting suggested that it's difficult to separate the roles and hard to recruit knowledgeable individuals for each. Mixed commentary offered by the remaining 35% of analysts pointed out that board composition is the more important issue; splitting can be a financial burden to smaller companies; combined roles have worked well in utilities, as has splitting the roles; and it depends on the environment and the person. What warrants further emphasis here is that merely separating the chairman and CEO roles doesn't guarantee independence. Rather, having the positions split *in addition* to having a board of directors that thinks and acts on its own is the best possible combination of circumstances in terms of enhancing value for shareholders.

- ***The independence of boards of directors is another key focus area for investors***. A common plaint expressed by the respondents is that it's very difficult to ascertain when a board really is independent. While almost half the individuals surveyed offered a suggestion for ***what percentage of the board should be comprised of outside directors*** (generally ranging from a minimum of 50% to 80%-90%), the analysts emphasized that competence, experience, morality, and what truly constitutes independence are more the issue than is a number. Other notable observations made were that a certain number of independent directors does not guarantee an effective board; the definition of what constitutes independence varies; management representation on boards is being (and should be) limited; and an outside entity should specify numerical standards for board independence. Analysts would appreciate the opportunity to have some interface with boards, such as having directors in attendance at major company-sponsored investor meetings. Regarding ***directors' terms***, slightly over half the respondents expressed a preference for annual elections, while one-quarter said they favored staggered boards. Entrenchment and complacency were the potential negatives inherent in a staggered structure, and consistency and continuity, the positives. Annual elections were viewed as affording transparency. About one-fourth of the respondents either had no opinion on the issue or suggested more limited terms within a staggered structure as an alternative to the status quo.

- ***Other affiliations of board members are also on analysts' radar screens***. The respondents appeared highly attuned to the potential concern that ***numerous board memberships*** held by directors—particularly those still holding active management jobs—could dilute their effectiveness. For the most part, the analysts viewed 2-3 extra board positions as a sufficient number, though some said that up to 4-5 more slots were acceptable if the person was retired. While some interviewees didn't note a precise figure, they generally agreed that limits need to be set to ensure a meaningful contribution by directors. Other notable observations included: use decent judgment; current CEOs shouldn't be sitting on the boards of other companies; and that rules (i.e., limiting board positions) invite being broken. Looking at affiliations from a different slant, a little under half the analysts felt that ***ostensible conflicts of interest*** regarding board members weren't really a problem. Materiality is key in determining if a conflict is real, and the corporation probably should make that determination. Proper disclosure is also critical in avoiding apparent conflicts. Some respondents, however, wanted to see no hint of cross dealings: "there should be no crossovers," the more independent, the better; and "I go by the 'red face' rule—if there's any impropriety, I shy away."

- ***D&O insurance is generally viewed as being a necessity, but shouldn't be of such a level that it would make directors complacent***. Interestingly, almost half the respondents either had no opinion on the topic or said they hadn't thought about it. Those who did opine, however, wanted to see some balance in regard to the insurance. On the one hand, some analysts reiterated the concept of forcing directors to "have some skin in the game," a notion previously expressed in regard to management, and thus not completely indemnify directors. But on the other, some respondents were opposed to the protection, saying there should be an expectation of honest behavior and that the insurance could serve as a crutch. As to an appropriate level of insurance, no specific numbers were offered; rather, there should be enough to enable directors to cover their risks and do their job without "jeopardizing their personal wealth and well-being," and "entice the best talent."

- ***Mixed views were offered regarding the topics of auditor rotation and having auditors also serve in a consulting role***. The number of analysts against ***rotation*** was double that of those favoring the practice. Respondents opposed to changing the deck hands cited the numerous problems with such a practice: that it would lead to a lack of continuity in a profoundly complicated function, be very expensive and impractical, and not provide the needed historical knowledge base necessary in an auditor. As well, it was pointed out that the number of auditing firms has shrunk to only a handful, and demanding rotation is tantamount to micro-managing. Analysts backing rotation offered suggestions as to the frequency with which auditors should be changed, ranging from 2-3 years to 7 years, with 5 years being the central tendency. As to having auditors play a ***dual role*** as consultants, over half the respondents spoke out against the practice, which was variously described as "distasteful," "unprofessional," and "a major problem." One analyst pointed out that not permitting the auditor also to consult would remove any pressure "regarding objectivity, clarity, offering a fair opinion," and several noted that experience has shown that the functions should be kept separate. Opinions on the positive side of the issue included: knowledge gained from consulting can be a money-saver; the ratio of audit to non-audit fees is the metric to focus on; auditing has become a loss leader to get the more lucrative consulting business; and full disclosure regarding the relationship should eliminate the potential for conflict.

- ***Wrap-up commentary centered on the previously expressed key theme of the critical need for independence.*** The analysts emphasized the importance of boards being comprised of highly qualified individuals who will act in the interests of shareholders. Some skepticism about existing boards, however, was also expressed.

METHODOLOGY

From April through June 2004, J.M. Cannell, Inc. (JMC) and Evan J. Silverstein (EJS), General Partner of Silcap LLC and a member of the Wall Street Advisory Group, conducted telephone interviews with 27 members of the investment community to gain an understanding of how corporate governance is integrated into the investment decision-making process. JMC and ES cooperatively selected the individuals in the sample, with input from the Edison Electric Institute (EEI). The interviewees were all investors with major institutions, with the exception of one sell-side analyst who is recognized for having very strong views about corporate governance.

JMC and EJS constructed the questions, with guidance from the Finance Executive Advisory Committee of the EEI. The queries sought an understanding of the importance of corporate governance to individual investment firms and how those firms approach the issue. As well, views on individual topics relating to management, boards of directors, and auditors were assessed. Appendix A contains a list of the questions asked.

Respondents evidenced a willingness to share their views, and were promised confidentiality. The discussions were, on average, 20 minutes in duration, although several extended substantially longer.

The results of the interviews follow. For each question, a summation of the answers is presented, followed by the analysts' actual comments. Please note that categorization of responses was occasionally not completely clear-cut, and a judgment had to be made by JMC. As well, percentages shown in reference to responses were rounded, which sometimes made the total add to more than 100%. Finally, the abbreviation CG was used throughout to refer to corporate governance.

SUMMATION AND ANALYSIS OF RESPONSES TO

QUESTIONS ABOUT

THE IMPACT OF CORPORATE

GOVERNANCE ISSUES ON THE

INVESTMENT DECISION MAKING PROCESS

1. ***How has corporate governance interface with investment decision making changed within your firm over the past five years?***

- Investors confirmed that corporate governance is decidedly on their radar screens. Almost two-thirds of the respondents acknowledged a heightened awareness of and sensitivity to the topic, though only a few (11%) indicated it had newly become a major issue in the decision-making process. Most of remaining analysts (26%) said their own and their firms' attitudes were largely unchanged toward CG, as it had historically been an important factor in choosing investments. Some of the key points made about how CG and investment decisions are connected included: the bad market experiences of late have prompted some investors to pay more attention to CG issues; CG is only one of a number of factors reviewed when choosing an investment, and sometimes isn't a critical one; shareholder activism on proxy issues may increase.

Notable Analyst Comments:

Heightened Sensitivity: 17 or 63%
• Our awareness is more heightened.
• We pay more attention to it these days (2 responses).
• We have a more formal system now for proxy voting. Analyst had been responsible. Over the years, a big guidebook was put together. But in the last 2 years, one point guy was assigned to oversee. If he has a question, he comes to the analyst. We have policies on some issues. The analyst automatically gets an email writeup of issues on a proxy, then he's responsible for checking the appropriate boxes. We have a database that analysts can go on to see how companies rank in CG. Analysts get regular updates on the rankings.
• The problems with defaults and banks brought to the forefront a way to anticipate who might be vulnerable. We look for red flags to differentiate the good from the bad.
• We have a daily morning meeting, and we're encouraged to do lots of meetings with managements. When something looks fishy, we take a long, hard look at it.
• Yes, it's increased. We got bagged on Tyco; we didn't understand the whole idea of the board doing its job and exercising control over management. So we look more closely at CG issues.
• We talk more about certain things. For example, poison pills weren't scrutinized as much historically. Shareholders are more sensitive to issues now. The focus on the executive compensation issue is changing. Growth strategies didn't work, but compensation packages haven't changed that much. The older compensation style was better; it entailed less volatile performance.

(Question 1, continued)

<u>Heightened Sensitivity: 17 or 63%</u> (continued)
• We have a heightened priority on focusing on board-level stuff, disclosure, etc. But on the fixed income side, it's not that big a deal.
• We're more aware now of what a company's CG track record is, e.g., about how directors deal with management compensation issues. But it's on the low end of our priority list.
• There's more talk about it. There's more awareness now that effective corporate governance benefits shareholders over time. We have a committee of 5 (I'm on it) who developed a policy on handling proxy votes.
• We spend more time now than a few years ago on CG issues. We're pretty flexible in giving individual portfolio managers the ability to vote on specific issues. There are no set guidelines for the firm regarding how to vote proxies
• We put a high weighting on open communications. We've picked our battles in the past, and I think we'll vote against management – engage in more proxy fights – going forward.
• There's somewhat more focus, but we don't spend a lot of time going through who's on the board, what's their motivation. Equity holders spend more time on such issues. If we own the first mortgage bonds, there's a presumption that our interests are protected.
• The two – CG and investment decision-making –have gotten closer together. There's more communication. Information is shared between the proxy person and analysts.
• The CG trend has gone only one way: up. I've discounted stocks with a CG problem, or if I'm not entirely sure how the company deals with CG.
<u>Bigger Issue: 3 or 11%</u>
• Yes, it's changed. It's one of the top 3 things we look at for international companies, but not the first thing for U.S. companies.
• Yes, we're focused on its more than ever before. It's a much bigger issue. But because we're still associated with an investment banking firm, the bankers get upset and we get push back. So, we usually vote with ISS guidelines.
• Because of lessons learned from Enron, Dynegy, and others regarding poor management and supervision, CG is high on the radar screen. The companies I follow rank high in CG. Just because a utility is regulated doesn't mean it's not subject to market forces.
<u>No/Little Change: 7 or 26%</u>
• We've had an active proxy department for 17 years, so CG isn't a new phenomenon to us. Some portfolio managers are more keyed into issues now. The investment area acting in conjunction with the proxy dept. is what's new.
• We've been corporate activists ever since I can remember. Corporate governance <u>is</u> material.

(Question 1, continued)

<u>No/Little Change: 7 or 26%</u> (continued)
• It hasn't really changed; it's always been a factor. It's one of a myriad of factors I look at.
• We've always been fairly focused on CG.
• It's changed very little. We've generally been pretty passive; we vote with our feet.
• We don't even look at proxies anymore; we have a group who does that, following ISS guidelines. There's almost no interface between investments and that group. As to investing, management style and presentation make a big difference. As a portfolio manager, I don't invest in any company if I don't see them at least once a year. That's a lot with 100 companies, but somehow I manage it.
• Not much changed. We've been very active since the mid-80s in CG. We've taken the proxy voting issue very seriously since that time. However, there's more interest now – both internally and from clients – about what we're doing and how we're doing it.

2. How do your firm's analysts/portfolio managers integrate governance considerations in their stock analysis and decision-making?

- There was a fairly even split among how respondents take corporate governance factors into account in their investment practices. Those who approach it actively (32%) said they could discount a stock for poor CG, and that CG differentiates how a stock is treated. Analysts viewing CG as only part of the decision-making and analytical process (28%) explained that CG was part of normal investment due diligence, that it was one factor in a number that are considered, and that it didn't serve as a screening factor. The remaining interviewees who place a lower priority on CG issues (32%) said that it could be a factor on the margin, that CG is considered by exception, it's viewed as a separate item, and is more of an ad hoc thing.

Notable Analyst Comments:

Active consideration: 8 or 32%
• It's relative. We discount a stock for poor CG; it doesn't restrict any investments I make.
• It can impact how we vote our shares on proxies. We treat our companies differently regarding how we view CG—good or bad. It could be an influential factor.
• Generic issues go on auto pilot, and the proxy committee tackles controversial things.
• When there's a significant change in CG politics—e.g., changing a staggered board, adding a poison pill—then it gets incorporated into the decision-making.
• We want management's interests aligned with those of shareholders.
• It's diffused. I abdicate the corporate-wide thing to the lawyers. For example, Shell has an unusual structure, and there I directly interfaced with them. I look at the annual report backwards, and ask questions on the basis of what I see. I get an idea of the morality of the company. For example, with utilities, if a company isn't a Delaware company, it could be incorporated where the law protects management at the expense of shareholders.
• We're long-term investors, so I ask how good management is at reinvesting at their cost of capital. When there's bad governance, it's a question of how they deploy their capital.
• We look to see if there's undue influence—boards that aren't independent, management's track record, disclosure. CG is a qualitative consideration, not quantitative.

(Question 2, continued)

Only part of a process: 7 or 28%
• It's part of the overall process. We look at how a company is structured, compensation, board composition, staggered board, etc.; in other words, we look at all the issues. Where there are significant risks, we talk about them with the investment committee. It has to be in the context of a portfolio committee evaluation. It's more of a joint process than the proxy folks being on the front end.
• CG is only one factor in our analysis; not the only factor. It depends on the company, industry, country as to how much a factor CG is.
• We do a writeup on credits quarterly. I do a category on CG—fit it into the general view of the company. I get a printout on the ISS rankings, plus the analysis from The Corporate Board—and then do my own analysis of the issues.
• It's the analyst's responsibility to review a company's SEC reporting, including the proxy. The analysts here have responsibility for voting the proxy. It's only part of the picture provided the portfolio manager. We vote on a case-by-case basis. If something sticks out, then we address it. It comes down to personal interface and knowing management.
• It's not a big part of day-to-day analysis. It's more of a general overview, due diligence, especially with new investment ideas.
• We look at a stock from a valuation standpoint. CG isn't a screening factor usually; it becomes more of an issue after we have a position in the company. To sum up: 1. We buy for fundamental reasons. 2. We then interact with the proxy guys. 3. If CG issues are raised, then we either buy more or sell.
• I look at the CG rankings my firm derives. It's part of my awareness, goes into my thinking; it's another variable to think about. But I don't care about the firm's rankings *per se*. I think the markets are generally efficient over time. It's not a matter of whether a company meets CG criteria; CG isn't equivalent to management quality. That said, more CG is better than less. For example, if there's properly structured CG at the board level, it's more likely the board will scrutinize management.
Lower priority: (8 or 32%)
• It's very informal. We have a pretty flat organization. It's up to the individual to decide about CG issues. Frankly, it's not at the top of my list. On the margin, I look at some issues, e.g., to see if the board is shareholder friendly.
• I have a hard time integrating it completely. I view it as a separate item. You have to consider management and management quality. CG is on the checklist, but down the list. It's not one of the top few items. Plus, in a regulated industry, companies are under more scrutiny.

(Question 2, continued)

<u>Lower priority: (8 or 32%)</u> (continued)
• It's more of an ad hoc thing.
• We integrate CG into the decision-making process by exception. It's not a factor in 75% of the companies we're considering. 5% are especially good companies, 20% have a problem or you can anticipate a problem. In terms of utilities, our investment philosophy is that there's a strong element of reversion to a mean—e.g., Three Mile Island, California energy crisis. On the other hand, if there were to be a collapse in the steel industry or a problem with CG, we'd see that as something to be investigated.
• CG is on the lower end of our priority list.
• It's kind of on the margin. It becomes more important if a company is embarking on a new course of action, such as a new business line or new management style.
• We haven't integrated CG into investment decision-making yet. It probably will become more prevalent, especially with the recent situation with DPL.
• Leastly—but that's not to say we don't do it. It's an art, not a science. We look at long-term trends at a company, at the cash flow power. We need a sense of where management's going, an understanding of how value is being created.
<u>Other (1 or 4%)</u>
• We always want to do the right thing. But there's very little I'm doing today regarding investment decision-making that's different. However, I'm less involved today because of the existence of the proxy group.

3. Does your firm have a separate corporate governance group apart from the investment area? If so, how does this group interface with the investment area?

- While 27% of the interviewees work at firms without proxy groups, the remaining three-quarters of respondents work at firms with separate such entities. How that group functions with the investment area, however, varies. Of the analysts at firms with a separate proxy function, 42% said that group actually does the voting. In some instances the proxy group appeared to have a position of power and in others, served in more of a passive capacity merely to ensure that proxies are being properly addressed. One analyst replied that the firm's board did the actual decision-making. Another 19% of analysts at firms with separate proxy groups replied that the investment group votes the proxies; in some cases, there is interaction between the 2 areas. The remaining 15% of respondents with separate proxy groups noted that the voting was a joint effort between the investment and proxy areas.

Notable Analyst Comments:

Yes—proxy group votes: 11 or 42%
• Yes. We have a separate person who does the voting.
• Yes, there are several people. But our board makes the ultimate decision. It's usually more routine, in line with some broad rules.
• Yes. It's the corporate actions group.
• Yes. It was instituted in late 2003.
• Yes. Generally, they just ensure that the proxies are being addressed properly.
• Yes. We never had one before, but there's now a proxy committee. The analyst can go before it, state a case regarding an issue, then they vote. They usually vote generically, unless you raise an issue, then they'll hear your opinion.
• Yes. We have internal policies, and the analyst has to submit an explanation to them. We vote ourselves, don't have someone external do it.
• Yes. There are two people dedicated to proxy submissions. We have a boiler-plate list of issues and vote accordingly.
• Yes. A CG expert was brought in.
• Yes. We've had a proxy group for 17 years, and it's always active. It's not a new phenomenon here.
• Yes. They're responsible for voting the proxy. They sit in on our investment meetings. Sometimes there's an overlap in people.

(Question 3, continued)

<u>Yes—investment area votes: 5 or 19%</u>
• Yes. They review our proxy voting. The analyst votes the proxy.
• Yes, but the investment group does the voting. Our board of directors periodically meets with the portfolio managers to discuss how votes were cast.
• Yes, there's a legal/compliance subgroup that develops guidelines. They look at things from a proxy perspective. Then there's a parallel proxy group. Then the analyst, portfolio manager vote the proxy. If there are conflicts among these, we have a discussion and reach a resolution. The investment group usually gets the final say, unless it's a compliance issue.
• Yes. There's a separate proxy group comprised of investment professionals and separate individuals with a legal and compliance background. This group and the investment area make joint recommendations. Sometimes the group doesn't understand the company very well, and that's where the analyst comes in.
• Yes, we have a corporate governance group that talks about issues and a separate proxy guy. But the analyst does the voting.
<u>Yes—joint effort: 4 or 15%</u>
• Yes. There are several. There's a proxy issue group that develops guidelines, what we do/don't prefer. They send the analyst the proxy, along with the firm's position on the issues. They ask for your opinion; the analyst gets to weigh in on every issue being voted. For example, when El Paso Corp. had the battle for control, it was a contentious issue internally. Everyone sat down, and we came to an agreement. We try to take a consistent position, and vote across the board on all issues.
• Yes. We have a group whose background and total focus is CG. It's a 2-way street with the investment area. If issues pop up from a CG standpoint, they can check with the industry expert and be proactive, not reactive. Or the analyst can identify an issue of concern and bring it to the proxy group. We're not doing box-checking here.
• Yes. We have a separate proxy solicitation group. They vote off of the portfolio managers', analysts' recommendations. However, I vote the proxies for the utility fund I manage.
• Yes. Portfolio managers and analysts give input to the person voting the proxy.
<u>No: 7 or 27%</u>
• No (response from 5 analysts).
• Not that I'm aware of. For voting proxies, we use ISS. They vote for you, make recommendations. It keeps the analyst out of the process.
• No. We vote in line with an existing procedure, to make sure we're covering ourselves and keeping the SEC happy.

4. **Are the rankings derived by corporate governance firms employed in your investment decision-making? If so, how?**

- Almost three-quarters of respondents don't incorporate outside corporate governance firms' rankings in their investment-decision making. The primary complaint against the ratings is that they're rigid, and that real life doesn't fit into an easy model. As well, analysts noted that they exercise qualitative judgment in the investment process, and that other trouble signs would be evident if the rankings were poor. The 30% of interviewees utilizing the outside rankings typically didn't follow the recommendations blindly. Rather, the ratings were used as initial screening tools, sources of information, and as assistance for clarifying certain factors.

Notable Analyst Comments:

No: 19 or 70%
• No, we don't subscribe to any. Things just don't fit into easy models. They can't get that granular; a model doesn't work.
• No. ISS and Glass-Lewis have set standards. Sometimes G-L will throw out independent directors who provide a product to a firm; i.e., a conflict that really isn't a conflict. The founder of a firm set out a list of proxy issues and suggestions back in 1998. I sometimes still refer to that. I'm not adverse to changing a vote after discussion with a company and getting an explanation on an issue, e.g., on director conflict.
• No. We have a general resistance to checking boxes.
• No, the rankings aren't important.
• No, I don't use them. The proxy group may; we're big enough to look at rankings.
• No. We're structured to remove the day-to-day proxy responsibility from front-line fund management.
• No. If the rankings were abysmal, there would be plenty of other red flags.
• No. I don't really pay a lot of attention to the rankings. The utilities are pretty homogenous in the rankings.
• No (response from 8 analysts).
• No. I'm aware they exist, maybe they're used elsewhere in the firm.
• No, I don't, but the proxy people may look at it. My judgments are qualitative regarding a company.
• No. We looked at outside firms, but we didn't like any. They were too mechanistic.

(Question 4, continued)

Yes: 8 or 30%
• Yes, we use ISS, as a default to the gold standard. We definitely look at their recommendations, but we don't run with ISS no matter what.
• Yes, we use them for an initial screen in stocks.
• Yes, we look at ISS. But I mainly use my own criteria. However, ISS can be helpful, e.g., in clarifying a board member's independence.
• Yes, we use ISS. We can go against them, but we have to go through lots of hoops to do, so it rarely happens. I don't pay a lot of attention to their rankings; I have my own sense of what I want to do. The solution to the CG crisis isn't structural. As Warren Buffett once said, "You can't do a good deal with bad people."
• Yes, we use ISS. We look at their recommendations. If the company is well-known, we don't need ISS as much. But we may use their recommendations for other companies with which we're not as familiar. We usually don't use them with utilities.
• Yes, we subscribe to ISS, IRC (Investor Responsibility Research Center), Glass-Lewis. But we don't follow their recommendations. We use them as an information source.
• Yes, we use ISS. They vote for you by making recommendations. That keeps the analyst out of the process.
• Yes, we're ISS subscribers. The proxy person gets the ISS recommendations, and that's a starting point. Then we deviate from them as appropriate. I personally don't use the ISS recommendations at all.

5. Are there specific governance issues that are "hot buttons" to your firm—e.g., staggered boards, management compensation? Please elaborate.

- A number of respondents either had no answer to this question or didn't address it specifically. Instead, they reserved their observations for the queries on individual issues that followed. Those analysts that offered commentary cited 5 areas that could set off alarm bells. In order of priority, they are: compensation, poison pills, board of directors (independence, experience, structure), related party transactions, and risk controls. In a nutshell, the responses centered around a desire for companies to be run in a fashion consistent with shareholder interests, and practices running counter to those interests attracted the investors' negative attention.

• We generally review compensation, related party transactions. If we don't trust management, we don't have that big of a position anyway. Our record is tilted toward voting with management. But we've been most likely to vote against stock options recently.
• Independent boards, having some comfort around audit and risk controls and some expenses.
• Board composition and compensation. Horrendous boards have been there forever and management compensations are ridiculous. Compensation obviously hasn't been based on performance. Some boards should have voted to sell their company or merge it years ago, but boards are poor, half asleep.
• Board independence and inexperience, related party transactions, compensation of senior management. We want to know how board members got on the board, and about a director's dealings with the company. We've found rating agency analysis really more helpful here, because it's qualitative.
• On the compensation side—e.g., when a company asks that shares be set aside for the bonus pool, we think they sometimes ask for an excessive number of shares. Poor stock performers ask for peer group average compensation regarding share issuance; that bothers me. I think performance should equal compensation, but grade inflation often exists.
• Poison pills without shareholder approval (2 responses.)
• I'm for expensing options. Against defensive measures like poison pills, compensation plans with excessive dilution, repricing options, caps on executive compensation, staggered boards.
• I generally criticize anti-takeover provisions, having no voting policy or voting guidelines.
• We don't like poison pills of any kind. We oppose ceilings freezing the amount of stock that can be bought.
• Not really. If we don't like something, we either don't buy the stock in the first place or we vote with our feet if we own it.
• We don't like management incentivized on earnings growth—that's a cautionary flag. Also, poison pills.

6. To the extent your firm takes an active position on shareholder issues, what is your objective? In other words, what are you trying to accomplish through activism?

- There was a fairly comparable distribution of respondents that are activists (56%) and non-activists (44%) on corporate governance issues. The vast majority (85%) of those describing themselves as activists cited shareholder interests and improving shareholder value as the reason for their proactive involvement. Holding management to their social responsibility and ensuring investment outperformance were also offered as explanations. Those respondents who aren't shareholder activists said, variously, they work behind the scenes with management on issues of concern; sell their shares if unhappy; and don't want to jeopardize prospective pension clients because of activism.

Notable Analyst Comments

Activists: 14 or 56%
• We want companies to embrace their social responsibility, do the right things, be more open. As to what we're trying to accomplish, I can't say; that's decided at a higher level.
• We want managements to be shareholder friendly, not to do things against the long-term interests of the shareholder. We're against things that enrich management and not the shareholder. We're trying to change behavior, period. To send a message. We don't want to micro-manage companies; we want them to have broad discretion in their own compensation plans. That is, unless a company has an egregious history of undue compensation.
• As a portfolio manager, I have a benchmark I have to outperform. So, when I am activist, I'm trying to ensure performance that will allow me to outperform.
• One recent instance was when we worked to try, but failed, to remove a CEO and several directors from a company. Our goal was trying to improve shareholder value. We're concerned that they'll continue to do transactions in a dilutive way, and that the board lacks independence.
• Our main objective is that no one group of shareholders is advantaged over any other group. For example, a rights offering open to one group, not another.
• Improving shareholder value or getting shareholder value realized.
• We've talked to some boards, but then, most boards are brain dead. We have a group of core companies we've owned for a long time. Their interests are aligned with shareholders. They're ROIC-focused. They have a good management team with an incentive scheme in place to work for the shareholder. How many electric and gas companies are like this? Less than 5% of the industry.
• There've been 2 cases where I've been very active; other PMs have had more. Our goal is to get the best deal for shareholders.

(Question 6, continued)

<u>Activists: 14 or 56%</u> (continued)
• At one point, we were very activist and frequently in the news media. That brought about muted hostility, so we now try to work with managements to resolve issues. Better managements are proactive and call me on controversial issues.
• To try to get valuation up.
• Yes. On a specific instance, we made direct appeals to institutional investors to throw their weight around when a company removed its takeover defenses. What potential benefits to the shareholder did that offer?
• Better allocation of capital. Sometimes CEOs don't have the long-term interest of shareholders at heart. We want to give a clear, objective feedback loop to ensure that value is being transferred back to shareholders.
• Yes. In one case, we were very instrumental in getting the chairman of a company fired. We're obviously trying to improve the returns to the shareholder.
• It's rare that we're activists. When we are, it's to maximize value because of our fiduciary responsibility to the client who owns the stock.
<u>Non-Activists: 11 or 44%</u>
• We're not activists. It's a free market system. We vote with our feet.
• We very rarely are activists. We don't want to upset prospective clients for our pension business.
• We only work behind the scenes. We speak to companies informally. We never offer shareholder proposals.
• We really aren't. We use ISS as an outside advisory firm on proxies.
• No activism. (6 responses, 1 indicating previous activism)
• We're not publicly active. We have raised issues with managements privately. Our firm's name is very well-known, so it's an unwritten law that we don't do anything to bring negative attention to it.
• Yes, we've made our voice heard on a few issues through a proxy vote. We tend to shy away from advising managements. We may communicate disappointment, and we've written a few letters. Our objective is to ensure that management knows our views on an issue. We're very long-term investors; in fact, we're the ideal holder, maintaining positions for 4-5 years and we don't trade. That preserves clients' capital and enhances their wealth.
• We work behind the scenes and do nothing publicly. We talk with senior executives all the time. Issues can be raised during meetings. The challenge to management—our underlying objective always—is the bottom line. We try to do what's in the best interest of our clients, who are looking for financial returns.
• No, not on the equity side, but some on bondholder issues.

7. ***Do some corporate governance factors preclude your firm's owning a stock? If so, what are they and why?***

- The preponderance of responses (83%) was that corporate governance factors don't preclude stock ownership. The handful of analysts who responded affirmatively (13%) pointed variously to discomfort with a company's situation, legal issues, and dysfunctional board composition as reasons why they might not own a stock.

Notable Analyst Comments

Yes: (3 or 13%)
• If something gives me serious pause—e.g., Enron. I was never comfortable with the way the company was structured, how management was compensated, so we never owned it.
• Strictly legal issues would be the only things that would preclude us from owning. The only thing we're required to do is adhere to the law.
• If the composition of the board is boilerplate and not functional. In IPOs, if a board isn't in place to satisfy CG criteria.
No: (20 or 83%)
• No (Responses from 15 analysts)
• I don't think so.
• No. Sometimes the valuations on crappy companies become disjointed enough that we'll buy them, simply because the valuation will improve.
• No. I don't know if this is really CG, but relations with the investor community are important. Poor disclosure and secretiveness suggest a company may have poor governance.
• I'm not aware of any. • Not that I know of.
Mixed (1 or 4%)
• It's up to the analyst to answer.

8. **<u>Please comment on your views of the following issues related to management:</u>**
    a. **<u>Compensation levels: caps</u>**
    b. **<u>Severance packages: caps</u>**
    c. **<u>Stock options:</u>**
        1. **<u>limiting the number</u>**
        2. **<u>recalibrating</u>**
        3. **<u>mandatory holding periods for stock after options exercised</u>**
    d. **<u>Splitting the chairman/CEO role.</u>**

8a. <u>Caps on compensation levels</u>:

- No one in the universe of respondents supported capping management compensation. A little over half the analysts expressed opposition to capping, while the remaining respondents offered either a qualified opinion or somewhat of a mixed response. The major reasons offered against capping included the need to be able to provide proper incentive to management; correlating compensation to performance; and having a hands-off attitude toward management. Providing the ability to attract good people through competitive compensation and the structure of compensation being more important than the level were also mentioned. But some reservations were expressed about not having a cap. These largely centered around recent examples of egregious compensation levels in the wake of poor performance and the related need to tie remuneration to performance. Disclosure of payment packages' details was also mentioned.

  <u>Notable Analyst Comments</u>

<u>Opposed to caps: 14 or 54%</u>
• Don't like. Management needs to be incentivized in the most appropriate way to ensure that compensation is linked to stock performance.
• Against it. Discretion should be kept with management, and assume that they'll do the right thing.
• I don't believe in them. Management should be required to own a certain amount of the company's stock.
• No, I'm strongly against them. I think a company should have the flexibility to be able to attract good people. In the utility space, the operational decisions have generally been okay, but compensation is an issue in a few cases. [Note: This analyst then cited 3 major utility companies in which he said egregious compensation levels had victimized shareholders.]
• Opposed to caps.
• As a rule, we don't vote against management.

(Question 8a, continued)

<u>Opposed to caps: 14 or 54%</u> (Continued)
• Against. We want compensation to be more correlated with performance than grade. We prefer a more balanced approach to proper incentives: Base salary + cash bonus + restricted stock (vs. options).
• We're geared more toward bondholder interests. Management is usually compensated on growth, earnings; we prefer hitting leverage targets. One distressed company I know has this.
• I'm not in favor of a hard cap. Appropriate compensation really shows whether the board is exerting control.
• Compensation structure is more important than a cap—i.e., cash vs. options.
• Bad idea. The value of management is tremendous. I think they should be highly incented. The problem is that bad managements set the bar too low, and then steal the money.
• No. Our policy is not to cap. If management is doing a good job, they should be rewarded.
• We don't seek to cap. We live in a democratic society. There are companies, industries with excessive compensation. Management should be paid for performance. It would be great to have a model, but there's not one out there. I think relative compensation makes sense. The problem with long-term plans is that compensation could be increasing.
• No. I don't want to see a cap on a company's earnings or a cap on how high the stock can go, or anything that would allow management to produce good earnings or a high stock price.
<u>Mixed commentary: 12 or 46%</u>
• Compensation is a subjective issue. We look at it on a case-by-case basis. Caps usually aren't an issue.
• Compensation should be tied to performance. I have some concerns, but they really relate to management getting big bucks after a company has had a bad year. It's okay if they have a successful year; they should be rewarded.
• Tough issue. Lots of companies benefit from bringing new managements in, and their effecting a turnaround. You can't do too much on the cheap. Investors shouldn't overly control how management is paid. But I don't want someone robbing the company, either.
• We're very supportive of measures that attract and maintain good employees, rewarding long-term performance and aligning shareholder interests with management pay. We will defer to ISS here, though. Where compensation has been egregious, we've voted our proxy accordingly. We ask management about their metrics, look at the dilutive effects of the compensation package.
• There have to be changes in some companies, where compensation is egregious [Note: analyst cited one specific example, which he said represented a failure of the system]. I'm a free market person. I want to see some link of payment to credit quality.

Question 8a, continued)

Mixed commentary: 12 or 46% ***(Continued)***
• I want to see compensation tied more closely to performance.
• Not a huge problem, as long as the appropriate incentives are in place.
• Not critical.
• No—as long as disclosure is adequate and costs treated properly. I'm a big proponent of expensing options.
• No, I'm not opposed to caps. I like management remuneration to equal shareholder interests. Incentive should be tied to fundamental performance criteria.
• Compensation level isn't much of a problem in the utility universe. I think it should be driven by the investment process.
• It's far less important than introducing risk to management if the stock price declines. This industry is good at destroying value. If you reward management with options, it's different from the shareholders' objectives. Proper compensation in my book is management having greater exposure to downside risk.

8b. Caps on severance packages:

- In contrast to their largely universal views against capping management compensation, the analysts were more of a mixed mind regarding caps on severance packages. Just under half the respondents said they weren't opposed to caps, while another one-third is against them. In the words of some of those supporting ceilings, "severance packages are rewards for failure"; "I have no interest in overpaying someone who's leaving who should be leaving"; and "It's absolutely ridiculous that managements who've run companies into the ground walk out with their pockets stuffed full." Several offered suggested levels for the caps: ~3x total compensation. The views of those analysts against caps were pretty consonant with opinions regarding capping management compensation: providing incentives to ensure good performance, and attracting strong talent. The remaining analysts opined that severance packages aren't needed in this day and age, and that they should be decided on a case-by-case basis.

Notable Analyst Comments

Not opposed to caps: (12 or 48%)
• No problem.
• I'm not sure what the right number is, but I'm not really opposed to it. It's hard to hire people when the starting point is their departure.
• Fine, but make the terms of the deal public.
• Great!

Question 8b (continued)

Not opposed to caps: 12 or 48% ***(continued)***
• I'm for them—2.99 times the total compensation package.
• They're good to have.
• Okay, within reason.
• We rarely get to vote on these. But as a rule, if the severance package is 3x total comp, we'd withhold votes for directors the next time.
• I'm philosophically in favor of it, if it means getting someone bad to go away.
• Severance packages are rewards for failure. Investors need to ensure that these packages are tied to market performance. The packages should be designed with performance in mind.
• If management isn't there due to poor performance, I don't want to see them get much of anything as they go out the door. It's absolutely ridiculous that managements who've run companies into the ground walk out with their pockets stuffed full.
• Once a management is gone, they can't help me. So, yes, cap, unless it can't be done for some contract reasons. At the same time, I have no interest in overpaying someone who's leaving who should be leaving.
Opposed to caps (9 or 36%)
• We're very supportive of measures that attract and maintain management, reward long-term performance and align shareholder interests with those of management.
• No caps.
• Bad idea. Some deals that were struck where management was paid off were advantageous to shareholders. It's a necessary evil.
• You should try to make sure there's an incentive for management to do well. Golden parachutes take that away.
• I'm not in favor of a hard cap.
• We generally don't vote against management.
• Strongly against. The company should be able to attract good people.
• I don't believe in them. Utilities lack outside expertise, so if a package could help attract some needed talent, that's good.
• Against them; discretion should be kept with management, and assume they'll do the right thing. I'm also against capping outside directors.
Mixed commentary: (4 or 16%)
• I don't know how you'd do that. But there has been an egregious example [Note: analyst cited a specific instance].
• I don't believe in this day and age that there's a need for severance deals. It should vary from industry to industry.
• I have no thoughts on this.
• No general statement; it should be decided on a case-by-case basis.

8c1. Stock options: limit the number

- Clearly, the treatment of options is a controversial issue to analysts. Only 12% of respondents believe that no limit should be imposed on option rewards on the grounds that management needs proper compensation, and "it's a free market." Another quarter of interviewees would like to see a limit, with several assigning a number: 3% of shares outstanding or resulting in no greater than 5% dilution. However, the remaining two-thirds of opinions were mixed. One interesting line of commentary is that almost one-third of the analysts would prefer to see restricted stock issued rather than options, as the former is "a better way of getting management to have 'skin in the game.'" Other comments made included a preference for variable over fixed compensation; options aren't a big focus area; dilution from options is important; options limits are considered on a case-by-case basis; and that options can "create upside potential without creating downside risk."

Notable analyst comments

Limit: 6 or 24%
• The top 5 execs should get no more than 5%.
• Options are good, as they give management incentives. But they should be limited. Sometimes some, but not all, execs are given options at a good price. That practice should be limited.
• Yes, we have broad rules on the %. It should be ~3% of shares outstanding.
• Yes.
• Should be no greater than 5% dilution, but we make exceptions on a case-by-case basis. We also want to have the related costs more easily known.
• It's not a huge issue in the utility industry, but I think limiting is a reasonable thing.
Don't limit: 3 or 12%
• It's a free market.
• I'm not sure what the right number is, but I think options should be expensed.
• Management should be properly compensated. If we don't like what we see, we vote with our feet.
Mixed commentary or other: 16 or 64%
• Options aren't a big focus to us.
• Options should be replaced with performance (i.e., restricted) shares
• Look at the dilution of packages. In our case, the proxy committee decided what's reasonable. We have a problem with anything over ~3%/year dilution; it could as low as 1%. Look at what the maximum is a single person could get in one year.
• There's more leverage with options than with restricted stock; with the latter, management is more at risk.

Question 8c.1 (continued)

<u>Mixed commentary or other: 16 or 64%</u> (continued)
• Some companies are way out of hand in awarding options to only a few people. Limiting options is a dangerous subject. I prefer variable comp over fixed comp. Options are the best variable tool.
• I prefer restricted stock to options, and stock grants given through formulas rather than management decisions.
• I prefer restricted stock over options. It's a better way of getting management to have "skin in the game." Everybody benefits from driving the stock price higher. But options aren't a make/break investment decision for us. I'm not in agreement with excessive options, but that's not a big concern for this industry.
• ISS has opinions on limits, and we look at what they say. But typically we don't go along with that guidance unless there's an egregious situation. If management isn't doing a good job, then we may vote with ISS.
• I prefer restricted stock
• No inflexible limit. That said, I prefer restricted stock.
• I like restricted stock. While I'm not opposed to options, I think they should be linked to shareholders' interests.
• No, but restricted stock is clearly better.
• That's a fairly technical issue.
• We look at on a case-by-case basis and factor it into our valuations. Options can be problematic.
• I really don't have a view; options don't enter into my analysis. I think it's good for management to have skin in the game, but sometimes that translates to inflating profits to increase their gain.
• Options create upside potential without creating downside risk.

8c.2. __Stock options: recalibration__

- Many analysts had strong negative opinions about repricing options, with almost two-thirds opposed to the practice. Respondents noted that recalibration is a reward for bad management or performance, managements shouldn't receive a reward that shareholders don't, and it's an attempt to make up for past losses. A few investors (15%) qualified their opposition to the practice, unless extenuating circumstances—such as a broad market decline—intervened. And the balance of the interviewees (some 30%) either had no view on recalibration or said they didn't know.

Notable analyst comments

Opposed: (15 or 56%)
• Not a great practice. You're making up for past losses by rewarding more options.
• A BIG NO! We absolutely don't believe in this.
• Against. The problem is that there's been a lot of this because management claims that without it, there's a brain drain of mid-level managers.
• We have big issues with this. It's a terrible tragedy.
• No. It's giving something of economic value away.
• I'm not a big fan of repricing.
• We don't look on this favorably.
• We're against recalibration. It's trying to play a stock price game. Too cute.
• I don't like.
• Strongly against or opposed (3 responses)
• No!
• I'm against. It's rewarding bad management or bad performance. I'm against re-loading options.
• No! Why should management be rewarded and not shareholders?
Mixed or qualified opinion: (4 or 15%)
• There's no reason for repricing unless the exercise price is increased.
• No, it's giving management too much. I don't like it unless there are very extenuating circumstances.
• I have an issue with recalibration, but it's a subjective matter.
• Dead set against unless in very unusual circumstances.
No opinion or don't know: (8 or 30%)
• No view on this. (4 responses)
• Fairly technical issue.
• I don't know. (2 responses)
• Not a big focus for us.

8c.3. Stock options: mandatory holding periods for stock after options are exercised

- Mandatory holding periods are the analysts' definite preference, with 59% of respondents lobbying in their favor. Despite that position's being fairly widely held, only a few suggestions were made as to what the holding period should be—3 years, 3-5 years, an infinite period, and equal to the holding periods of investors. The remaining respondents were fairly evenly distributed in being against mandatory holding of options (11%), having no opinion (15%), and offering a mixed commentary (15%). Those opposed to a mandate pointed out that a member of management might have to exercise for personal reasons, and that could result in a decrease in his/her ownership position in the stock. Analysts with mixed views pointed out variously that management philosophy should be the dictate regarding holding periods, and that it varies by company and industry.

Notable Analyst Comments

For mandatory holding periods: 16 or 59%
• Yes—3 years.
• Yes, I'd support. The amount of time is variable, as it depends on how long it took to exercise. But I'd probably say 3-5 years.
• I don't know the firm's opinion on this, but it makes good sense to me as an analyst.
• I generally like restricted stock rather than options, and there are longer holding periods for restricted stock. I don't know what the holding period should be; I'd say, go by the reasonable man rule.
• That's a fair thing, but what the holding period should be is arbitrary.
• Yes. Risk/reward should be as symmetrical as possible. I like Dominion's model, where management is at risk for some finite period of time.
• Yes—3 years minimum vesting.
• Good idea (2 responses).
• Yes: 1/3, 1/3, 1/3—phased vesting.
• It's a good idea, but I don't know the exact period. And I don't know if that would keep people from exercising.
• Yes, for an infinite period. Everyone should have to hold on to the stock.
• I like the idea of a vesting period. Reward plans should favor long-term performance, not short-term objectives.
• Not a bad thing.
• A good idea. The compensation payout should roughly equal the holding periods of investors.
• I like to see ownership by top management, a multiple of executive compensation. I don't think you should punish companies who don't, but should encourage them to have ownership. I don't know how long they should be required to own—maybe get the stock in a few years.

Question 8c.3 (continued)

Against mandatory holding periods: 3 or 11%
• It's not necessary. If someone wants to sell, they can. It's a question of how quickly they'll disclose the sale.
• I wouldn't support this. They may have to exercise for personal reasons.
• I don't like them because it interferes with management's ability to get a fair value for his options if he can't sell anything to pay taxes. I want management's ownership in the company's stock to continue to increase. If options have to be exercised, that could cause stock to have to be sold.
Mixed commentary: 4 or 15%
• It's a good idea, but it's not necessary.
• I favor the notion, but wouldn't dictate it. It's a function of the stock and the industry.
• It's up to the corporation, as to how it fits into their management philosophy.
• Management should have a certain percentage of their compensation in the company's stock. If that means holding options, then do, but they shouldn't have to hold them forever.
No opinion: 4 or 15%
• Not an area of big focus for us.
• No opinion offered. (2 responses)
• We haven't addressed this.

8d. Splitting the chairman/CEO role

- Over half the respondents agreed that they would like to see the chairman and CEO posts held by different individuals, while only 8% are opposed to a split. Those favoring a separation commented that problems with combining the roles are a concentration of power; potential for a shaky board structure; no checks and balances; diminution in the ability for each role to be performed well; and lack of independent thought. As to opposing splitting, it was suggested that it's difficult to separate the roles and hard to recruit knowledgeable individuals for each. The remaining 35% of analysts who offered mixed commentary pointed out that board composition is the more important issue; splitting can be a financial burden to smaller companies; combined roles have worked well in utilities, as has splitting the roles; and it depends on the environment and the person.

Notable Analyst Comments

For splitting: 14 or 54%
• I'm for it. You can have a powerful CEO that acts to squash communications among and sway decisions of the board.
• I tend to be in favor of that, but take it on a case-by-case basis. When the chairman is also CEO, the board structure can be shaky.
• For it. I want 2 guys there for me rather than one; that provides 2 points of view.
• Yes, it's inevitable.
• Yes, it's a healthy thing.
• I support a separate CEO and chairman.
• I'd condone it. It would provide checks and balances.
• Yes, due to the conflict of interest when they're combined. That links back to compensation.
• Probably ISS is against the roles being combined.
• I suppose it's a good idea, though I haven't given it much thought.
• I like when they're split. When together, there's too much power residing in one person.
• It's a good idea to have the 2 roles separated; both are important roles for a company. Combining the two takes away a little from the ability to do each role well.
• In general, I'm for a split role, though there aren't that many examples of it in utilities.
• They should be separated, with independent thought for each. The board should be a balance of participation. There's no sense of accountability when the roles are combined.

Question 8d (continued)

Against splitting: 2 or 8%
• I don't require it. I'm okay with it.
• Splitting isn't something we'd push. We're trying to split the roles for some of the funds we manage. It gets hard to recruit a knowledgeable non-company guy to be chairman.
No comment or opinion: 1 or 4%
• One response
Mixed commentary: 9 or 35%
• It depends on the company. There are 2 camps, and one in the middle. It's more important to look at the board composition, and how independent it is. Does a company have a lead director? I like that, versus all committee assignments.
• It's probably a good idea. Some research has shown it doesn't have a big impact on performance, though.
• Theoretically it makes sense, but for small companies, it's more of a financial burden.
• It depends on the corporation's environment. I'd object to it if it would overload the company, with management having too much to do.
• I think splitting would be positive, but it's not mandatory.
• I don't think it matters too much.
• I don't feel strongly about it. There've been many instances in utilities where the combined role works well. It's a morality question; competence is less the issue.
• It's more appropriate when they're split. So, I'm in favor of it in principle, but it doesn't always work well in practice. I've seen the combined model and the split model each work well and poorly.
• Our policy is that it depends on the person.

9. Please comment on your views of the following issues related to boards of directors:

a. **Independence: % of directors**
b. **Limit on number of other board memberships**
c. **Conflicts of interest that aren't really conflicts**
d. **Staggered boards**
e. **D&O insurance**

9a. Independence of board (% of independent directors)

- Almost half the respondents offered a suggestion for what percentage of the board should be independent. The responses ranged from a minimum of 50% to 80%-90% (and one touching 100%), with mention also made of the need for a majority and a supermajority. Several analysts commented that management representation on the board is being (and should be) limited, and that it's very difficult to determine if, in fact, a director is actually independent. The one-third of interviewees not specifying a number for independent directors opined that competence, experience, morality, and what truly constitutes independence are more the questions. The remaining 16% of responses noted that a certain number of independent directors doesn't guarantee an effective board, the definition of independence varies, and an outside entity should specify numerical standards.

Notable Analyst Comments

Number/percentage specified: 12 or 48%
• >50%. A number of companies are beginning to limit the number of management personnel who are board members.
• In the U.K, it's 50/50, excluding the chairman. I think that's a good rule of thumb for the U.S.
• 2/3 should be independent.
• >80% independent is a good thing. I don't know how you determine real independence, though a lot of progress has been made in that direction in the last 12 months—e.g., there are new faces on the TXU board.
• Yes, a supermajority. Independence is difficult to determine. For example, how many years is a director tenured (longer=less independent, more like a club)? Are they all from the same region?
• A majority should be independent. But it's more a quality of the board. You can't really tell who's independent.
• Minimum 2/3, preferably ¾. How do you ensure they're truly independent? We use a service—IRRC—that's like ISS but doesn't recommend how to vote. They have one way of defining what's independence (no other source of income associated with being a director).

Question 9a (continued)

Number/percentage specified: 12 or 48% ***(continued)***
• >1/2
• Minimum of ½. Regarding independence, it's tough to judge. You need industry expertise. More disclosure related to independence would help.
• At least 80%. 90% would be better. Only 1 management person should be on the board. More people from management gives a different slant of where the company is coming from.
• 90% independent. Have only the top guy from the company. You don't need 5 insiders to tell the same story; the top guy can. One hallmark of independence is a certain ownership position in the company.
• 75-100%
No number/percentage specified: 9 or 36%
• Don't know if there should be a hard rule. Generally, I like the vast majority of the board to be independent.
• No hard number. We need competent boards. It's a morality question—are directors doing the right things, or lining their pockets. Some independent directors are self-interested and this is an easy job. That equals incompetence.
• I don't look for a %. The real issue is, what's really independence. It's not our role to determine the board structure. Look at the listing standards.
• A significant number of outsiders. I'd like outside directors to meet independently of management.
• I think a board should be largely independent. But directors need to be both independent and qualified.
• It'd be a crude judgment at best to try to set a number.
• No %. Independence of the directors is what's key. In multi-segment companies, I want expertise from different industries.
• There's no optimal number. The composition of the board and experience of directors are what matters. I'd prefer the number of directors fixed and not altered without a shareholder vote, so management can prevent a takeover (e.g., in autos, health care) by creating a poison pill.
• It's hard to assess from a purely statistical standpoint; you have to go through the history. A lot of boards are still old boys' networks; the board makeup still has to change. A large percentage of mergers don't work—there are still too many companies, management teams, and boards. It's a structural problem with the industry, where local pride is perpetuated by the board. Standards for independence aren't meaningful. But red flags should go up if you're dealing with the country club set or if director nominations come from management. Directors should be nominated by shareholders.

Question 9a (continued)

Mixed/ other commentary: 4 or 16%
• It depends. That criteria isn't essential for an effective board.
• In principle, I'm in favor of a largely independent board. But there are problems; you can get people who are independent but are weak. To determine independence of a director, look for an obvious relationship with the chairman. And you always need a woman, a minority. May not be the best board you could have.
• I don't want to set such standards. Maybe AIMR or EEI should set them.
• It's a dicey issue. It depends on your definition of independence. We haven't taken a position on how to define it.

9b. Limit on number of other board memberships by directors

- Respondents specifying a limit for additional board memberships (31%) and those who didn't (27%) were roughly equal. Those wanting a ceiling imposed generally felt that 2-3 extra boards were sufficient before an individual lost effectiveness, though some said that up to 4-5 more slots were acceptable if the person was retired. One outlying response was that 10-20 board memberships were okay. The group of interviewees not assigning a number noted that it was difficult to pinpoint a precise figure, but generally seemed to agree that limits need to be set to ensure an effective contribution by directors. The remaining 42% of responses offered mixed commentary, including: use decent judgment; current CEOs shouldn't be sitting on the boards of other companies; and that rules invite being broken.

  Notable Analyst Comments

Number/percentage specified: 8 or 31%
• 2-3. Much beyond that, you're losing focus and becoming a professional board member.
• Yes, after 3 or so board slots, someone loses effectiveness.
• The question becomes how effectively can they do their job with many boards. If retired, 5. If active, 2.
• If retired, can hold a fair number, but not >5. If active, not >1, not including non-profits. But that's not a rule; you have to use judgment.
• If you don't have a job, could have more board slots, but not >6 or 7.
• It's good to have a limit. If retired, you have more time. If active, less time, say no > 3.
• Yes, 2 if active, 4 if retired.
• 10-20.
No number/percentage specified: 7 or 27%
• No strict policy. If a director is an executive in another company and on 3 other boards, I think the issue should be raised. There's a limit where someone can't contribute enough. And you should look at the attendance record of directors.
• It's hard to pinpoint a number. The issue is when you're on 6 boards at a time. How do you do it? And what counts in assessing the number—non-profits? Foundations?
• I think you should look at how many other boards directors are on. If they're on too many, then you have to question their commitment to your board. But we shy away from making noise about the issue.
• Yes. I don't know the magic number. But especially with a full-time operating job it's hard to give enough time and focus to other boards.

Question 9b (continued)

<u>***No number/percentage specified: 7 or 27%***</u> ***(continued)***
• No legal limit. But if a director shows signs of "sleeping during meetings," you've got a problem. If they're really active directors, that's okay.
• I haven't heard what our policy is, but it makes sense to limit. A person has only so much time, and you don't want to dilute his time and energy.
• Yes, but I don't know what the number is. It's hard enough to get good directors. For example, in the utility industry, there are 100 companies. At 6 directors each, that's 600 people. The devil is in the details.
<u>***Mixed/ other commentary: 11 or 42%***</u>
• I guess there should be a limit, but it depends on whether the guy is currently employed. There's a benefit from having exposure to a lot of boards. If he has the time, that's not such a bad thing.
• This isn't something I've seen come through in our shop.
• No opinion (1 response).
• Current CEOs shouldn't be sitting on other companies' boards.
• I don't think you should impose a limit, though it makes sense. The boards of hedge funds and mutual funds are shams. Boards are ostensibly independent, but in reality they're not, as they can change at will.
• I don't care so much. But I look favorably on instances where a CEO has resigned from other boards to focus on his own company.
• When you have rigid rules, people can find a way to circumvent them.
• Just use decent judgment. What some activists want done is downright silly—e.g., getting Buffett off the board of Coke. Sometimes a person has unique qualities which put him on many boards, rightfully.
• No limits. I'd just prefer that they act like grownups and be responsible for knowing how much they're capable of doing well.
• No number. People should figure out what they can really handle competently.
• Our guidelines don't address this.

9c. Conflicts of interest (that aren't conflicts)

- A little under half the analysts don't view ostensible conflicts as a problem. Their respective takes on the issue are that if the apparent contradiction isn't material, it's not problematic; the definition is a technical one; and the corporation should be the one to determine if a conflict really exists. Only 8% of respondents view the problem as real, saying "it gives me a sense of hesitation about relationships that might exist," and "there should be no crossovers." The remaining 50% of interviewees provided qualified answers on the issue including: proper disclosure should take care of the issue; conflicts exist to be managed; the more independent, the better; if conflicts exist, they should be *de minimis*; and "I go by the 'red face' rule—if there's any impropriety, I shy away."

Notable Analyst Comments

No problem: 11 or 42%
• It's a technical definition. It wouldn't bother me.
• It's not an issue. We're not heavily involved in trying to structure the board.
• ISS and Glass-Lewis have set standards on this. G-L will sometimes throw out independent directors who provide a product to a firm. It's a case of a conflict not really being a conflict.
• It's good to be aware, but if it's a small conflict, it's not so egregious.
• It should be up to the corporation to regulate.
• I don't view it as a conflict.
• That's ridiculous! The SEC really overstepped on that one.
• It may be a conflict, but it's not a problem. The director should recuse himself on issues related to the conflict.
• I don't think I'm upset by that.
• If not material, it's not a conflict.
• No big deal.
Concerned about it: 2 or 8%
• I see it all the time. It gives me a sense of hesitation about relationships that might exist. Should do away with the conflict if at all possible.
• There should be no crossovers.

Question 9c (continued)

Qualified response: 3 or 50%
• It's always easy to level that charge. Sunlight is the best disinfectant. Frequently there's more smoke than fire. No problem, as long as it's fully disclosed.
• All should be disclosed and explained—i.e., that it's not material.
• It's common sense stuff; it's hard to set rules. As a rule of thumb, the more independent, the better. And there should be logical controls to make people not do egregious stuff.
• Directors should list where potential conflicts exist. If it's tiny, as a % of income, revenues, probably no problem. But I really don't know how to answer.
• I go by the "red face" rule. If there's any prospective look of impropriety, I shy away.
• No response (1 response)
• How can we worry about things like this? You just get lost in the details. That said, compensatory memberships (you're on mine, I'm on yours) should be banned.
• The best answer is not to have a conflict. But if one exists, it should be *de minimis*.
• It's an issue. It depends on how material it is.
• Conflicts are there to be managed. Try to solve the problem rather than not being willing to acknowledge there is one.
• Perception is everything. It's a tough issue, but any impropriety should be looked at askance.
• I prefer common sense rather than going over things line-by-line. Let common sense rule.
• It's a materiality issue, but it's hard to ferret out. It gets back to disclosure.

9d. ***Staggered boards***

- Slightly over half the respondents expressed a preference for annual elections of directors, while one-quarter said they favored staggered boards. Those wishing a new slate of directors chosen each year pointed to the entrenchment and complacency potentially inherent in a staggered structure, and the transparency that annual elections offer. Analysts affirming classified boards said they equate to consistency and continuity. The remaining 22% of respondents either had no opinion on the issue or suggested more limited terms within a staggered structure as an alternative to the status quo.

Notable Analyst Comments

Prefer staggered boards: 7 or 26%
• Good idea. We elect 1/3 of the U.S. senators each year; it should be the same with boards.
• Yes, it equates to consistency.
• I'm okay with them.
• Prefer staggered.
• Gives a little continuity, so it's a little better. In annual elections, by the time the new guys get their feet wet, it's time to have another election.
• A better way than annual; gives more continuity.
• Not a hot button to us.
Prefer annual elections: 14 or 52%
• I want directors elected every year.
• I don't favor staggered boards. I recognize the importance of continuity with a staggered board, but don't like the feeling of entrenchment it suggests. Go to annual elections.
• Prefer annual. More transparency that way.
• Annual.
• Annual elections. I'm prepared to take a risk of someone other than management's being disruptive.
• I favor approving annual elections.
• Favor annual election. There's a level of complacency that's dangerous in staggered boards.
• Staggered boards are more entrenched. I prefer annual elections.
• Against staggered boards.
• Staggered boards create continuity, but cause entrenchment.
• My preference would be to vote against staggered boards.
• Prefer annual.
• Always against staggered. Always for declassifying the board.
• I prefer not to entrench management. Prefer annual elections.

Question 9d (continued)

No or mixed opinion: 6 or 22%
• No opinion. Staggered boards can lead to hostile takeovers.
• No opinion.
• It takes time to have knowledge of a company. Maybe more limited terms would be better—annual to perhaps biennial?
• Staggered boards were created for the purpose of slowing down a change of control. I like annual elections. Or maybe 2-year staggered terms?
• Not a concern. I don't know the cost/benefit to the utility of them.
• No strong feelings.

9e. D&O Insurance

- A little over half the respondents offered some opinion regarding D&O insurance. Most agreed that having the protection is a necessity, given the litigious nature of society and the difficulty in attracting good people without it. Some qualified their affirmation, though, in suggesting that D&O insurance should be limited so directors and officers would "have some skin in the game." Some analysts expressed opposition to the protection, with one quoting Warren Buffett, who said "We don't do insurance here; we expect to be honest and straightforward." No one suggested a set level of insurance, but several people thought there should be enough to enable directors to do their job without "jeopardizing their personal wealth and well-being." Those analysts not venturing forth with an opinion (44%) either had no response or said it was an issue they'd not thought about.

Notable Analyst Comments

Opinion expressed: 15 or 56%
• It's hard to get good people without insurance. I'd prefer to have people with some skin in the game.
• I think there should be insurance, with no specified limit. I support it as long as it's not retroactive or supporting criminal activity.
• The amount of money doesn't make a difference. Shareholders would prefer not to see premiums paid, period. There should be a set limit so boards constrain themselves. Without that, you remove the onus on a director to conduct himself properly. X versus 3X is adequate.
• You have to have it, as we live in a litigious society.
• A huge issue. It's hard to attract talented people without it.
• What risk are the directors really taking? A company has to provide some level of insurance, but it seems like such a big crutch. Directors have to have a stake in the game.
• If I were on a board, I'd probably want a lot. I haven't looked at studies. Do they self-insure? The value is in having it; you hope and assume you don't have to use it.
• You've got to have it. I'd prefer a structure where the largest shareholders are polled for director nominations.
• I don't know enough to speak intelligently on the issues. But I think you should provide enough insurance so directors can do their job without jeopardizing their personal wealth and well-being.
• A sensible level, but one that doesn't completely indemnify the directors and officers.
• No rule of thumb. To quote Warren Buffett: "We don't do insurance here. We expect to be honest and straightforward."
• Should be adequate to cover risks, and to entice the best talent as directors.

Question 9d (continued)

<u>Opinion expressed: 15 or 56%</u> (continued)
• Don't know the level, but insurance is a necessary evil.
• I wouldn't want directors to think they'd get off scott free because their legal fees are paid for.
• I don't know how much a company should have. Does it cover individuals or the enterprise? A company needs to provide directors with protection or they won't sign on.
<u>Don't know, haven't thought about it, or no comment or opinion: 12 or 44%</u>
• Haven't given it much thought.
• I don't really know; haven't thought about it. I'm sure premiums have increased 50% in the last 2 years.
• Don't know much about it. But it's an interesting issue.
• I've no thoughts. It's not something we address.
• No feelings about it.
• I've no idea.
• No comment or opinion (6 responses).

10. Please comment on your views of the following issues related to auditors:

a. **Rotation**
b. **Conflict of interest (consulting role)**

10a. Rotation

- Those against rotating auditors (41%) were double the number of analysts (19%) who favor rotation. Respondents opposed to changing the deck hands cited the numerous problems with such a practice: that it would lead to a lack of continuity in a profoundly complicated function, be very expensive and impractical, and not provide the needed historical knowledge base necessary in an auditor. As well, it was pointed out that the number of auditing firms has shrunk to only a handful, and demanding rotation is tantamount to micro-managing. Analysts backing rotation offered suggestions as to the frequency with which auditors should be changed, ranging from 2-3 years to 7 years, with 5 years being the central tendency. The remaining 41% of interviewees offered mixed or qualified thoughts, which tended to present both the pro and con sides of the issue.

Notable Analyst Comments

For rotation: 5 or 19%
• Yes, 5 years.
• Every 4-5 years? I'm for rotating, but it's not a big point to push on companies. It's not something I've seen on proxy votes.
• Not on an annual basis. 3, 5, 7 years might make some sense. After all, there are only 2-3 auditors left out there.
• I'd like a periodic tender of auditing firms, say every 5 years. Put the business out for bids.
• Yes, every 2-3 years. It's the same issue as with staggered boards: it takes time to have knowledge of a company.
Against rotation: 11 or 41%
• Not a good idea. It's another morality question. You're asking another whole team of auditors to come right up to speed on a company. It's impractical.
• No. You need the historical knowledge base. It's profoundly complicated.
• No, it gets to micro-managing. If a company has a good auditor, and non-audit fees are reasonable, not a lot of related party dealings—then okay to keep.
• I've not voted for rotation. Would prefer more continuity.
• There'll always be rogue companies. There aren't that many auditors out there. It's easy to have self-checks.

Question 10a (continued)

Against rotation: 11 or 41% ***(continued)***
• No. Very expensive to do. The world has changed. Accounting firms don't need to be rotated now.
• No. Should go back to having one firm do internal auditing, then another firm do an external audit for the annual report. The last firm would provide a lot of checks and balances.
• Although I've not thought much about it, I'd see a change as a red flag.
• I don't think it really matters. Auditing should be auditing.
• No.
• No. It remains more efficient to have continuity. There are enough rules post-Enron regarding provision of other services.
Mixed/ other commentary: 11 or 41%
• It's good to change every now and then, but it could cost a lot more.
• From a shareholder perspective, rotating auditors is good, but not from a management perspective.
• Probably a good idea to rotate, but how many auditors are left? With Sarbanes-Oxley, auditors probably aren't too inclined to include a lot of garbage.
• Probably a good idea. The Canadians have 2 sets of auditors and vary the lead position. A new auditor is competing financially, though there can still be a fundamental conflict.
• No thoughts.
• Interesting question. I can see the benefit, also understand the disruption that would be created where you change auditors every few years.
• Pro: a new auditor could overturn something the prior one didn't. And familiarity with the books is good. Con: Audit work is so extensive, that bringing in a new firm may cause problems.
• Not a bad idea. 3-5 years is probably reasonable. The downside to rotating is the cost. If rotating, could auditors get sloppy? After all, you're rotating among the same people.
• On balance, rotating is more a good thing than bad. In principle, should rotate. As a practical matter, it's tough—more expensive, more work for management.
• Yes, rotate every 4th year. But understand there are costs involved every time you change.
• Probably. I want continuity, but not people who don't do a job well.

10b. Conflict of interest (consulting role)

- There is a strong feeling against having auditors play a dual role as consultants, with 56% of respondents speaking out against the practice, which was variously described as "distasteful," "unprofessional," and "a major problem." One analyst pointed out that not permitting the auditor also to consult would remove any pressure "regarding objectivity, clarity, offering a fair opinion," and several noted that experience has shown that the functions should be kept separate. Only 7% of the interviewees thought it would be okay to allow both functions to be handled by one firm. The remaining 37% of respondents provided mixed or qualified views such as: knowledge gained from consulting can be a money-saver; the ratio of audit to non-audit fees is the metric to focus on; auditing has become a loss leader to get the more lucrative consulting business; and full disclosure regarding the relationship should eliminate the potential for conflict.

Notable Analyst Comments

Against permitting auditor to consult: 15 or 56%
• Don't allow.
• Not good at all. Auditor should be just that. Then there's no pressure regarding objectivity, clarity, offering a fair opinion.
• Shouldn't permit. Look at Enron.
• A major problem.
• Keep functions separate.
• Distasteful, unprofessional.
• Auditing should be the dominant relationship.
• ISS thinks it's a mistake.
• Should be separate.
• Not a bad idea to separate. Experience suggests that separating is good.
• I'd be more comfortable if you could ring-fence.
• I'd prefer not to see it.
• Should start farming out non-audit stuff. Perceived conflict if both done by same firm. We've seen a dramatic decrease in non-audit fees: on average in 2002, they were \$0.75 of every \$1.00; in 2003, \$0.51 of every \$1.00. If you see higher than average non-audit fees, take a look at what's going on.
• Auditor should audit, consultant should consult. Split consulting business from auditing.
• Would like to see consulting restricted, but I haven't pushed that on companies.

Question 10b (continued)

For permitting auditor to consult: 2 or 7%
• No concerns.
• Yes, okay. The internal aspect is the consultant, the external aspect the auditor.
Mixed/ other commentary: 10 or 37%
• It's a bad thing. But auditing has become a loss leader, so the firm still has to sell other business to make up the loss.
• Probably shouldn't allow consulting. But if auditors can offer knowledge from the auditing work, that could save the company money.
• I think the issue is pretty fleshed out. It's a matter of using auditing as a loss leader for more lucrative consulting.
• Depends on the level of consulting activity. It's an issue, I just don't know how to deal with it. We need a Glass-Stegall for accountants.
• As long as it's fully disclosed, okay, but I'd prefer not.
• Should justify clearly why revenues from consulting are greater than auditing.
• If < 50% of fees are for consulting, that's really good; < 25%, great. If > 75%, egregious.
• As long as a Chinese wall exists and precautions are taken, no problem.
• The problem is probably solving itself. Auditors are spinning off consulting operations. If they get too close, I'm against it.
• Should have a minimal non-auditing role.

11. Additional Comments: Are there any additional comments you'd like to make regarding corporate governance?

- In the wrap-up, the key theme that resurfaced and was emphasized is the critical need for boards of directors to be independent, comprised of highly qualified individuals, and to act in the interests of shareholders. Some skepticism about existing boards was also expressed. One analyst noted a desire for more shareholder activism, along with its salutary impact. And a comment was also made about a perceived correlation of poor disclosure and communications with investors, and the quality of CG.

Notable Analyst Comments

• Sometimes it's hard to get directors out; we recently tried and didn't succeed. (Note: Analyst cited a specific company example where this was the case, despite ownership by 20 institutions).
• Qualifications for directors should be that they be more directly responsive to shareholder interests than to management, have financial and legal expertise. They should defend shareholder interests.
• Most boards are just shams. The level of work required to really help is enormous. They have a minimum level of fiduciary responsibility, and rely mostly on management representatives. They do very little analysis or work, they're just a rubber stamp for management. There's a growing tension between management and their boards the more activist shareholders become.
• There needs to be more independence!
• Boards in this industry still suck; you're on a board if you're a friend of the CEO.
• Companies just need to realize they need to do the right thing in CG matters. If you look at boards 30-40 years ago, they were stewards of capital. They should be the same thing now.
• This interview caused me to think about some new things. I'd like to see more shareholder activism. It costs nothing, and can do a lot. We're long-term investors with a 2-4 year time horizon, so good CG matters to us.
• CG is critical. It's the core of everything. We need independent boards scrutinizing managements. There should be good composition on the boards, with competent, reasonably knowledgeable, and proactive individuals.
• I don't know if this is really CG, but I pay attention to a company's relations with the investment community. When a company has poor disclosure and is secretive, that suggests to me that it may have poor CG.

APPENDIX A

QUESTIONNAIRE

1. How has corporate governance interface with investment decision making changed within your firm over the past five years?

2. How do your firm's analysts/portfolio managers integrate governance considerations in their stock analysis and decision-making?

3. Does your firm have a separate corporate governance group apart from the investment area? If so, how does this group interface with the investment area?

4. Are the rankings derived by corporate governance firms employed in your investment decision-making? If so, how?

5. Are there specific governance issues that are "hot buttons" to your firm--e.g., staggered boards, management compensation? Please elaborate.

6. To the extent that your firm takes an active position on shareholder issues, what is your objective? What are you trying to accomplish through activism?

7. Do some corporate governance factors preclude your firm's owning a stock? If so, what are they and why?

8. Management
    a. Compensation (cap on levels)
    b. Severance packages (cap)
    c. Stock options
        i. Limit on number
        ii. Recalibration
        iii. Mandatory holdings periods (for stock after options exercise)
    d. Splitting chairman/CEO role

9. Boards of Directors
    a. Independence of board (% of independent directors)
    b. Limit on # of other board memberships by directors
    c. Conflicts of interest (that aren't conflicts)
    d. Staggered boards
    e. D&O Insurance

10. Auditors
    a. Rotation
    b. Consulting role (conflict of interest)

11. Additional Comments: Are there any additional comments you'd like to make regarding corporate governance?