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Corporate Governance Update:
Investor Communication and "Fifth Analyst Call"

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As the 2011 proxy season approaches, companies are focused on drafting their proxy statements and preparing for their annual meetings. With mandatory non-binding say-on-pay votes on the ballot and continued focus by corporate governance activists on executive compensation, communication issues with investors, especially large stockholders, are taking on increased importance.

Recently, a group of institutional investors representing approximately $2.2 trillion in assets under management, led by Walden Asset Management, has asked that some companies host an annual conference call specifically for institutional investors to focus on corporate governance discussions in the proxy statement.[1] The call would be held after the publication of the company's proxy statement and prior to the company's annual meeting of stockholders. Each company that is approached by this group must consider this request in the context of its own situation; however, we offer some thoughts below on why companies may wish to resist this proposed new obligation. As a practical matter, such a conference call would be unlikely to provide investors with any useful information beyond the disclosures in the proxy statement; as a legal matter, any material, non-public information disclosed by the company must be provided to all stockholders, rather than to a select group of institutional investors.

"Fifth Analyst Call"

The Walden group's request for a "Fifth Analyst Call" states, "[t]he aim of the call will be for issuers to explain to institutional investors their corporate governance

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[1] "Request for Investor Dialogue: Fifth Analyst Call on Corporate Governance and the Proxy Statement," Dec. 1, 2010, available at www.shareholderforum.com/e-mtg/Library/20101201_FifthAnalyst.pdf. Pension Investments Research Consultants (PIRC Ltd.) publicly supported the concept of the Fifth Analyst Call in its comment letter to the SEC in response to the SEC's Concept Release on the U.S. Proxy System, PIRC Comment Letter on S7-31-10 (Nov. 18, 2010) available at www.sec.gov/comments/s7-31-10/s73110-61.pdf.

philosophy and strategy and for investors to ask questions and raise concerns prior to voting their shares at the [annual meeting of stockholders]." According to the Walden group's proposal, the call would be hosted by the company and "co-chaired by the company and a 'lead investor.'" The agenda would be agreed upon in advance and would be "driven by and confined to the proxy statement." The Walden group's proposal requests that the call be attended by the company's independent board chairman or lead director, the company secretary, and possibly the general counsel or head of investor relations. Chairs of important board committees are also "encouraged to participate although this is not a prerequisite for conducting the call."

The list of topics proposed by the Walden group is a standard set of corporate governance issues: governance framework and philosophy; audit and/or risk committee matters; compensation discussion and analysis; board structure, effectiveness, and succession planning; and other items in the proxy statement that may arise such as change in auditors or the board's position on stockholder proposals. Importantly, the Walden group's proposal would limit participation in the Fifth Analyst Call to institutional investors who hold shares in the company and "have a commitment to actively vote their shares." In addition, the Walden group encourages governance analysts and equity analysts to join the call as well.

It is difficult to see how a call on these topics would add materially to the investor participants' understanding of the company's position on these issues. First of all, the discussion necessarily would be redundant, as these matters are covered extensively by required disclosures in the company's proxy statement and on the company's website. Proxy statement disclosures should be of high quality, reflecting input from the company's legal and investor relations teams and a review by the board of directors. Ideally, the language in the proxy statement should be the result of cooperation by many different sources within the company to ensure that it is legally sufficient, easily readable, and responsive to stockholders' concerns. Discussions of these disclosures on a call therefore could require the participation of a fairly large team from the company in order to be able to respond to sophisticated questions and comments on the proxy statement, and as a practical matter would not permit the team members to confer with each other in order to give a coherent, appropriate and accurate response to a participant's question.

The Walden group is correct to highlight the importance of communication with investors on proxy statement topics. However, it makes more sense for this to be accomplished in advance of the proxy season, preferably in the summer or fall, before the proxy season gets underway. The company may wish to schedule calls or visits with key investors to identify their concerns and questions, particularly in hot-topic areas like executive compensation. The proxy statement then can be responsive to those interests or concerns to the extent practicable.

It is not clear why the Walden group calls for the participation of the independent board chairman or lead independent director, but we would urge any companies that do undertake a Fifth Analyst Call to resist this request. Generally, neither the independent board chairman nor the lead director participates in the drafting of the proxy statement or in regular analyst calls. The significant burden of preparation and participation in this extraneous call should not be placed upon this director, who already carries a great deal of responsibility and fulfills many time-consuming duties for the board. Most important, the disclosures in the proxy statement should adequately cover all that this director could say about the corporate governance topics at issue. Corporate governance disclosures in the proxy statement are extensive and contain detailed reports from the board, particularly its compensation and audit committees. Moreover, a wide variety of important governance issues are covered in the company's proxy statement and corporate governance principles. The lead director cannot speak on behalf of board committees, nor should he or she be pressured to give greater detail regarding board deliberations or discussions than is contained in the disclosures approved by the committees or the full board. Nor should this burden be placed upon the committee chairs that the Walden group encourages to participate. The costs of such a process clearly outweigh the benefits.

Regulation FD Concerns

One potential cost of the Fifth Analyst Call is additional risk of legal liability. As a legal matter, whenever communications are made to a select group of investors, as proposed by the Walden group, Regulation FD must be considered. The Securities and Exchange Commission (SEC) has brought several Regulation FD actions in the past year and is clearly paying close attention to possible violations.

One example, a recently settled Regulation FD enforcement action relating to "implied messages," indicates that companies must be extremely careful when communicating to a small group, particularly at a key time in the corporate calendar.[2] In that situation, the SEC alleged that senior corporate executives had directed the company's investor relations group to contact each of the analysts covering the company as well as some key stockholders and to use a set of talking points designed to suggest that second quarter earnings would be less than the consensus estimates. Following these contacts, analysts lowered their earnings estimates, the company's share price dropped, and six days after the investor calls, the company filed a Form 8-K announcing that sales and earnings would be negatively affected by the economy in the second quarter. The

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[2] *See* In the Matter of Office Depot, Inc., Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 63152, Oct. 21, 2010.

SEC's enforcement action, which followed a story in The Wall Street Journal, was brought on the theory that the company selectively signaled that earnings would not meet street expectations, the materiality of which was allegedly borne out by the reaction of the analysts and the market. While the stated purpose of the Fifth Analyst Call is limited to corporate governance matters discussed in the proxy statement, it is always possible that other topics could arise during the call, and it is further possible that company representatives could inadvertently or obliquely deliver a material message. Recent Regulation FD enforcement actions show that if material information is delivered and understood by investors, whether explicitly and intentionally or not, Regulation FD may be implicated.

The Walden group argues that there is no greater risk of a Regulation FD violation during a Fifth Analyst Call than during a regular analyst call on financial results, noting "[t]he call will focus on information already disclosed in the proxy statement and provide an opportunity for investors to ask questions and get clarification." Even if that is true, and Regulation FD is not violated by the disclosure of material, non-public information during a Fifth Analyst Call, the spirit of the law is at risk of infringement. "Clarifications" that impact how an investor will vote on a proxy matter may be viewed as material in hindsight and potentially raise issues regarding selective disclosure. The purpose of Regulation FD is to ensure that any communications of importance by a company are made to all its stockholders simultaneously, or as close to simultaneously as practically possible in the case of an inadvertent disclosure. By contrast, the purpose of the Fifth Analyst Call is to gather a group of investors and give them "clarification" that is not available to regular stockholders. Companies should be wary of giving a preferred position to any group of stockholders and violating the policy of equal treatment that animates Regulation FD. Obviously, these same concerns are present in any proxy situation, but the group dynamic created by a Fifth Analyst Call will increase the pressure on the company to make selective disclosures. Moreover, participation by lead directors or other company representatives that do not ordinarily interact with investors also will increase the risk of an inadvertent disclosure under Regulation FD.

Benefits vs. Burdens

It is always worth remembering that good corporate governance, though obviously important, is not a goal in and of itself, nor should it be the main focus of companies or investors. At best, good corporate governance protects investors and companies through transparency and rigorous corporate housekeeping; at worst, it distracts market participants from their essential purpose of creating and capturing value.

As corporate governance requirements continue to be added, with none removed, the balance between utility and burden becomes ever more precarious. Walden's request for the Fifth Analyst Call is the type of step that tips the scale, adding a new and onerous set of obligations without corresponding usefulness for either investors or the companies in which they invest.[3] Investors will be better served when companies can stay focused on their substantive pursuits and strategic goals to the benefit of all stakeholders. Companies should beware the temptation to adopt measures such as the Fifth Analyst Call in order to boost their corporate governance ratings, particularly when it has been shown that such ratings do not consistently predict corporate performance by any measure.[4]

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[3] *See, e.g.*, Martin Lipton & James Cole, "The Fifth Analyst Call" Client Memorandum (Jan. 6, 2011) ("Adding a Fifth Analyst Call to the already heavy burdens—of dealing with proxy advisory firms like ISS, institutional investors like CalPERS and other organizations like the Council of Institutional Investors on issues of corporate governance, and the SEC on issues of disclosure—that corporations bear today, seems to not be worth the effort.").

[4] Indeed, it has been shown convincingly that corporate governance indices do not consistently predict corporate performance by any measure. *See* David A. Katz & Laura A. McIntosh, "Do Corporate Governance Ratings Fail To Make the Grade?" N.Y.L.J., Jan 24, 2008 (discussing Sanjai Bhagat, Brian Bolton & Roberta Romano, "The Promise and Peril of Corporate Governance Indices," *European Corporate Governance Institute Working Paper Series in Law*, Working Paper No. 89/2007, Oct. 2007, available at www.wlrk.com/docs/ThePromiseandPerilofCorporateGovernanceIndices.pdf.); Robert Daines, Ian Gow & David Larcker, "Rating the Ratings: How Good Are Commercial Governance Ratings?" Rock Center for Corporate Goverrnance at Stanford University Working Paper, June 26, 2008 (concluding that, despite claims by proxy advisory and corporate governance ratings firms, governance ratings provided by RiskMetrics, GovernanceMetrics International, and The Corporate Library do not correlate with corporate performance, risk, or undesirable outcomes such as accounting restatements or shareholder litigation), available at www.law.stanford.edu/display/images/dynamic/publications_pdf/dgl6-26-2008_1.pdf.