Power by Proxy

➤ **AUDIT COMMITTEE MEMBERS** have been particular targets of "withhold" votes this proxy season.

The California Public Employees' Retirement System (Calpers), the largest U.S. pension fund, has been withholding its vote for directors who authorized the auditor to perform nonaudit services at more than 90 companies in its portfolio. In many cases, Calpers also has voted against the ratification of the auditor.

"We believe that corporate auditors being compensated for work outside their normal audit duties raises potential conflicts of interest—and potentially questionable audits," Mark Anson, Calpers's chief investment officer, said in a statement in April.

Sarbanes-Oxley already bars auditors from providing the following nonaudit services to an audit client: (1) bookkeeping or other services related to the accounting records or financial statements of the issuer; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker, dealer, investment advisor, or investment banking services; and (8) legal services and expert services unrelated to the audit. SOX also empowers the board to bar the auditing firm from providing any other nonaudit service.

Audit committee directors get voted down for buying nonaudit services from their audit firms.

But SOX doesn't prohibit all nonaudit services. Nonaudit services are allowed if a firm's audit committee preapproves services that aren't on the prohibited list and discloses its decision to investors. Preapproval isn't necessary if fees for nonaudit services are less than 5% of the total paid to the audit firm in the year in which the services are provided. Also, members of the audit committee hold a lot of power to authorize many nonaudit services that Sarbanes-Oxley doesn't explicitly prohibit, says Steven A. Solieri, a professor of accounting and information systems at the University of Scranton. He cites special reports that examine internal controls or even reports that critique an audit client's information systems—so long as the audit firm doesn't design them.

Calpers's massive campaign to check the "withhold" box on the annual-meeting proxy cards at 90% of the 3,000 companies in its portfolio in order to express unhappiness about corporate behavior goes well beyond nonaudit services, encompassing assorted gripes from hostile takeover bids to executive compensation.

But the tactic, which is essentially a vote of no-confidence, is limited in actually forcing change. It technically doesn't count as a "no" vote. It isn't an official abstention. Boards aren't compelled to take any action in response to a withhold vote. Indeed, directors can get reelected to the board even if a significant number of votes are withheld, as long as shareholders aren't presenting a rival slate of candidates. Disney CEO Michael Eisner, for example, remains on the company's board even though 43% of Disney shareholders who voted withheld their support for his reelection at the company's annual meeting this year.

Still, aside from selling their stock, investors don't have many other choices. Most of the millions of proxy cards mailed to shareholders in advance of annual meetings don't include any space to vote against a management-endorsed slate of directors or other proposal. And if a shareholder signs a proxy card but doesn't vote on a particular issue, the company can often count that vote as a "yes."

But that may change. The Securities & Exchange Commission (SEC) proposed a new rule in October 2003 that makes it easier for large shareholders to nominate their own directors. Under the proposed rule, if at least 35% of the votes withhold approval of a director, a large investor—or group of shareholders—would have the right to put one or more director candidates on the company's proxy the following year.

Still, it remains to be seen to what extent this proposal will be finalized because of broad dissent from corporations, business groups, and some of the SEC's own commissioners.

The commissioners are reportedly concerned about shareholders representing special interests targeting directors at companies where no problems exist instead of focusing on the most troubled companies. They're also concerned the proposal would give institutional investors too much power, often at the expense of small stockholders. The Business Roundtable, a group representing chief executives, for example, has said large investors could hold companies hostage, threatening to submit a proxy-access proposal unless the company accedes to their demands.

In response, the SEC is considering relaxing the provisions of the proposal. But even a scaled-down version that empowers shareholders to nominate and vote for their own directors may make next year's corporate elections even more contentious. ■