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*Shareholder Access to the Corporate Ballot*
(Lucian Bebchuk, editor, Harvard University Press, 2005)

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# Shareholder Nominations of Corporate Directors:

## UNINTENDED CONSEQUENCES AND THE CASE FOR REFORM OF THE U.S. PROXY SYSTEM

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### INTRODUCTION

When the Securities and Exchange Commission introduced its access proposal,[1] providing a method for shareholders to add their nominees for director to company proxy statements, it exposed two of the weakest and most controversial elements of the U.S. system of corporate governance : (1) the nomination and election of directors, and (2) the voting of stock at shareholder meetings.

Reform is clearly needed in both these areas. However, in proposed Rule 14a-11 the Commission has chosen to address only the first of these matters — director nominations. The proposal does not deal with the second and closely related problem of election procedures and the mechanics of proxy voting.

The care taken in drafting the Commission's proposal is evident in its complicated arrangement of trigger provisions, ownership thresholds, two-year time frame, and independence requirements for candidates. The scheme clearly reflects sensitivity to the competing interests of shareholders and corporate executives. The chorus of criticism that has arisen from both sides — investors claiming the rule is too restrictive and managers protesting that it goes too far — suggests that the Commission has come close to achieving the balance it was seeking.

Nevertheless, even the most skilfully designed rule will fall short of its goals if it cannot be effectively implemented or if it leads to unintended consequences.

The purpose of this discussion is not to review the questions of law, policy, and authority surrounding shareholder access, but to examine the practical implications of proposed Rule 14a-11 and review basic reforms needed to improve the proxy system.

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Specific proxy system reforms have been suggested by the Business Roundtable (BRT)[2] and by this author on behalf of Georgeson Shareholder Communications Inc.[3] These and other suggestions for improving proxy communications and the mechanics of share voting should be evaluated broadly on the merits, with a view to strengthening U.S. corporate governance, rather than evaluate narrowly in the context of the shareholder access proposal. Regardless of whether Rule 14a-11 is adopted in either its present or amended form, reform of the U.S. proxy system is both necessary and timely.

## Inadequacies of the Current Proxy System

The U.S. proxy system has always been regarded as the most effective in the world. U.S. corporations routinely achieve participation at shareholder meetings in excess of 80% of outstanding shares — far higher than in any other country. These spectacular results reflect the U.S. governance system's unique mix of features: high quorum requirements set by state law and corporate charters; detailed federal proxy rules that mandate full disclosure and voting rights for all shareholders; a tradition of widespread public ownership of equity securities dating back more than a century; and a populist, free market culture that sustains the uniquely American brand of "shareholder democracy."

While U.S. companies are justifiably proud of their voting results at annual meetings, little attention has been paid to how these results are achieved. Even a superficial look beneath the surface raises questions about the integrity of proxy mechanics and voting results. The U.S. proxy system lacks transparency; it provides no audit trail; it has few accountability mechanisms; it is complex and costly; its rules and regulations fail to reach the activities of service providers who play major, though largely invisible, roles in communications and vote processing; it tolerates record-keeping inaccuracies; and it produces voting results that cannot be verified.

Problems in proxy operations have avoided detection because of their eye-glazing technicality and because they often fall outside regulatory coverage. Proxy mechanics are governance plumbing. They operate largely out of sight and are poorly understood even by governance experts and regulators. There has long been an assumption that if operational deficiencies occur in the proxy system their impact is neutral and unlikely to affect the outcome of contested solicitations in any predictable way. As the vast majority of shareholder meetings are uncontested and involve actions characterized as "routine," the few voting percentage points that might be altered by operational irregularities

have been deemed immaterial and not worth the cost required to achieve a higher level of accuracy.

In election contests, where voting results are recognized as having serious consequences, the proxy process shifts into high gear and special ad hoc procedures are implemented. These procedures include: color coded proxy cards to differentiate dissidents from incumbents; multiple mailings of fight letters; media campaigns and advertisements; direct contact with beneficial owners; expanded telephone solicitation; use of Web sites and Internet communications; face-to-face meetings with institutions and shareholder groups; retention of third-party tabulators and independent inspectors of election; retention of outside experts and consultants; review and challenge of tabulation results; litigation and other tactics. It is also important to note that in election contests the New York Stock Exchange (NYSE) suspends the operation of its Rule 452 (the 10-day rule), thereby preventing brokers from casting discretionary votes for directors.[4]

On average, there are 40 or fewer proxy contests annually in the U.S.[5] Because proxy contests are rare, implementation of extraordinary measures to compensate for deficiencies in the proxy system has become standard practice accepted by both contest participants and regulators. Nevertheless, the need to rely on ad hoc procedures in the conduct of contested solicitations, where voting results really matter, is itself a clear admission that the underlying proxy system is inadequate.

Transparency, reliability, and accuracy could certainly be achieved in proxy processing as it is routinely in securities trading, clearance, settlement, and in corporate actions such as tender and exchange offers. However, the effort has not been made. Wall Street proxy departments have never been held to the high standards that apply to securities administration and the corporate actions handled by reorganization departments. Votes simply have not been deemed as important as cash and securities.

Defenders of the status quo argue that the proxy system gets the job done and boast that it gets high scores on external measures of performance. They claim, "If it ain't broke, don't fix it." The truth, however, is that the proxy system is already in disrepair. If subjected to greater demands and more proxy contests, it will sooner or later break down. A serious operational collapse occurred during the 1993 proxy season and today there are warning signs that problems are likely to recur. Proliferating activist campaigns, withhold and just-vote-no solicitations, just-vote-yes campaigns in support of shareholder resolutions, and potential short-slate election contests are all on the rise. When shareholder

access to nominations of corporate directors is sooner or later adopted, demands on the proxy system will accelerate and expectations will rise. An efficient, transparent, accountable, accurate proxy system will become a necessity.

## Unintended Consequences of Direct Access

Proposed Rule 14a-11 specifically encourages shareholders to increase their use of contested solicitations. If the rule were adopted, access campaigns would replace shareholder proposals as the tactic of choice for activism and governance reform. In practice, access campaigns under the proposed rule would resemble traditional short-slate election contests, while trigger campaigns would take the form of the exempt solicitations and mini-contests that began to appear during the 2003 and 2004 proxy seasons.[6] Exempt campaigns include "withhold" solicitations against incumbent directors, "just-vote-no" campaigns against management proposals, and "just-vote-yes" campaigns in support of shareholder resolutions. Both withhold and just-vote-no campaigns are designated as trigger mechanisms under the proposed access rule.

Exempt solicitations and mini-contests differ from traditional election contests in important ways. A critical difference is the one-sided nature of campaigns that do not seek proxy voting authority. In sports terms, these exempt campaigns require strong offense but little defense. Proponents in exempt solicitations are free to attack incumbent directors and managers, but are less obligated to establish their own credentials or articulate a strategic plan. By contrast, in a traditional election contest both incumbents and dissidents must present convincing cases on two fronts: (1) attacking the opponent's weaknesses, and (2) presenting a credible strategy to increase shareholder value; a much more demanding task. Exempt solicitations are easier, less costly and demand a lower level of commitment from dissidents than a full-fledged election contest. Exempt campaigns also permit proponents to exploit shareholder frustration and to punish companies and executives for underperforming the market or taking politically incorrect stands on governance matters. With their low cost, limited demands, punitive impact and power to publicly embarrass targeted companies, these exempt solicitations are becoming the weapon of choice for shareholder advocates and governance activists.

Disputes surrounding a few of the exempt campaigns waged during the 2004 proxy system gave warning signs that the proxy system is not capable of handling an influx of contested solicitations. Problems that arose in connection with the MONY Group merger meeting, the Red Envelope election contest, and

the Disney Corp. withhold campaign highlighted problems and uncertainties in proxy mechanics.

In the MONY solicitation, a dispute arose when dissidents conducting an exempt solicitation against the AXA Financial, Inc. merger, mailed the company's proxy card with their solicitation materials. Security and Exchange Commission (SEC) staff policy supported this action, as did the federal District Court. However, the Court of Appeals for the Second Circuit disagreed, ruling that use of the management proxy card by dissidents was prohibited in an exempt solicitation.[7] Further, the appeals process delayed the solicitation, which led to a change of record date and a new solicitation that arguably altered the final outcome of the transaction. The conflicting views and policies of practitioners, service-providers, regulators, and the courts on such a basic question — use of the company proxy in a just-vote-no campaign — do not inspire confidence. Uncertainty about such a core procedure as the appropriate distribution of proxy cards, which is essential to access rights and exempt solicitations, reinforces fears about the proxy system's readiness and reliability.

The Red Envelope election contest did not involve an exempt solicitation, but it illustrates the problems that can arise when shareholders attempt to split their votes among competing board candidates, as contemplated by the SEC's access proposal. In the Red Envelope contest, proxy advisor Institutional Shareholder Services (ISS) chose not to fully support either management or dissidents. Instead, it recommended a split vote, suggesting that clients vote for a slate of directors it selected from both sides. ISS's instructions to vote the split position on the dissident card caused widespread confusion and resulted in some investors executing proxies that did not reflect their intentions. The confusion worked to the advantage of dissidents, and management had to conduct a last-minute campaign to help shareholders revoke their original proxies and cast new votes. The incident revealed problems of proxy design and the difficulty of splitting votes.

During the debate over the Disney withhold campaign, dissidents and other activist shareholders questioned the inclusion of discretionary broker votes in the final tally. They claimed that if discretionary votes cast in favor of the incumbent directors were excluded, the withhold vote would have been substantially higher. The Disney campaign increased public awareness (but not understanding) of discretionary voting practices under NYSE Rule 452, the "10-day rule." The SEC's access proposal is silent on the applicability of Rule 452 to access campaigns, which would be a matter for the NYSE to decide. Nevertheless, discretionary broker voting is a widely misunderstood and

contentious issue on which shareholders and issuers are deeply divided. The access proposal trigger mechanisms rely on the achievement of minimum vote thresholds. So long as the validity of discretionary broker votes is disputed, shareholders will question the fairness of the access procedures and accuracy of voting results.

These three cases illustrate problems that can result from ambiguities in the proxy system. Following are some additional problems and questions about proxy operations that would cause uncertainty if the access rule were adopted:

1. *Inaccurate shareholder records.* The "shareholder list" used for solicitation and tabulation of votes at shareholder meetings is actually a compilation of public and non-public data collected from different sources on the record date — the Depository Trust Company (DTC) participant position listing (the Cede list), the share register maintained by the issuer or its transfer agent, the customer account records of banks and brokers, and the internal records of investment managers and their agents. As these records are being assembled, no effort is made to conduct an audit or reconcile inconsistent share positions. For example, the number of shares on the DTC omnibus proxy invariably differs from the shares in the Cede account on a company's share register. No procedure is available to reconcile the discrepancy. Other record keeping practices are similarly lax. Back-office service providers admit privately that overvotes by brokers routinely average 1% of their share positions. It is well known that loaned shares can be double voted.[8] The official response to complaints about overvoting of loaned stock is that the practice does not matter so long as the overvotes do not exceed a broker's total share position. In general, the proxy system displays a cavalier approach to accuracy and a willingness to assume that if things look all right on the surface, it is not necessary to ask questions about what goes on behind the scenes.
2. *Confusing proxies, instruction forms, and ballots.* The voting instruments provided to shareholders include the basic proxy card, voting instruction forms for use by beneficial owners, and ballots for those who vote in person at the shareholder meeting. Electronic and telephone voting have also become increasingly important and institutional investors use a variety of proprietary systems to access proxy materials and to vote electronically. The basic voting documents and their electronic counterparts are always carefully formatted and are scrutinized by regulators to avoid

confusion among the choices offered to shareholders. However, access solicitations under proposed Rule 14a-11 would require the use of a completely new form of "universal" proxy that would list both the incumbent board nominees and the shareholder-nominated candidates. For the first time the U.S., proxy process would combine dissident and incumbent nominees on one proxy card. Would it work? In a case where eleven candidates (nine incumbents and two shareholder nominees) were competing for nine board seats, how would the two shareholder candidates be distinguished from the incumbents? What instructions would shareholders be given to explain their voting choices? Would the SEC staff oversee the design of the universal card to ensure that its format did not favor either group of candidates? Would the SEC also get involved in the design of a new universal voting instruction form (VIF) to be used by ADP Investor Communication Services (ADP-ICS)? Would an issuer facing an access contest feel compelled to decide in advance which incumbent directors would not be seated in the event the shareholder candidates were elected? Would this information be disclosed in the proxy statement or indicated on the universal proxy, or would it be best not to disclose it? These and many related questions about proxy card format, disclosure tactics, voting instructions, and investor education should be thoroughly considered before access is adopted.

3. *Tabulation problems.* Under the current proxy system there are two parallel tabulation systems: (1) The tabulation of proxies from registered holders by the transfer agent or inspector of election is a transparent process, in which the tabulator can match the proxy cards (or have them optically scanned) against the shareholder list. (2) The tabulation of beneficial owners'voting instructions by ADP-ICS or other agents is a far more complex procedure, involving multiple parties, conducted privately, and inaccessible to oversight by external inspectors of election. These two parallel tabulation systems, one transparent, the other invisible, create problems of reconciliation and consistency in the application of tabulation procedures and presumptions. How should tabulators interpret the intentions of shareholders who mistakenly vote in favor of all candidates in a contested access solicitation? Should the vote be set aside, should the shareholders be completely disenfranchised, or should a cure process be available? Would consistent decisions be made by inspectors reviewing proxies of registered holders and by ADP-ICS reviewing the voting instructions of beneficial owners? Should issuers have the right to

review the tabulator's decisions, particularly with respect to beneficial owners? Should shareholder proponents be entitled to equal rights of review? Should independent inspectors be mandated in all cases of access solicitations, as is now the custom in election contests? Should shareholder proponents be asked to bear part of this additional cost? Should the SEC adopt a rule opening up back-office tabulation of beneficial owners' voting instructions to review by issuers, dissidents, and independent inspectors? Should back-office disclosures extend to the voting of loaned stock, which may pass through several different owners after leaving the lender? Without such review procedures, could the integrity of votes under the access rule be enforced?

4. *Shareholder confusion.* Shareholders, particularly beneficial owners of stock held in a broker's name, already exhibit various degrees of misunderstanding about the complicated rules that govern the voting of their shares. Provisions in the access rule would add to their confusion. For example, the rule specifies that group voting privileges (permitting shareholders to check a box on the proxy indicating a vote for all directors collectively, rather than voting for directors individually) would be suspended, removing an option that many shareholders rely upon. The access rule might also require elimination of procedures for voting in blank, where shareholders sign proxies without checking any boxes, allowing their shares to be voted as recommended by management. Activists and shareholder proponents would certainly object to the fairness of voting in blank in a contested access solicitation. Shareholders might also have concerns about conflicts of interest in the recommendations of proxy advisors in access contests. Would a proxy advisor be conflicted if one of its institutional clients were to nominate or publicly support a shareholder candidate? Would proxy advisors be under pressure to routinely support trigger proposals and shareholder candidates? How would shareholders react to a lopsided campaign, in which one side ran an aggressive solicitation and the other did not, or to abusive campaigns in which candidates were subject to personal attack? These are common questions that currently arise in election contests. However, the proliferation of these issues across a broad array of campaigns would require a more systematic approach than the ad hoc measures and litigation used to prevent fraud and abuses in the relatively few contests that occur now.

The access rule is intended to help shareholders deal with "bad" companies, i.e., those with poor performance, poor governance, or other problems. If the drafters' expectations were met, trigger proposals and access campaigns would not be waged against "good" companies, nor would they provide ammunition for special interest groups. Yet despite the rule's carefully drafted checks and balances, it is likely that opportunities for manipulation and abuse will arise. There has already been extensive debate about whether shareholders will apply the rule widely or selectively. Many commentators are predicting that because of the rule's two-year time frame, shareholders are likely to support trigger proposals in all cases, rather than selectively, simply to eliminate delay when the need to nominate candidates arises in the future. Trigger campaigns are already being referred to as a "free option" that merits an automatic "yes" vote from shareholders.

Access solicitations could be used manipulatively to achieve a tactical advantage, such as suspending the 10-day rule vote. Once a trigger requirement had been met and the nomination right was in place, any qualifying shareholder (including special interest groups) could seek eligibility to propose board candidates. Even if they proposed candidates who were unlikely to attract support from other shareholders, the act of nominating them could trigger suspension of the NYSE's 10-day rule. In companies with high retail ownership loss of discretionary broker votes might reduce the voting response sufficiently to threaten quorum. In the hands of an aggressive shareholder advocate, the tactic could be a powerful bargaining tool. This is just one of the unintended consequences and possible abuses that could result from the interplay of the access rule with current proxy practices.

## Suggested Proxy System Reforms

The Business Roundtable and Georgeson have suggested a series of changes to the proxy system that would simplify its procedures, eliminate unnecessary back-office infrastructure, reduce costs, increase transparency, and permit audit and vote confirmation procedures to be adopted. The suggested changes are not radical. They would reduce regulation, not increase it. They would have minimal impact on market structure or other back-office administrative procedures, as they would take effect only in connection with shareholder meetings and would affect only proxy-related communications and share voting. If the suggested reforms were implemented, the U.S. proxy system would work as follows:

- On the record date for a shareholder meeting, voting rights would be transferred from depositories, banks, and brokers to beneficial owners by means of sequential powers of attorney (or "omnibus proxies"). Beneficial owners would thereby be empowered to make voting decisions and to sign proxy cards.
- On the record date, brokers, banks, or their agents would produce lists of beneficial owners in whose accounts shares were held. These lists would be consolidated by central service providers into an official record date beneficial owner list and delivered to the issuer, transfer agent, tabulator, or independent inspector of election for use in the proxy solicitation and tabulation.
- Issuers would continue the current practice of sending "search" notices pursuant to SEC Rule 14a-13 for the purpose of notifying brokers, banks, and their agents of meeting and record dates and determining the number of beneficial owners entitled to receive proxy materials.
- The record date beneficial owner list would be confidential, and its use would be restricted in the same manner as the list of registered holders. In a contested solicitation, the beneficial owner list would be accessible to dissidents under the same federal and state law standards applicable to the list of registered holders.
- Beneficial owners who preferred to remain anonymous rather than engaging in direct communication with the issuer could create a designated nominee account that would screen their identity and function as beneficial owner. The nominee would be administered by a bank, broker, or other fiduciary selected by the beneficial owner. The nominee's name would appear on the record date list of beneficial owners and it would be legally empowered to vote. Beneficial owners who established nominees would bear the cost, including the administrative fees of banks and brokers. However, these costs would be privately negotiated rather than set pursuant to an NYSE fee schedule. Competition between banks and brokers would establish market rates for these services, presumably lower than the current fixed fees.
- Beneficial owners would receive proxy materials directly from issuers, make voting decisions, sign proxies, and return them directly to tabulators or independent inspectors of election. Beneficial owners, particularly institutional investors, would retain the option to outsource any of these activities to fiduciaries or service providers.
- Householding and account consolidation procedures would continue to

be available in cases where a beneficial owner held multiple accounts with a broker or had separate accounts with different brokers. Beneficial owners could continue to use householding services to eliminate duplicate mailings. However, multiple accounts would be maintained and voted separately in order to establish an audit trail. Over time, beneficial owners with multiple accounts would make increasing use of electronic rather than physical delivery of proxy materials, reducing the need for householding. Such administrative services would continue to be outsourced at negotiated fees.

- Brokers and banks would no longer have a direct role in their customers' proxy communications and voting. The cumbersome back-office infrastructure now required to service brokers and banks in forwarding proxy documents, issuing vote instruction forms, tabulating instructions, and voting on master ballots would simply disappear. (See "Eliminating NOBOs and OBOs," below.)
- Discretionary votes by brokers under NYSE Rule 452 (the "10-day rule") would also be eliminated, as brokers would no longer participate in the proxy process. (See "The 10-Day Rule," below.)

## Eliminating NOBOs and OBOs

Since the early 1980s, the U.S. proxy system has distinguished between Objecting and Non-Objecting Beneficial Owners. "OBOs" refer to beneficial owners who "object" to having their identity disclosed to issuers in connection with proxy communications, and "NOBOs" are those who do "not object" to having their identity disclosed. Issuers are entitled to obtain lists of NOBOs for purposes of communication, but they are denied access to information about OBOs.

A customer's decision to select NOBO or OBO status is made at the time the investment account is opened. Research has not yet been conducted to determine the quality of the information given to investors, how the choice is explained, whether there is opportunity for periodic review.

Under the suggested reforms, the NOBO/OBO distinction would be eliminated. Customers setting up investment accounts with brokers and banks would no longer be asked to select NOBO or OBO status. However, to protect shareholders' right to privacy, any beneficial owner who preferred not to be disclosed to issuers would be entitled to create a nominee account that would conceal the identity of the underlying owner. The nominee would be given legal voting

power (with decision making authority reserved to the beneficial owner, delegated to a trustee, or shared) and the nominee would be identified on the record date list of beneficial owners rather than the customer. In this manner, shareholder privacy could be maintained through the simple mechanism of a nominee. The important difference is that these privacy arrangements would be made on an exception basis at the initiative of the beneficial owner, who would also bear the cost.

The NOBO/OBO procedure originally arose from a compromise forged during the takeover era of the 1970s and '80s. At that time companies sought the power to identify beneficial owners for the purpose of uncovering corporate raiders who were concealing their pre-takeover stock accumulations in confidential "street name" accounts. Shareholder activists fought to preserve shareholders' right to privacy in the belief that hostile takeovers are a healthy mechanism to improve corporate performance, increase accountability, and prevent management entrenchment.

The NOBO/OBO rule (similar in its complexity to the current access proposal) was a regulatory solution that satisfied neither shareholders nor corporations. It had a number of unintended consequences, the most important of which were the increased cost of communication and the creation of a monopoly service provider in the role of the "intermediary" appointed by the SEC. The intermediary's role was, and continues to be, the collection of NOBO data from brokers and banks and the preparation of NOBO lists for companies that request them. The high cost of these lists, based on a fee schedule approved by the SEC, raised the ante for all shareholder communications from issuers to beneficial owners.

ADP, the intermediary designated by the SEC to administer the NOBO process, has expanded its role to include all proxy-related communications to beneficial owners as well as the internal tabulation of voting instructions. Virtually all brokers now outsource their proxy record keeping and processing to ADP's ADP-ICS, which is reimbursed for these services based on a fee schedule set by the New York Stock Exchange with the approval of the SEC. This arrangement continues to be highly controversial, primarily for two reasons: first, the absence of competition is believe to sustain an artificially high fee structure and to prevent cost reduction through normal competitive market forces; second, having a single service provider channelling the votes of America's corporations carries the following risks: (1) the calamitous consequences if there were a mechanical failure at ADP-ICS ( a concern that surfaced publicly during the 1993 proxy season); (2) the possibility of fraud or corpo-

rate terrorism directed at the single central proxy utility; (3) the lack of transparency in the back-office mechanics over which ADP-ICS presides; (4) the absence of regulation or other accountability mechanisms for a public function that affects all U.S. public companies and investors.

Elimination of the NOBO/OBO distinction is critical to simplifying the proxy system and reducing its costs. This change would affect part, but not all, of the services currently provided by ADP-ICS. The primary impact would be to eliminate the requirement for a single, exclusive intermediary, thereby enabling other service providers to compete with ADP-ICS in servicing beneficial owners. With beneficial owners empowered to vote and brokers removed from the voting process, the current ADP-ICS system of voting instruction forms and internal tabulation would be unnecessary. Beneficial owners would vote on the same proxy cards used by registered owners (or electronically), simplifying the entire process and eliminating the daisy chain of intermediaries from communications and proxy voting.

Under the simplified proxy system ADP-ICS's role as provider of administrative and record keeping services to brokers and banks would continue, with the important difference that it would no longer be exclusive. ADP-ICS would also continue to provide proxy administration and vote processing services, such as ProxyEdge, to institutional investors, including links to third-party proxy advisors and voting services such as Institutional Shareholder Services (ISS) and Investor Responsibility Research Center (IRRC). Again, the critical difference would be that ADP-ICS would no longer be the exclusive provider of these services. Transfer agents and other service providers would begin to compete for these administrative, record –keeping, and voting assignments, stimulating technological innovation and driving down costs.

The benefits of eliminating NOBO/OBO procedures from the proxy process would be: simplification, greater transparency, increased competition, reduced costs, and greater use of electronic technology for communication and voting. Issuers would have access to the names, addresses, and share ownership of beneficial owners (or their designated nominees) and would be able to communicate with them directly during proxy solicitations. Issuers or their agents (including ADP-ICS) would distribute proxy materials directly to beneficial owners by mail or electronically, just as they now do with registered shareholders. Direct communication with beneficial owners would bypass brokers and banks entirely (except where nominees were used), eliminating the back-office infrastructure now required for distributing proxy materials through multiple layers of custodians and for processing beneficial owners' voting instructions.

This change alone would simplify the proxy system and reduce processing costs substantially, and it would do so without sacrificing the efficiencies that result from centralized record-keeping and householding.

## The 10-Day Rule

NYSE Rule 452 governs the discretionary voting of proxies by brokers on behalf of their customers, who are the beneficial owners shares of held in "street name" accounts. The basic rule dictates that brokers must vote as instructed by the beneficial owners. However, the rule's critical provision permits brokers to vote in their discretion (that in practice means voting as recommended by management) when instructions have not been received from customers, provided that proxy materials have been forwarded in a timely manner. The rule provides further that discretionary broker voting is not permitted on any matter that "may affect substantially the rights or privileges of such stock."[9] The NYSE staff reviews proposals in the proxy statements of all NYSE listed companies to determine if discretionary broker voting will be permitted. The *NYSE Weekly Bulletin* lists shareholder meetings with a check mark or an X by each proposal indicating whether discretionary voting will or will not be allowed. A list of 18 "material" matters is published in sec. 452.11 of the NYSE Constitution and Rules as a guide to the staff's decisions on discretionary voting.

It is worth noting that Nasdaq does not have its own 10-day rule. Nor does it have procedures or a staff assigned to make determinations on discretionary voting. When brokers need guidance on discretionary voting with respect to proposals at Nasdaq companies, ad hoc decisions are usually made by the staff of ADP-ICS, which bases its decisions on NYSE guidelines. However, it seems anomalous that ADP-ICS should be called upon to fill a regulatory void, acting in lieu of a self-regulating organization (SRO) in making potentially important decisions as to which matters are "material" or "routine" at shareholder meetings of Nasdaq companies. Some matters, such as bylaw amendments or bundled proposals, require judgments that arguably should be reserved to SROs and regulators.

This ad hoc, stopgap solution is another example of the proxy system's tendency to deal with operating problems privately and informally, in ways that are far from transparent and often poorly understood by the investing public.

Under the 10-day rule, shareholder resolutions opposed by management are always deemed to be "material." In the rare case where management recommends a vote in favor of a shareholder proposal, discretionary voting is allowed.

This arrangement can result in inconsistencies. For example, the NYSE staff has ruled that brokers may cast discretionary votes for a shareholder proposal to declassify the board of directors when the proposal is endorsed by management.[10] However, a management proposal to classify the board does not qualify for discretionary voting. It is unclear why classification of the board is a material matter but declassification is not.

Discussion of discretionary broker voting has been complicated by disputes over the legal status of "broker non-votes."[11] Although [SH1]the terminology is misleading, broker non-votes represent the difference between the number of votes cast by brokers on "material" proposals pursuant to instructions from their customers (the "instructed" vote) and the number of votes cast by brokers on "routine" proposals (which presumably includes some "instructed" votes plus "discretionary" votes). The status and impact of broker non-votes has become a central issue in the contentious debate over campaigns to withhold votes from directors. As withhold votes play a critical role in triggering nomination rights under the SEC's access proposal, clarification of ambiguities surrounding the definition of "votes cast" under SEC rules and state law will be essential.[12]

As long as the 10-day rule remains in effect it will be impossible to accurately determine the actual voting intentions of beneficial owners in street name accounts. Based on anecdotal evidence,[13] it is clear that many beneficial owners do not understand the highly technical application of Rule 452, much less the complicated procedures that govern the voting of shares they hold in a street name. Sophisticated investors have been known to misconstrue voting instructions and conclude that their shares are always voted by their brokers or always voted for management even when they do not sign a proxy or submit instructions. Despite the use of reminder letters (often written in obscure legalistic terms), beneficial owners often do not pay attention to voting mechanics. These problems are implicit in the chronically low level of instructed votes from beneficial owners, as compared with the consistently high level of votes cast by registered owners.[14]

The reforms suggested by Georgeson and the BRT recognize that the ambiguities created by discretionary broker voting under NYSE Rule 452 must sooner or later be resolved. Elimination of Rule 452 "cold turkey" could cause serious hardship for companies with a high concentration of shares held by retail accounts in broker name. Without discretionary broker votes such companies might have difficulty achieving quorum needed to transact business at their shareholder meetings.[15]

At the same time, the suggested reforms take into account what appears to be an inexorable trend to curtail and eventually eliminate discretionary broker voting. NYSE listing standards now prohibit broker votes on equity compensation plans.[16] The Council of Institutional Investors has for several years been lobbying the Commission to eliminate all broker "non-votes," claiming they amount to nothing more than a form of pro-management "ballot-stuffing." Indeed, the distinction that Rule 452 requires the NYSE staff to make between routine and material proposals is becoming increasingly burdensome and contentious. Given the importance of governance standards and the focus on directors' duties and accountability, the traditional view that the uncontested election of directors at annual meetings is a "routine" matter is now subject to serious challenge.

The suggested proxy system reforms would cause the practice of discretionary voting to disappear by eliminating brokers from the voting process. With brokers no longer responsible for processing their clients' votes, a default to discretionary voting on routine matters would no longer be possible. In addition, elimination of Rule 452 would free the NYSE from the increasingly difficult and questionable task of classifying proposals as routine or material. It would also eliminate the pressure for Nasdaq to establish its own procedure.

## FAQs about Proxy Reform

Regrettably, the contentious public debate over access has overshadowed a reasoned discussion of proxy reform. Some critics of reform, many of whom have an economic stake in the status quo, have sought to characterize the BRT rulemaking petition as an obstructionist tactic designed to impede adoption of the access proposal. In fact, the opposite is true. Proxy reform is needed not just because of the access proposal, but because of widespread changes promoting greater use of the proxy process in corporate governance. These changes include: shareholders' growing demand for a more meaningful role in nominating directors, shareholders' use of proxy votes to influence corporate policy, the declining acceptance of traditional arrangements such as discretionary broker voting, increasing skepticism about the fairness of proxy operations, and the resulting need for a transparent proxy system that can be understood and trusted by both shareholders and issuers.

Public education is an important part of any reform initiative. Here is a list of frequently asked questions and answers about the proxy system changes proposed in the BRT rulemaking petition and the Georgeson comment letters.

*1. Would the proxy reforms proposed by the BRT and Georgeson delay the implementation of the access proposal?*

No. The reverse is true: delay in adopting the access rule is causing delay in proxy reform. Although the access proposal did initially prompt concern about the proxy system, the two issues — shareholder access and proxy reform — involve different questions of law, policy, and regulatory authority. Each should be examined separately and on its own merits. The likelihood that some form of access will be adopted in the near future increases the need for prompt action to improve the proxy system.

*2. Are the suggested proxy reforms intended to help companies mobilize retail investor votes and weaken the power of institutional investors?*

No. This suggestion[17] is based on erroneous assumptions about retail shareholders — that they consistently vote differently from institutions, are more likely to support management, or are unable to perceive what is in the best interest of all investors. There is no evidence to support this characterization. Nor is it appropriate to promote class warfare between retail and institutional investors. Under the U.S. securities laws all shareholders are entitled to receive the same disclosure documents and to make independent voting decisions free of undue influence. Reforms permitting direct communications would facilitate shareholder voting, not alter its outcome.

*3. Would elimination of NOBO/OBO classifications permit beneficial owners to maintain privacy protections and avoid having their identity disclosed to issuers?*

Yes. Under the suggested reforms beneficial owners would be able to set up nominee accounts or other trust arrangements to preserve their privacy, prevent their identity from being disclosed to issuers, avoid receipt of unwanted documents, and participate in voting decisions to whatever degree they prefer. The reforms would have the general benefit of shifting the cost of privacy arrangements to the users, rather than requiring issuers and all shareholders to pay for them. Presumably, beneficial owners with active trading accounts or substantial assets under management would be able to negotiate preferential rates or avoid extra charges.

*4. Would reform of the proxy system cause institutional investors to be subject to more aggressive solicitation and arm twisting by issuers?*

No. The suggested reforms could actually help eliminate some of the unneces-

sary and repetitive communication that now occurs during proxy solicitations because of the systemic inability to identify and confirm receipt of institutional votes. Large institutional investors are already required to disclose their stock ownership on quarterly 13F filings, so their ownership is not confidential. In fact, many institutions want issuers to know how they are voting in order to "send a message." In addition, there is a growing trend, evident in the new rules requiring mutual fund vote disclosure, to increase transparency in the voting process.[18] Many institutions have independently called attention to the need for a proxy audit trail and end-to-end vote confirmation. These objectives could be achieved by the suggested reforms, but they require an open communication process that is incompatible with some institutions' preference to avoid communication with issuers. Institutions must decide which has priority—votes or privacy. Fears of aggressive solicitation and coercion should be substantially discounted. Most shareholders are not coercible. Retail investors generally own too few shares to make coercion practical or worthwhile. Public pension funds cannot be coerced because issuers have no leverage over them and, more important, because the effort would backfire. Coercion can be a concern when investment managers create conflicts of interest by investing in the shares of companies for whom they manage assets. In such cases fiduciary rules are clear that the investment manager must vote in its clients' best interest, not in its own economic interest.[19]

*5. Would proxy reform permit institutional investors to continue using centralized, automated proxy administrative and voting services?*

Yes. Record keeping and administrative services now provided to institutional investors and their custodians, primarily by ADP-ICS, would continue. In a system of direct communication, ADP-ICS would assemble, consolidate, and deliver the record date beneficial owner lists. ADP-ICS would also maintain the records of delegated voting power that would be the basis for a proxy audit trail. However, the elimination of NOBO/OBO classifications would mean that a single intermediary would no longer be mandated, thereby ending the exclusivity of the ADP-ICS role, opening up opportunities for competition, reducing costs, and eliminating the need for the NYSE to maintain a fee schedule for proxy services.

*6. Is proxy reform intended to eliminate discretionary broker voting?*

No. NYSE Rule 452, the 10-day rule, permitting brokers to cast discretionary votes on routine matters at shareholder meetings, has already been curtailed by

NYSE listing standards and is likely to be cut back further. Shareholder activists, led by CalPERS and the Council of Institutional Investors, have lobbied for its complete elimination since 1989. Given the difficulty of justifying discretionary votes for directors in today's rigorous governance environment, further curtailing of the rule or its complete demise seems likely. The suggested reforms would eliminate the need for the 10-day rule, but would offset the loss of broker votes by establishing direct communication with beneficial owners.

*7. With direct communication would the confidentiality of brokers' customer relationships be preserved?*

Yes. Although the proposed reforms call for the creation of record date lists of beneficial owners, broker affiliation would not be disclosed on those lists and would not be made available to third parties, except in cases where verification of voting results required an audit. Audits would presumably be conducted confidentially by independent inspectors of election under court order. Broker account information is currently accessed by ADP-ICS for the creation of NOBO lists. The creation of record date beneficial owner lists would follow the same procedures and would not put brokers' account relationships at any additional risk. (See "Eliminating NOBOs and OBOs," above.)

*8. Would the suggested reforms impact beneficial owners negatively in the same manner as Canada's National Instrument 54-101, which gives beneficial owners who choose anonymity the choice to either pay the distribution costs for proxy material or not receive it?*

No. Corporate issuers in the U.S. are legally obligated to distribute proxy material to all shareholders and to pay the related costs. Elimination of NOBO/OBO distinctions would not remove this obligation. Under the suggested reforms, issuers would still be obligated to distribute material to all shareholders, including beneficial owners, and to pay the expenses of doing so. The only additional cost for a beneficial owner who chose anonymity would be for the maintenance of a nominee account. Institutional investors in the U.S. already bear the costs of their custodial arrangements.

*9. Would the suggested reforms necessitate an overhaul of other market structures or interfere with administrative and back-office procedures?*

No. The suggested reforms are limited to proxy communications and share voting. They would take effect only on the record date for a shareholder meeting and would apply only to the production of ownership records and the

assignment of voting rights. Underlying arrangements for trading, transfer, and account administration would be unaffected by these limited procedural changes.

## Conclusion

The goal of the access rule, in the words of the Securities and Exchange Commission, is to enable shareholders to "participate meaningfully in the proxy process for the nomination and election of directors." In drafting its proposal the Commission focused on director nominations without addressing reform of the proxy process. This approach is analogous to renovating a house without updating the wiring and plumbing. The house may look good, but its systems won't work and it won't be liveable.

Despite the controversy and delays, the access proposal has already substantially altered the governance environment in the United States. Activist shareholders during the 2004 proxy season began to shift their strategy away from rule 14a-8 resolutions in favor of withhold and just-vote-no campaigns. These actions were clearly taken in anticipation of the access rule being adopted.

For all the reasons discussed above, the proxy system's wiring and plumbing must be upgraded to meet the demands of twenty-first century corporate governance. The benefits are clear: First, reform would provide transparency to the proxy system, eliminating unnecessary infrastructure, taking the wraps off back-office practices, and allowing every step of the process to be monitored. Second, it would permit the creation of an audit trail, an essential accountability mechanism for the confirmation of close votes and contested solicitations. Third, it would permit end-to-end vote confirmation, enabling investors to be certain that their votes reach the tabulator and are cast in accordance with their instructions. Fourth, reform would reduce reliance on controversial and outdated practices, such as the 10-day rule, without causing investor disenfranchisement or loss of votes. Fifth, it would enable issuers to learn more about who owns their stock and facilitate their communications with all shareholders. Sixth, reform would encourage greater use of electronic communications and share voting, reducing reliance on printed documents, thus speeding up the solicitation process and lowering costs. Seventh, reform would simplify the proxy system's cost structure by eliminating bureaucracy and obsolete procedures, introducing competition, and permitting fees to be set by market forces rather than by regulators and SROs.

The question is when and how reform can be implemented. The access

proposal continues to polarize investors and the business community. Shareholder advocates are so eager to obtain nominating rights that they reject any criticism of Rule 14a-11, including calls for proxy reform, which they believe will cause delay. Many issuers are equally firm in their conviction that the issues of regulatory authority, federalism, and governance integrity at stake in the access rule are of greater urgency than proxy reform.

In this highly charged environment it continues to be difficult to focus public attention on the merits of restructuring the proxy system. As in the case of the Sarbanes-Oxley Act, an industry crisis may be required to mobilize interest in the issue, with the risk that Congress will become the agent of reform rather than industry experts and the Securities and Exchange Commission.

## NOTES

1. Proposed Rule: Security Holder Director Nominations, SEC Release N. 34-48286 (October 14, 2003).

2. Request for Rulemaking Concerning Shareholder Communications, submitted by the Business Roundtable April 12, 2004, at www.sec.gov.

3. Comment letters dated December 12, 2003 and April 12, 200 in connection with SEC release No. 34-48286, at Note 1, above; and comment letter dated May 3, 2004 in connection with the Business Roundtable rulemaking petition, at Note 2, above.

4. New York Stock Exchange Constitution and Rules, paragraph 2452, Rule 452.

5. See, Georgeson Shareholder Communications Inc. "Annual Corporate Governance Review — Shareholder Proposals and Proxy Contests, 2003," p. 34, at www.georgesonshareholder.com.

6. Ibid., p. 34, "In line with the NYSE, Georgeson defines contested solicitations as campaigns where dissidents distribute a separate proxy card. Hence a "Just Vote No" campaign . . . is not included," See also SEC Rule 14a-2(b) (1) for the definition of an "exempt" solicitation.

7. *The MONY Group Inc. v. Highfield Capital Management LP et al.,* United State Court of Appeals for the second Circuit, Docket No. 04-0678.

8. See., e.g., "Share Lending vis à vis Voting: A Report Commissioned by the International Corporate Governance Network," at ww.icgn.org.

9. NYSE Rule 452.11: "When member organization may not vote without customer instructions."

10. NYSE Rule 452.11, Item 12, as amended, states: Generally speaking, a member organization may not give a proxy vote without instructions from beneficial owners when the matter to be voted upon: . . . (12) authorizes the implementation of any equity compensation plan, or any material revision to the terms of any existing equity compensation plan (whether or not stockholder approval of such plan is required by subsection 8 of Section 303A of the Exchange's Listed Company Manual).

11. For a comprehensive discussion of this issue, see "The Director Election Process: Analysis and Alternatives," by Robert Todd Lang, presented at the Annual Meeting of the American Bar Association, August 9, 2004, and scheduled to be published in the September, 2004 issue of *Insights* and also, in this publication, Robert Todd Lang, "The Director Election Process: A Governance Resolution of A Governance Problem," September 2004.

12. Ibid.

13. See, John C. Wilcox, "What Next for the 10-Day rule?" in the *Corporate Governance Advisor,* September/October 2003, p.12.

14. Instructed votes from beneficial owners average less than 30% of shares owned, whereas registered owners respond at an average rate in excess of 80% of shares owned. These statistics reflect the author's own observations of proxy solicitations conducted by Georgeson.

15. See Wilcox, op cit, p. 14.

16. See note 10.

17. Stephen Deane, "Business Roundtable Proposal Emphasizes Votes of Retail Investors," *The Friday Report,* April 23, 2004, at www.ISSproxy.com.

18. Investment Company Act of 1940, Release No. 25922 (Jan. 31, 2003) and Rule 30b1-4.

19. Investment Advisers Act of 1940, Release No. 2106 (Jan. 31, 2003), Rule 206 (4)-6, and the Egan-Jones no-action letter dated May 27, 2004.