# The System Isn't Broken: A Legislative Parade of Horribles

Martin Lipton, David A. Katz and Laura A. McIntosh*

In the first eleven months of 2009, regulators and lawmakers have proposed a dizzying array of reforms that, if implemented, would exacerbate short-termism, undercut directorial discretion, further empower institutional investors and shareholder activists, and impose unnecessary and potentially costly burdens on public companies. Few of the proposed reforms are truly new, and nearly all are ill-conceived. They appear to proceed in part from a misguided impulse on the part of regulators and lawmakers to be seen as "doing something" about the current recessionary environment—though hardly any of the proposed reforms have even a remote connection to the origins of the credit crisis that precipitated the economic downturn—and in part from an opportunistic desire to use the financial crisis as an excuse to enact an activist "wish list" of reforms. Politicians and regulators are using the financial crisis and current economic environment to promote an agenda that could significantly change the landscape of corporate America.

Members of Congress, the Department of the Treasury and the Securities and Exchange Commission (SEC) all are currently engaged in putting forth corporate governance initiatives. The proposed reforms include shareholder proxy access rules, corporate governance proxy disclosure requirements, executive compensation proxy disclosure requirements, requirements as to the structure, composition and election of the board of directors, executive compensation clawbacks, say-on-pay referendums, independence requirements for compensation committees and their outside consultants, supermajority shareholder approval of "excessive" pay, and mandatory majority voting. Pending federal legislation includes the Shareholder Bill of Rights Act of 2009 (Bill of Rights Act),[1] sponsored by Senators Charles Schumer and Maria Cantwell, the Shareholder Empowerment Act of 2009 (Empowerment Act),[2] sponsored by a group of Representatives, the Excessive Pay Shareholder Approval Act (Excessive Pay Approval Act),[3] sponsored by Senator Richard Durbin, the Treasury's Investor Protection Act of 2009 (Investor Protection Act), the Corporate and Financial Institution Compensation Fairness Act of 2009 (Compensation Fairness Act),[4] sponsored by Representative Barney Frank and the

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* Martin Lipton and David A. Katz are partners at Wachtell, Lipton, Rosen & Katz in New York City. Laura A. McIntosh is a consulting attorney for the firm.

1 Shareholder Bill of Rights Act of 2009 (S. 1074).

2 Shareholder Empowerment Act of 2009 (H.R. 2861).

3 Excessive Pay Shareholder Approval Act (S. 1006).

4 Investor Protection Act of 2009; *see also* U.S. Department of the Treasury Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees, TG-218 (July 16, 2009); U.S. Department of the Treasury Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: Say-On-Pay, TG-219 (July 16, 2009). The Investor Protection Act addresses say-on-pay and compensation committee independence; the Compensation Fairness Act (as initially proposed on July 21, 2009), which was passed by the House Financial Services Committee on July 28 and by the House on July 31, includes those provisions and goes further to prohibit excessively risky compensation practices at financial institutions. Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269) (as passed on July 31, 2009). The Investor Protection Act, with amendments, was approved by the House Financial Services Committee on November 4, 2009.

Restoring American Financial Stability Act of 2009 (Financial Stability Act),[5] a draft of which was introduced by Senator Christopher Dodd.

Amidst this veritable avalanche of reform, the SEC has already approved the New York Stock Exchange's (NYSE) proposal to eliminate broker discretionary voting in uncontested elections beginning next year.[6] The elimination of broker discretionary voting is likely to have far-reaching impacts, although the effects will be felt differently by public companies depending on their relative size and their specific shareholder profile.

The key features of the proposed regulatory and legislative initiatives are discussed below. If these proposals are adopted substantially as proposed, they are likely to have a lasting impact and further impede the ability of American public companies to compete in the global marketplace.

*Shareholder Proxy Access*

The latest chapter in the continuing saga of proxy access began in June 2009 as the SEC released proposed proxy access rules for the third time this decade.[7] The first proposal, in 2003, was the subject of fierce debate—the SEC received a record number of comment letters on the proposal—and was shelved in 2004.[8] The prevailing sentiment at that time was that the issue of proxy access was highly complex and carried many hidden consequences. For a time, it appeared that the issue had been largely superseded by the widespread adoption of a majority voting standard for the election of directors. In 2007, in response to a court ruling that unsettled the SEC's long-held position that shareholder proposals on proxy access could be excluded from the proxy statement,[9] the SEC took the unusual step of issuing two conflicting alternative proposals on shareholder access, each approved by 3-2 votes of the SEC Commissioners.[10] Later that year, the SEC voted to continue its policy of permitting companies to exclude shareholder proposals relating to board nominations or director elections from the company proxy statement. Now comes the latest installment, and, under the new leadership of SEC Chairman Mary Schapiro, the SEC seems poised to take definitive action even over the strong objections of two Commissioners.[11] The SEC comment period ended August 17, 2009, and the SEC, which

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[5] Restoring American Financial Stability Act of 2009 (Nov. 10, 2009 Discussion Draft introduced by Sen. Dodd). The discussion draft of the Financial Stability Act is 1136 pages, of which approximately 19 pages relate to corporate governance matters. The discussion draft takes a different approach on many of the corporate governance matters by using the SEC's power to approve the listing standards of national stock exchanges as opposed to simply preempting state law.

[6] SEC Release No. 34-60215; File No. SR-NYSE-2006-92 (July 1, 2009). *See also* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: SEC Revisits Shareholder Access to Director Nominations," NYLJ, Aug. 30, 2007; David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Proxy Access—Not Then, Not Now," NYLJ, Sept. 28, 2006.

[7] SEC Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09 (June 10, 2009).

[8] SEC Release No. IC-26206 (Oct. 14, 2003).

[9] *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006).

[10] SEC Release No. 34-56160 (Aug. 3, 2007) and SEC Release No. 34-56161 (Aug. 3, 2007).

[11] Separately, proxy access is an element of the proposed Bill of Rights Act. The Financial Stability Act gives the SEC authority to adopt, and then directs that the SEC adopt, proxy access rules within 180 days of the proposed

originally had announced its intention to adopt final rules by November 2009 to be in place for the 2010 proxy season, has deferred any action on the proxy access proposal until early 2010 as recently indicated by SEC Chairman Schapiro:

> I am committed to bringing final rules to the full Commission for consideration early in 2010. We recognize that this timing means that any new rules will not be in effect for the 2010 proxy season, but we think it's far more important that we adopt the right rules — rules that make sense and are workable — than it is for us to act rashly.[12]

As part of its proposal, the SEC raised more than 500 questions that it asked be addressed in the comment process. In response, the SEC received more than 500 letters from a variety of sources: private investors, shareholder activists, corporate raiders, public companies, chief executive officers, law firms, law school and business school professors, individual directors, entire boards of directors and other interested parties.[13]

This most recent proposal from the SEC, like the previous iterations, requires issuers to include in their proxy materials director nominees proposed by shareholders who satisfy ownership and other requirements. Any shareholder or group of shareholders that has held at least one percent of the stock of a public company (with larger thresholds for Small-Cap companies) for at least a year would be entitled to have their proposed nominees for up to 25 percent of the entire board included in the company's proxy statement and on its proxy card, on a first-come, first-served basis. Under this proposed rule, exclusion of proposals related to elections and nominations would be permitted only in very narrowly defined circumstances.

The SEC's proposed approach is both unwise and unnecessary. The one percent threshold is extremely low[14] and will further empower activists to manipulate the corporate process in pursuit of their own agenda. The first-come, first-served procedure proposed by the SEC will give shareholders a perverse incentive to rush to nominate directors to ensure their place in line. Moreover, the SEC proposed rule does not require a nominating shareholder to hold, or even to state a commitment to hold, stock in the company for any period of time if it succeeds in electing a nominee to the board. It would be detrimental to provide increased rights

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bill's enactment. On November 4, 2009, the House Financial Services Committee approved an amendment to the Investor Protection Act offered by Representatives Maxine Waters and Gary Peters that would give the SEC specific legal authority to implement proxy access rules. The Committee then approved the Investor Protection Act, as amended, by a 41 to 28 vote. *See* Jessica Dye, "House Panel Tweaks, Clears Investor Protection Bill," Law360 (Nov. 4, 2009).

[12] Chairman Mary Schapiro, Address to the Practising Law Institute's 41st Annual Institute on Securities Regulation (Nov. 4, 2009).

[13] These letters can be found at http://sec.gov/comments/s7-10-09/s71009.shtml.

[14] RiskMetrics Group, a public company formerly known as Institutional Shareholder Services or ISS, generally has a four percent threshold for shareholder nominations to be included in the proxy statement: "Our bylaws set forth the provisions by which we will include in our proxy materials the name of a person nominated by one of our shareholders, or group of our shareholders, who meets specified requirements for election as a director. Generally, a nominating shareholder must have owned at least 4% of our outstanding common stock continuously for at least 2 years and must provide notice to us in accordance with our bylaws." *See* RiskMetrics Group Proxy Statement dated Apr. 29, 2009 at 6, available at http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDI2NXxDaGlsZElEPS0xfFR5cGU9Mw==&t=1.

to shareholders who are free to seek short-term gain through the manipulation of board composition (and perhaps corresponding movements in stock price) without requiring such shareholders to continue to have an economic stake in the company. If the point of requiring a nominating shareholder to hold a substantial number of shares is to be sure that the shareholder has real "skin in the game," that shareholder ought to be obliged to maintain its "skin" for some period should its nominee be elected.

Overall, the proposal raises issues of enormous complexity, as the SEC evidently recognized in the large number of questions on which it sought comment. As has been true from the beginning of the proxy access debate, opening shareholder access is a step that could have the negative effects of causing corporate disruption and waste, deterring qualified candidates from standing for election and undermining the effectiveness of board processes. Shareholders have always had the ability to nominate directors for election and have had great success in placing directors on many boards.[15] It is highly debatable whether such nominations need to be facilitated further by providing shareholders with access to the company's own proxy statement, especially at a time when shareholders increasingly follow regimented, one-size-fits-all voting recommendations from proxy advisory firms. While it is difficult to predict, many observers believe that adoption of anything like the SEC proposed proxy access regime would result in a very significant increase in shareholder nominations and proxy contests. Some leading mutual funds supposedly are considering whether to form a clearinghouse of potential board candidates to be available for shareholder nominations at companies that are targeted for proxy access and are even reconsidering long-standing polices against offering their own employees or consultants as candidates.[16]

Delaware has demonstrated that there is a sensible alternative to the federalization of an important area of state corporate law. In April 2009, Delaware enacted legislation enabling the adoption—via board action or shareholder initiative—by Delaware companies of bylaws permitting shareholder access to company proxy materials.[17] Delaware's private-ordering approach, which can be effected by carefully drafted company bylaws, enables companies and their shareholders to tailor proxy access to their own specific circumstances and keeps the issue of proxy access in the proper realm of state law. Federalizing proxy access on a one-size-fits-all basis was a terrible idea in 2003 and again in 2007. It is no better now. The financial crisis does not provide any rationale for the federal government to overrule state corporate law statutes and private ordering that it has not even given a chance to be applied in practice.

In addition, the role of the board of directors is an element that appears to be absent from the debate about shareholder access to the company's proxy materials; the SEC should not be mandating a process that could lead to dysfunctional boards of directors of public

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[15] *See, e.g.*, Business Roundtable, Written Testimony for the Record of John Castellani, President, Before the Senate Banking Subcommittee on Securities, Insurance and Investment; Protecting Shareholders and Restoring Public Confidence by Improving Corporate Governance (July 29, 2009) at 14–20 (discussing shareholders' various abilities to make their views known to the companies they invest in—from direct communication to the board to shareholder proposals to withhold vote campaigns to proxy contests).

[16] *See* Stephen Davis and Jon Lukomnik, "Take Heed: Investors Empowered on Proxy Access," Compliance Week (July 14, 2009).

[17] Delaware Gen. Corp. L. § 112 (effective Aug. 1, 2009).

companies at little or no cost to the proponents. SEC Commissioner Troy Paredes recognized the importance of collegial decision-making in a recent speech to independent directors:

> What makes for an effective board of directors?
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> . . . .
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> Boards of directors are expected to improve decision making by spurring deliberation. In acting as a body, the promise is that boards will draw on the distinct perspectives, experiences, sensibilities, and expertise that different directors offer. The expectation is that as the group works through a range of ideas and arguments, the ultimate decision will be better as a result of the directors' collective efforts.
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> The active engagement of directors is a lynchpin of meaningful deliberation. Decision making should improve when directors—whether interacting with each other or with management—engage in open and frank discussions, even if it means being critical. When assessing some course of action, directors should ask probing questions and follow-ups of each other and of management; should challenge key assumptions; should offer competing analyses; and should develop competing options to ensure that alternatives are considered and not cast aside too readily. Put differently, directors should be willing to dissent, and disagreement from others should not be discouraged or suppressed. When it leads people to engage rigorously, disagreement helps ensure that the unknown is identified, that information is uncovered, and that challenges and opportunities are assessed in a more balanced way. Indeed, a board may want to consider designating one or two directors whose express charge is to be skeptical and to press when needed.
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> However, there is a word of caution. Disagreement and spirited deliberation should not give way to hostility. Distrust and disharmony can threaten an enterprise; boards need collegiality and cooperation. Dissent will be most constructive, then, when conflicting viewpoints and pointed resistance do not trigger defensiveness, but instead are encouraged as catalyzing better decisions.[18]

*Executive Compensation*

Proposed legislation concerning executive compensation addresses both disclosure requirements and specific corporate practices. The Empowerment Act would require all publicly-traded companies to disclose specific performance targets used to determine senior executive officers' eligibility for bonus, equity and incentive compensation. Furthermore, the Empowerment Act would require all publicly-traded companies to develop and disclose a policy for reviewing any unearned bonus, incentive or equity payments that were awarded to executive officers owing to fraud, financial statements that require restatement or some other cause. This mandatory "clawback" obligation would require recovery or cancellation of such unearned payments to the extent feasible or practical. The Financial Stability Act would require, in the event of accounting restatements due to material noncompliance with financial reporting

[18] SEC Commissioner Troy A. Paredes, Remarks at Independent Directors Council's 2009 Investment Company Directors Conference (Nov. 13, 2009).

requirements, recovery of amounts in excess of what would have been paid under the restated financial statements from any current or former executive who received incentive compensation (including stock options) during the three-year period preceding the date that restatement is required. In contrast, the clawback provision of the Sarbanes-Oxley Act of 2002 covers only the chief executive officer and chief financial officer, applies only if the noncompliance results from misconduct, and relates to compensation events during the year following the misstatement. In an unprecedented approach, the SEC is currently pursuing two cases against CEOs—using Section 304 of the Sarbanes-Oxley Act of 2002[19]—for clawbacks of incentive payments. The SEC has not alleged that either CEO personally engaged in misconduct, but simply that the incentive payments and bonuses were earned based on misstated financial results. In one case the SEC filed a complaint against the CEO[20] and in the other case the SEC staff issued a "Wells" notice indicating its preliminary recommendation that the SEC commence an action against the executive.[21]

The Investor Protection Act, delivered to Congress by the Department of the Treasury, would mandate non-binding, advisory say-on-pay votes on executive compensation packages for each annual meeting and for "golden parachute" arrangements for executives in the context of a change-in-control transaction. The Investor Protection Act also would require disclosure of such arrangements, the conditions upon which they may become payable and the aggregate amount of all such compensation. The Bill of Rights Act, sponsored by Senators Schumer and Cantwell, and the Financial Stability Act, introduced by Senator Dodd, would mandate would mandate separate annual non-binding shareholder votes to approve the compensation of named executive officers. The Bill of Rights Act would require shareholder approval of "golden parachute" arrangements in the context of a change-in-control transaction at any shareholder meeting concerning an acquisition, merger or similar transaction. The Financial Stability Act would direct the SEC to adopt rules requiring shareholder approval of "golden parachute" arrangements in the context of a change-in-control transaction for any principal executive officer, to the extent not previously approved by shareholders.

The Excessive Pay Approval Act would require an annual supermajority shareholder vote to approve "excessive compensation" of any employee of a public company. "Excessive compensation" is defined as compensation (broadly defined to include fringe benefits, bonuses and any other form of remuneration) to an employee of a public company in any year exceeding an amount equal to 100 times the average compensation for services performed by all employees of that company during such year. The proxy statement seeking the supermajority shareholder approval would need to disclose the compensation paid to the lowest paid employee, the highest paid employee, the average compensation paid to all employees, the number of employees who are paid more than 100 times the average compensation for all

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[19] 15 USC § 7243 (Forfeiture of certain bonuses and profits).

[20] *See* SEC v. Jenkins, Case No. 2:09-cv-01510-JWS (D. Ariz., filed July 22, 2009).

[21] *See* Item 8.01 of Form 8-K for Beazer Homes USA Inc. filed Nov. 16, 2009 ("the Staff of the . . . Commission issued a Wells notice to the Company's Chief Executive Officer, Ian J. McCarthy, indicating that they have preliminarily determined to recommend that the Commission bring a civil action against him to collect certain incentive compensation and other amounts allegedly due under Section 304(a) of the Sarbanes-Oxley Act of 2002 . In their Wells notice, the Staff did not allege any lack of due care by Mr. McCarthy in connection with the Company's financial statements or other disclosures.").

employees and the aggregate compensation paid to employees who are paid more than 100 times the average compensation.

The Compensation Fairness Act, passed by the House of Representatives on July 31 and containing the most extreme compensation-related legislative proposal of all, would—in addition to requiring non-binding shareholder votes on executive compensation and "golden parachute" arrangements—authorize federal regulators to prohibit any compensation or incentive pay that regulators determine encourages "inappropriate risks." This would apply to broadly defined "financial institutions" (a term which could include any financial institution with more than one billion dollars in assets that "the appropriate federal regulators" determine should be covered). Under the bill as passed by the House, all "financial institutions" would be required to disclose compensation structures that include any incentive-based elements; federal regulators would review incentive compensation structures at all covered financial institutions and make determinations as to whether the compensation promoted undue risk. As noted by the U.S. Chamber of Commerce in a letter to the Chairman and Ranking Member of the House Committee on Financial Services, the Compensation Fairness Act would "constitute an unprecedented governmental intrusion into matters that have historically been addressed by private actors."[22]

The Compensation Fairness Act also includes non-binding annual shareholder votes on compensation for top executives at all public companies as well as on golden parachutes.[23] In addition, the version adopted by the House of Representatives included an amendment to the Compensation Fairness Act, proposed by Representative Mary Jo Kilroy, requiring that institutional investors with greater than $100 million in assets annually report publicly how they voted on say-on-pay and golden parachute votes.[24]

Further, the Investor Protection Act would require all public company compensation committee members and their advisors to be independent (using new, stricter independence standards than those currently in place at the NYSE) and, if a compensation committee did not hire an independent compensation consultant, the Investor Protection Act would require disclosure as to why the committee determined not to do so.[25] The Financial

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[22] U.S. Chamber of Commerce, "Letter on H.R. 3269, the 'Corporate and Financial Institution Compensation Fairness Act of 2009'" (July 27, 2009). The Chamber also noted that "In many firms, because incentive compensation plans range from the CEO to the receptionist, these provisions would place the federal government in the position of regulating compensation for all, or a vast majority of, employees in a company. This would be particularly intrusive when coupled with the provisions of H.R. 3126 which would allow the proposed Consumer Financial Protection Agency to regulate the compensation of employees who interact with consumers, regardless of industry, such as real estate agents, or even cashiers who accept credit cards."

[23] The Chamber of Commerce commented that "The "Say on Pay" provisions can be improved by making the votes triennial and providing for a 5 year opt-out if approved by a super-majority of shareholders." *Id.*

[24] Amendment to H.R. 3269 Offered by Ms. Kilroy. *See also* Proxy Voting Transparency Act of 2009 (H.R. 3351). Currently, hedge funds and public pension funds do not have to report the results of their proxy votes, though mutual funds do. *See also* Alicia Caramenico and Ted Allen, "House Committee Approves 'Say on Pay' Bill," RiskMetrics Group Risk & Governance Blog, July 29, 2009.

[25] The Compensation Fairness Act also requires that all compensation committee members be independent directors and that all compensation consultants be independent, the latter under new independence criteria established by the SEC.

Stability Act would require compensation committee members to satisfy independence standards to be established by the applicable stock exchange. The Financial Stability Act would also require compensation consultants, legal counsel and other advisers to the compensation committee to be "independent," based on rules to be promulgated by the SEC. Moreover, the Financial Stability Act would authorize compensation committees to retain independent advisors and would require compensation committees to oversee the advisers they retain.

Executive pay has long been a touchstone for debate and an easy target for populist-minded reformers. Disclosure and communication are key elements in the process of harmonizing company goals and shareholder interests. Say-on-pay legislation may have superficial appeal to certain groups, but there is no reason to believe that it would increase communication between companies and their shareholders. There is not even a shareholder consensus in favor of say-on-pay proposals.[26] It is clear that say-on-pay would increase the ability of RiskMetrics and other proxy advisory firms to substitute their judgment for that of the board of directors in establishing compensation. Some chief executive officers have raised concerns that say-on-pay could lead to further government intervention and shareholder micromanagement with the result that talented executives could leave public companies for privately-held firms. Other chief executive officers have expressed concerns that institutional shareholders or hedge funds could use a say-on-pay policy to attempt to coerce management into making certain short-term decisions that would not be in the company's best long-term interests.[27]

The fact is that the directors, and not the shareholders, are charged with the responsibility of determining executive compensation. Indeed, despite the furor that has raged in activist circles for years over executive compensation, directors should be confident in following normal procedures, with the advice of an independent consultant and the company's legal counsel, as they make decisions on executive pay—decisions that must take into account complex concerns of not only aligning incentives and risks but also of retention. Case law is clear that courts will protect decisions on executive pay made by directors on an informed basis, in good faith, and without a taint of self-interest. In the current environment, directors would be well-advised to structure compensation that links pay with the long-term performance of the company and to avoid compensation that might encourage undue risk.[28] It is properly the province of the directors to determine executive compensation, and it would be a mistake for shareholders to attempt to usurp or undermine the proper functioning of the board in this critical area.

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[26] For a discussion on say-on-pay proposals during the 2009 proxy season, *see* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: 2009 Proxy Season Review and a Look Ahead to 2010," NYLJ, Oct. 29, 2009; *see also* RiskMetrics Group Postseason Report, Oct. 2009, at 24-25.

[27] *See* Del Jones, "CEOs openly oppose push for say-on-pay by shareholders," USA Today, July 15, 2009 ("For example, certain investors could threaten to vote "no" on the CEO's pay to coerce the CEO into making decisions for short-term gain, such as delaying capital investment or taking on unnecessary debt. Such tactics could temporarily boost the stock price to the detriment of the company's long-term health").

[28] *See* Martin Lipton and Jeremy L. Goldstein, "Executive Pay and Directors' Duties," July 20, 2009.

*Broker Discretionary Voting*

In July, the SEC approved the NYSE's proposal to eliminate broker discretionary voting in uncontested elections.[29] As a result, effective in the 2010 proxy season, brokers will not be able to vote on behalf of clients who fail to provide voting instructions in uncontested director elections at NYSE-listed companies. This is a significant change, as broker votes accounted for approximately 19.1 percent of votes cast during the 2009 proxy season. In addition to increasing the proxy solicitation expenses for annual meetings, the rule change is expected to have the even more deleterious effects of significantly empowering activist and institutional shareholders, marginalizing retail shareholders, and precipitating more frequent board changes.[30] According to SEC Chairman Schapiro: "The rule change . . . is designed to help assure that voting rights for matters as critical as the election of directors are exercised by those with an economic interest in the company, rather than by brokers. I believe this will improve corporate governance and enhance accountability."[31]

The impact of the elimination of broker discretionary voting in uncontested elections is likely to depend primarily on two factors: the relative size of the public company and its shareholder composition. To generalize, public companies can be divided into four groups: Large- or "Mega"-Cap companies, Mid-Cap companies, Small-Cap companies and Controlled companies; each of these types of companies will fare differently with the elimination of broker discretionary voting. Each of these types of companies may face quorum issues in situations where the quorum is not established through routine proposals like the ratification of auditors, although this is most likely to be a problem for Mid-Cap and Small-Cap companies, since generally they have higher percentages of retail shareholders.

Controlled companies generally should not be affected by the elimination of broker discretionary voting, even in situations where the controlling shareholders do not have an absolute majority of the outstanding shares, since the voting outcome is likely to arrive at the same result whether or not the brokers can vote. Moreover, controlled companies are the least likely to be targeted by hedge funds and other activists.

Large- or "Mega"-Cap companies are likely to see the next smallest impact with the elimination of broker discretionary voting, as they tend to have the highest percentage of institutional ownership (estimated to be in the neighborhood of 75 percent[32]). However, since

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[29] Separately, the Empowerment Act also includes a prohibition on broker discretionary voting for all publicly-traded companies.

[30] For an in-depth discussion of the issues raised by this rule, *see* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Activist Shareholders Would Gain Power from Proposed Rule Change," NYLJ, Mar. 27, 2009.

[31] Chairman Mary Schapiro, Address to the Practising Law Institute's 41st Annual Institute on Securities Regulation (Nov. 4, 2009). Chairman Schapiro recognized that "the implementation of the revised rule heightens concerns about shareholder participation and education, which need to be addressed", indicating that the SEC "staff is working hard on these education efforts . . . ." *Id.*

[32] According to the Conference Board, institutional investor ownership in the largest 1,000 U.S. public companies increased from an average of 46.6 percent in 1987, to an average of 61.4 percent by 2000, to an average of 76.4 percent by year-end 2007. Conference Board Press Release, "U.S. Institutional Investors Boost Ownership of U.S. Corporations to New Highs, Reports the Conference Board; Pension Funds Make Growing Investments in Hedge Funds," Sept. 2, 2008.

institutional investors tend to provide direction on how to vote their shares, they are likely to have even greater power at the ballot box, since a lower percentage of the outstanding shares will be voted. This is likely to increase institutions' and activists' ability to run successful withhold vote campaigns.

Mid-Cap companies tend to have a lower percentage of institutional ownership and therefore are likely to face a more substantial impact from the elimination of broker discretionary voting. Assuming institutional ownership in the range of 30 to 35 percent, Mid-Cap companies, in certain circumstances, are likely to be unduly influenced by proxy advisory firms such as RiskMetrics. For example, in such a company, if RiskMetrics recommended to its institutional clients that they withhold votes in a director election, prior to the elimination of broker discretionary voting, there would be a significant likelihood that as a result of broker discretionary voting, the withhold vote campaign would fail. However, with the elimination of broker discretionary voting, under those same circumstances, the institutional shareholders, who generally follow the recommendations of the proxy advisory firms in uncontested elections, would prevail in a withhold vote campaign. As more and more companies adopt a majority voting standard for the election of directors (which may become mandatory[33]), withhold vote campaigns will be increasingly meaningful, as they will give shareholders the ability to block directors from being elected and potentially force the resignation of incumbent directors,[34] For the company to prevail in such circumstances, it would need to hire a proxy solicitor and expend significant resources and funds in an effort to communicate with the underlying shareholders and to attempt to get them to vote.

Small-Cap companies are likely to fare the worst as a result of the elimination of broker discretionary voting, since they tend to have the largest percentage of retail shareholders.[35] Therefore, these companies, who are likely to be the least able to spend additional funds in any economic environment, will face the greatest need to do so. Unless the Small-Cap companies can get their retail shareholders to vote their shares (which will take a concerted effort by these companies and their proxy solicitors), they are unlikely to achieve satisfactory vote levels. Moreover, since public companies need to publicly disclose their voting results, these companies are likely to be viewed as very attractive targets by hedge funds and other activist investors; for a relatively small investment, these activists will be able to exert great influence at a shareholder meeting, in many cases dictating the outcome.[36]

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[33] The Bill of Rights Act and the Empowerment Act would require all publicly-traded companies to elect directors under a majority-voting standard.

[34] *See* David A. Katz and Laura A. McIntosh, "Director Elections and Majority Voting," NYLJ, Dec. 29, 2005.

[35] The SEC clearly recognizes the significance of this issue. In a recent speech, Chairman Schapiro stated: "Retail investors have a history of low participation rates, but notice and access distribution of proxy materials may contribute to a further reduction in participation rates. This poses a special challenge for companies with broad retail investor bases. That is why some have proposed client-directed voting—where brokers would be allowed to solicit voting instructions from their shareholder clients in advance of the company proxy materials." Chairman Mary Schapiro, Address to the Practising Law Institute's 41st Annual Institute on Securities Regulation (Nov. 4, 2009).

[36] In both the United States and Europe, the median market capitalization of a target company has fallen from $275 million in 2008 to $75 million in 2009, while proxy fights have increased this year by 27%. *See* Sam Jones and Lina Saigol, "Activist Investors Eye Smaller Prey," FT.com, July 23, 2009.

### *Board Requirements*

Nowhere is the usurpation of board discretion more egregious than in the numerous proposed reforms directed at the composition and structure of the board of directors. The Bill of Rights Act and the Empowerment Act would require all publicly-traded companies to split the role of board chairman and chief executive officer.[37] The chairmanship would be required to be held by an "independent" director. The proposed legislation offers varying definitions of "independence" and could result in a more stringent definition than the one currently used by the NYSE.[38] The Financial Stability Act has a weaker requirement than the Bill of Rights Act, only requiring companies to disclose in their annual meeting proxy statements why they have chosen either to separate or not to separate the positions of the board chairman and the chief executive officer.

Director independence became a touchstone of corporate governance via regulatory and legislative reforms in the wake of the Enron, WorldCom and Adelphia scandals. Standards of independence now are firmly ingrained in corporate culture and, disturbingly, due to the efforts of activist shareholders and proxy advisory firms, are periodically being further increased. Though many independent directors do bring needed objectivity and outside expertise to board deliberations, there can be a downside to "excessive" independence. As Judge Frank Easterbrook recently noted, "Independent directors tend to be ignorant directors. Independence means that they don't know what's going on, except what managers tell them."[39] Moreover, another influential jurist, Delaware Vice Chancellor Leo Strine, has noted:

> Increasingly, boards are comprised of one person who knows everything about the company and who has an intense interest in its future—the CEO—and nine or ten other people selected precisely because they have no possible interest in or connection to the company that might cause them to be perceived as conflicted—or that might cause them to have any genuine concern for the corporation's future.[40]

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[37] Separation of the roles of chairman and CEO has received high-profile support this year in the form of a report from the Millstein Center for Corporate Governance and Performance at the Yale School of Management. Together with the Chairmen's Forum, a group of nonexecutive chairmen convened by the Millstein Center, the Millstein Center issued a policy briefing arguing for voluntary adoption of the independent chair model. The paper contemplates possible exchange listing standards to compel compliance if the model is not widely adopted by public companies. *See* The Millstein Center for Corporate Governance and Performance, Policy Briefing No. 4, "Chairing the Board: The Case for Independent Leadership in Corporate North America," Mar. 30, 2009.

[38] One example is the potential independence of former executives of an issuer. The Bill of Rights Act would exclude any former executive officer of the issuer from being an independent director, while the Empowerment Act excludes anyone who has been an executive of the issuer in the preceding five years and the NYSE excludes anyone who has been an executive officer within the preceding three years. See Shareholder Bill of Rights Act of 2009 (S. 1074), Sec. 5(e)(2); Shareholder Empowerment Act of 2009 (H.R. 2861), Sec. 2(d)(2); NYSE Listed Company Manual Sec. 303A.02(a) and (b). With respect to other categorical bars to independence, the Bill of Rights Act defers to the rules of the exchange on which an issuer is listed, while the Empowerment Act spells out specific criteria that, in many cases, are more stringent than those of the NYSE.

[39] Frank H. Easterbrook, "The Race for the Bottom in Corporate Governance," 95 Va. L. Rev. 685, 693 (2009).

[40] Leo Strine, "Toward Common Sense and Common Ground? Reflections On The Shared Interests Of Managers And Labor In A More Rational System Of Corporate Governance" (Keynote Address to The Journal of Corporation

The Bill of Rights Act also would require each public company board to establish a risk committee, comprised entirely of independent directors, which would be responsible for establishment and evaluation of risk management practices. The Financial Stability Act would only require risk committees for large financial institutions.

In perhaps its most far-reaching feature, the Bill of Rights Act would require boards of directors of publicly-traded companies to be declassified. As a result, all public company directors would be subject to annual election; staggered boards, which have been an available option since the dawn of the corporate form, would become illegal as a matter of federal law. Under the Financial Stability Act, staggered boards would be prohibited unless adopted or ratified by the shareholders of the company. This proposed legislation ignores the dramatic changes in the prevalence of staggered boards that has taken place over the last nine years by private ordering without any federal intervention; for example, the percentage of S&P 500 companies with staggered boards has declined from 61 percent in 1999 to 34 percent at the end of 2008.[41] The elimination of staggered boards would increase the vulnerability of public companies to unsolicited takeovers and would further encroach on territory properly governed by state corporate laws.

Moreover, the Bill of Rights Act and the Empowerment Act would require all publicly-traded companies to elect directors under a majority-voting standard. The proposed standard would apply only to uncontested elections and would require that the number of shares voted "for" a director's election exceed 50 percent of the votes cast with respect to that director's election. Incumbent directors who are not reelected by a majority vote would be required to tender their resignation to the board of directors (with the Bill of Rights Act mandating that the board accept such resignations). Similarly, the Financial Stability Act would mandate a majority voting standard in uncontested elections of directors and would require that any director who does not receive a majority vote submit a resignation to the board of directors, but would allow the board to accept the resignation or vote unanimously to reject it, in which case the company must disclose the reasons for the rejection and why the rejection was in the best interests of the company and its shareholders.

*Governance Disclosure*

In early July, the SEC proposed a package of new proxy disclosures, generally to be effective for the 2010 proxy season, concerning a wide variety of corporate governance and compensation issues.[42] Among other things, the proposed rules would require a description of, and justification for, a company's leadership structure, including whether and why a company has chosen to combine or separate the positions of chief executive officer and chairman of the board, and whether and why a company has a lead independent director. The proposed rules also would require a description in proxy statements of the board's role in risk management as well as a discussion in the Compensation Discussion & Analysis section addressing the relationship between a company's overall employee compensation policies and risk management practices

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Law), Mar. 1, 2007, available at http://www.law.upenn.edu/academics/institutes/ile/CCPapers/040507/Strine%20Speech.pdf.

[41] Classified Boards Year Over Year, www.SharkRepellent.net (from 302 at year-end 1999 to 172 at year-end 2008).

[42] SEC Release Nos. 33-9052; 34-60280; IC-28817; File No. S7-13-09 (July 10, 2009).

and/or risk-taking incentives (to the extent material). Required information about directors, board nominees and executives would be significantly expanded, with longer look-back periods for disclosures. The proposed rules also would require detailed disclosures regarding compensation consultants who advise on executive and director compensation and provide other services to a company, including potential conflicts of interest and, significantly, quantification of the fees paid for each type of service. These proposals, if implemented, would impose a significant burden on companies that, in our view, is not justified by any benefit.

These proposals would also impact shareholder meetings and proxy contests. One proposed change would require that companies disclose voting totals on Form 8-K within four business days after a shareholder meeting, other than contested director elections, where disclosure would be required within four business days after preliminary voting results are determined.[43] Another proposed change would allow a person soliciting in support of nominees who, if elected, would constitute a minority of the board to seek authority to vote for another soliciting person's nominees in addition to or instead of the incumbent board's nominees to round out its short slate.[44] A third proposed change would allow a third party to send out unmarked copies of management's proxy card while communicating the third party's own views as to how the proxy should be voted, without the third party independently having to file proxy materials.[45] These last two proposed changes would further increase the likelihood of proxy contests and withhold vote campaigns, providing additional tools for activists to use in pursuit of their short-term focused agendas.

The Financial Stability Act would mandate annual proxy disclosure indicating whether the compensation committee has retained a compensation consultant and whether the work of the compensation committee has raised any conflicts of interest, demonstrating the relationship between executive compensation and financial performance, and comparing, in graphic form, the amount of executive compensation to the company's financial performance or investor return over a five-year period (or other period determined by the SEC). The Financial Stability Act would also require proxy disclosure as to whether company employees (not just executive officers) may engage in hedging transactions with respect to company securities awarded to the employee as compensation.

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[43] Under current rules, voting results of any matter that was submitted to a vote of shareholders during the fiscal quarter must be reported in the Form 10-Q or Form 10-K covering such fiscal quarter. Under California law, California corporations and many foreign corporations are required to disclose voting results upon the written request of a shareholder within 60 says of the shareholder meeting. *See* Cal. Corp Code Sections 1509, 1510(a).

[44] The proposed rule change is consistent with the no-action relief granted by the SEC staff in March 2009 in the context of a proxy contest regarding the solicitation of proxies to vote in the election of directors where two dissidents had submitted separate "short slates" of director nominees for election at the same annual meeting. *See* Application of Rule 14a-4(d)(4) to Solicitation for Proposed Minority Slate of Icahn (Mar. 30, 2009), and Application of Rule 14a-4(d)(4) to Solicitation for Proposed Minority Slate of Eastbourne Capital, L.L.C. (Mar. 30, 2009). The no-action letters permit a soliciting shareholder to "round out" its short slate of directors with the nominees of other dissident shareholders rather than, as had historically been the case, only with nominees of the incumbent board.

[45] If adopted, this proposed rule would overturn the Second Circuit's decision in MONY Group, Inc. v. Highfields Capital Management, 368 F.2d 138 (2d Cir. 2004), where the court found that a dissident shareholder could not send out copies of management's proxy card to shareholders and simultaneously rely on the exemption from filing proxy materials.

*Proxy Mechanics*

The SEC recognizes that it is necessary to review "proxy plumbing" and Chairman Schapiro has directed the SEC "staff to conduct a comprehensive review of the mechanics by which proxies are voted and the way in which information to shareholders is conveyed."[46] The SEC staff is reviewing "the entire process through which proxies are distributed and votes are tabulated."[47] This includes a review of the current system that allows beneficial owners to prevent the disclosure of their names and addresses to the companies in which they hold securities. Moreover, the SEC is reviewing the role of proxy advisory firms in the current proxy voting process.

Part of the difficulty is that the current proxy voting system is out of date and requires significant retooling. However, the SEC is advocating vast changes, proposing regulation on matters such as proxy access, without first fixing the underlying system that gives institutional and activist shareholders a built-in advantage over retail shareholders. The "proxy plumbing" should be fixed before these changes are implemented, so that the playing field for public companies is fair and transparent for all constituencies.

*Conclusion*

Many of these reform proposals represent misguided attempts to assert federal control over areas that have traditionally, and successfully, been governed by state law.[48] The benefits of the state law model have been demonstrated time and again by states' useful regulatory innovations, timely responsive actions and individualized regimes that help companies to maximize efficiency and minimize unnecessary burdens. Especially with respect to the details of corporate governance (such as whether a company splits the roles of chief executive officer and board chairman), a one-size-fits-all, top-down approach would have the effect of forcing conformity where it does not belong and serves no useful purpose. State lawmakers and companies are addressing many of the topics covered in the proposals and they are doing so in thoughtful, individualized ways that permit flexibility and promote productivity. Federal lawmakers should not commandeer this healthy and constructive process.

These proposals would have the effect of increasing unhealthy pressure on companies to focus on short-term stock price results.[49] Hedge funds and professional institutional investment managers control more than 75 percent of the shares of most major companies; in recent years, we have seen how these shareholders have demanded that companies produce unsustainable quarterly earnings results at the expense of long-term stability and growth.[50] President Obama in February decried the "reckless culture and quarter-by-quarter

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[46] Chairman Mary Schapiro, Address to the Practising Law Institute's 41st Annual Institute on Securities Regulation (Nov. 4, 2009).

[47] *Id.*

[48] For a thorough discussion of this issue and other related points, see Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis, "A Crisis Is a Terrible Thing To Waste: The Proposed 'Shareholder Bill of Rights Act of 2009' Is a Serious Mistake," May 12, 2009.

[49] *See id.* and Lawrence Mitchell, "Protect Industry from Predatory Speculators," FT.com, July 8, 2009.

[50] *See* Lipton, Lorsch and Mirvis, *supra*.

mentality that in turn have wrought havoc in our financial system."[51] As one commentator succinctly put it, these large and active shareholders are not investors, they are traders. Share turnover numbers are revealing: annual turnover on the NYSE in recent years has been greater than 120 percent, mutual fund turnover has been as high as 110 percent, and pension fund turnover has been more than 90 percent; by comparison, historical rates averaged in the 10-20 percent range before 1980.[52]

As Vice Chancellor Strine stated in a 2007 speech:

> As much as corporate law scholars fetishize the agency costs that flow from the separation of ownership and control in operating companies, they have been amazingly quiet about the "separation of ownership from ownership." What I mean by that is that the equity of public corporations is often owned, not by the end-user investors, but by another form of agency, a mutual fund or other institutional investor. It is these intermediaries who vote corporate stock and apply pressure to public company operating boards. . . . Most corporate law scholars have not burdened their minds with the fact that undifferentiated empowerment of these so-called stockholders may disproportionately strengthen the hand of activist institutions who have short-term or non-financial objecti[ve]s that are at odds with the interests of individual index fund investors. That proxy fights and derivative suits against money management boards are virtually unheard of under the "Business Trust" statutes that are prevalent in the governance of mutual funds is accepted by corporate law scholars with equanimity. But these same scholars claim the much greater number of such fights and suits against the board of operating companies is grossly insufficient and a justification for reforms in the corporation law governing operating corporations.[53]

Inexplicably, it is these very traders that these reform proposals would empower, further promoting the influence of those shareholders who seek short-term profits at the expense of long-term investment; the result is a recipe not for recovery but for relapse.

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[51] President Barack Obama, Speech on Executive Compensation, Feb. 4, 2009.

[52] *See* Mitchell, *supra*.

[53] Strine, *supra*.