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Corporate Governance Update: Proxy Plumbing Fixes Are Desperately Needed

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The U.S. proxy system is set to undergo a comprehensive review for the first time in nearly 30 years. Last week, the Securities and Exchange Commission (SEC) voted unanimously to issue a concept release “seeking public comment on the U.S. proxy system and asking whether rule revisions should be considered to promote greater efficiency and transparency.”¹ This so-called “proxy plumbing” concept release marks the beginning of what will certainly be a years-long process with an emphasis on fact-finding to examine the effects of shifts in “shareholder demographics, the structure of share holdings, technology, and the potential economic significance of each proxy vote.”²

Major reform of the voting infrastructure is long overdue. Significant structural and procedural changes in shareholding and proxy voting over the last 30 years have fundamentally altered and expanded the proxy landscape.³ The SEC estimates that more than 600 billion shares are voted every year at more than 13,000 shareholder meetings.⁴ The concept release, which is necessarily wide-ranging, welcomes comments on all aspects of the proxy process and solicits comments on specific issues in three general areas: (1) the accuracy, transparency and efficiency of the voting process; (2) shareholder communications and shareholder participation in the proxy process; and (3) the alignment of voting power and economic interest.

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¹ “SEC Votes to Seek Public Comment on U.S. Proxy System,” U.S. Securities and Exchange Commission Press Release, July 14, 2010 (“SEC Press Release, July 14, 2010”) available at www.sec.gov/news/press/2010/2010-122.htm; see also Concept Release on the U.S. Proxy System, 17 CFR Parts 240, 270, 274 & 275; Release Nos. 34-62495; IA-3052; IC-29340; File No. S7-14-10 (“Proxy Plumbing Release”) available at www.sec.gov/rules/concept/2010/34-62495.pdf.

² Opening Remarks by SEC Chairwoman Mary L. Schapiro at SEC Open Meeting, July 14, 2010 (video available at www.sec.gov/news/openmeetings/2010/071410openmeeting.shtml).

³ For a discussion of some of the recent regulatory changes that have impacted the proxy voting system, see, e.g., Martin Lipton, David A. Katz and Laura A. McIntosh, “The System Isn’t Broken: A Legislative Parade of Horribles,” in The Altman Group, Governance Compendium Series, Volume 1 (2009), available at www.altmangroup.com/pdf/GovernanceCompendium2009Vol1TAG.pdf.

⁴ Speech by SEC Chairwoman Mary L. Schapiro: Remarks at the National Conference of the Society of Corporate Secretaries and Governance Professionals, July 9, 2010 (“Schapiro Speech, July 9, 2010”).

Accuracy and Transparency

This category covers the logistics of proxy voting, including over-voting and under-voting of shares. The SEC hopes to correct defects—or the perception of defects—in the proxy system by moving toward a model in which each vote is accurately cast, counted, and confirmable. Accordingly, the SEC is seeking data as to whether over- or under-voting has a material impact on the proxy process and comments as to whether broker-dealers’ procedures for allocating votes should be standardized or required to be disclosed.⁵ The SEC also is interested in whether the currently limited ability of shareholders and companies to confirm that votes were cast per instructions is causing uncertainty in or damaging the credibility of the proxy process. The concept release seeks comment on possible procedures for vote confirmation.⁶

In addition, the concept release discusses the practice of proxy voting by institutional shareholders, which frequently lend their shares. Shares cannot be voted by the lender unless they are recalled, and since shareholders currently have no formal process to discover the matters to be voted upon at a meeting before the proxy is mailed, at which point the record date typically has passed, shareholders may not be able to recall their shares in time to vote on important matters. The SEC is considering potential reforms that would require issuers to inform shareholders of the record and meeting dates, as well as the matters to be voted upon, in advance of the record date.⁷ The SEC also is examining the structure and size of proxy distribution fees, which are a significant concern to issuers.⁸

Shareholder Communications

The concept release addresses a variety of communication issues that arise in the proxy context. These include improving communications between issuers and beneficial owners, facilitating communications among shareholders regarding matters presented for a vote, increasing the relatively low level of shareholder participation in the proxy voting process, and enhancing the ability of shareholders to obtain and evaluate information relevant to voting decisions, such as through interactive data formats in proxy statements.⁹

The SEC is particularly concerned with improving communications between issuers and beneficial owners who hold stock in street name and object to having their identities disclosed to issuers, so-called “OBOs” or objecting beneficial owners. Under the current regulations, an OBO may be contacted only through the securities intermediary that has the customer relationship with the stockholder.¹⁰ Organizations such as the Business Roundtable

⁵ Proxy Plumbing Release at 36-37.

⁶ Proxy Plumbing Release at 41.

⁷ Proxy Plumbing Release at 44-45.

⁸ Proxy Plumbing Release at 50.

⁹ Proxy Plumbing Release at 64.

¹⁰ See 17 CFR 240.14b-1(b)(3)(i).

and the Shareholder Communications Coalition have advocated for the elimination of OBO status so that issuers can communicate directly with the beneficial owners. Shareholders who still wished to remain anonymous could hold their shares in a nominee account; the costs of anonymity would then be borne by the shareholder rather than by the issuer.¹¹ The SEC is seeking comment on this proposal and other possible amendments to the current regulations regarding OBOs.¹²

In recent years, the SEC has championed reforms that have significantly altered the proxy landscape, including the elimination of discretionary broker voting,¹³ the “notice and access” model of proxy delivery,¹⁴ and the electronic delivery of proxy statements.¹⁵ The elimination of the broker discretionary vote in director elections¹⁶ coupled with the widespread adoption of a majority voting standard in the election of directors, have increased the ability of shareholder activist organizations and proxy advisory firms to affect vote outcomes. Arguably, better communication between issuers and shareholders and among shareholders could help to counter these potentially distorting forces.

Voting and Economics

The separation of voting power and economic interest is a relatively new phenomenon and one that the proxy system is struggling to accommodate. In the proxy plumbing concept release, the SEC has wisely decided to examine the potential for significant misalignment of voting power and the effect that such misalignment has on the integrity—or the perception thereof—of the proxy system. In particular, the SEC plans to consider the effect that its own regulations have in skewing the traditional one share, one vote equation. The SEC has highlighted three areas for consideration: the role of proxy advisory firms, the rules that typically produce a gap between record dates and meeting dates,¹⁷ and hedging and other

¹¹ See Proxy Plumbing Release at 70-71.

¹² See, e.g., Kenneth L. Altman, “Practical Solutions to Improve the Proxy Voting System,” (Oct. 21, 2009) available at www.altmangroup.com/pdf/PracticalSolutionTAG.pdf (proposing the All Beneficial Owner (ABO) concept).

¹³ On July 1, 2009, the SEC approved an amendment to NYSE Rule 452 and § 402.08 of the NYSE Listed Issuer Manual that eliminated discretionary voting by brokers in uncontested elections. See Release No. 34-60215.

¹⁴ See Shareholder Choice Regarding Proxy Materials, Release No. 34-56135 (July 26, 2007) available at www.sec.gov/rules/final/2007/34-56135.pdf.

¹⁵ See Use of Electronic Media for Delivery Purposes, Release No. 33-7233, n. 32 (Oct. 6, 1995) (providing guidance in which the SEC explained that delivery of proxy materials may be made electronically if a shareholder has affirmatively consented to electronic delivery).

¹⁶ The Dodd-Frank Wall Street Reform and Consumer Protection Act also would require the stock exchanges to prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter, as determined by the SEC, which could lead to the elimination of broker discretionary voting in its entirety.

¹⁷ State corporate law requires issuers to set a record date in advance of a shareholder meeting, and holders of record are entitled to notice of the meeting and to vote at the meeting. Typically, record dates may be no more than 60 days prior to the meeting date. See, e.g., Del. Gen. Corp. L. § 213(a), Model Bus. Corp. Act § 705.

investment strategies that facilitate the separation of voting power and economic interest.¹⁸ The SEC is seeking data regarding the scope and significance of the resulting “empty voting” as well as possible regulatory actions such as requiring disclosure of decoupling activities.¹⁹ Specifically, the concept release notes that “[t]he proxy rules, the periodic reporting system, and rules adopted pursuant to statutory provisions such as Sections 13(d), 13(f), and 13(g) of the Exchange Act might be modified or a new disclosure system could be developed to elicit fuller disclosure of empty voting.”²⁰

With respect to proxy advisory firms, the concept release notes concerns about potential conflicts of interest and the lack of accuracy and transparency in advisory firms’ voting recommendations, and asks, among other questions, whether the SEC should exercise its authority under the Investment Advisers Act of 1940 to require proxy advisory firms to register with the SEC or whether proxy advisory firms should be required to publicly file their vote recommendations, perhaps on a delayed basis.

The increasing power of proxy advisory firms to influence or control a significant percentage of the vote in a company despite having no direct economic interest therein is cause for concern. Informed shareholder voting may be impaired when such firms have undisclosed conflicts in formulating their voting recommendations, such as dual client relationships (in which the proxy advisory firm provides vote recommendations to institutional investors on matters for which they also provide consulting services for the issuer) or issue reports and voting recommendations with factual inaccuracies for which they are unaccountable.²¹

Governance distortions resulting from “hidden” stock ownership are a problem that is being confronted not only in the United States but worldwide. The massive expansion of the derivatives market in the last decade has brought this issue to the fore: A Deutsche Börse/Eurex study from 2008 found that derivative instruments grew around 24 percent per year

Traditionally, the same record date has been used to determine the identities of both the shareholders entitled to notice of a meeting and the shareholders entitled to vote at the meeting. This does not have to be the case, however; since 2009, Delaware permits companies to use separate record dates for these two matters. Del. Gen. Corp. L. § 213(a). A Delaware company can establish a voting record date much closer to the meeting date, thereby potentially increasing the chances that the voters are actually the stockholders.

¹⁸ Proxy Plumbing Release at 104-05.

¹⁹ Proxy Plumbing Release at 143-45.

²⁰ Proxy Plumbing Release at 145. The concept release also questions whether the SEC, Congress, state legislatures or individual issuers should: require voters to certify on the form of proxy that they held the full economic interest in the shares being voted, or to what extent their economic interest in the shares was shorted or hedged; require disclosure of the issuer’s shareholder meeting agenda a sufficient time ahead of the record date to enable investors who have loaned shares to recall those shares; permit only persons who possess pure long positions in the underlying shares to vote by proxy, or to vote only to the extent of their net long position, or require a cooling-off period for investors with no or negative economic interests before voting; or prohibit empty voting, especially in cases of a negative economic interest in the issuer by the shareholder. *Id.*

²¹ Proxy Plumbing Release at 107, 114.

in the last decade into a market with roughly 457 trillion euros of notional amount outstanding.²² Regulatory initiatives to prevent abuses of derivative instruments are being considered in Germany, Italy, and the Netherlands; the United Kingdom implemented new disclosure and transparency rules regarding cash-settled derivatives in 2009.²³

Conclusion

The reform of the proxy process is likely to be a fairly long-term endeavor. In addition to finalizing many rules proposed over the last year and a half—including a controversial proxy access proposal that we have opposed—the SEC also will be focused on implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law this week.²⁴ Nonetheless, the SEC seems confident that it has the resources to address proxy reform at this time. Indeed, the SEC must do so if it is to become, as Chairman Schapiro hopes, “as nimble and efficient, as comprehensive and effective as the financial markets which [it is] charged with regulating.”²⁵

With the proxy plumbing concept release, the SEC is embarking on a major initiative. The many and dramatic changes that have taken place in the securities industry over the last 30 years—including technological innovations, changes in the nature of stock ownership, the evolution of proxy service providers, and new financial products²⁶—will undoubtedly be found to require significant reforms in the proxy voting process. In particular, we hope that the SEC will give serious consideration to the influence of proxy advisory firms in the voting process and to the distorting effects and lack of transparency caused by non-traditional structured and derivative arrangements that separate voting and economic interests. These areas, along with the topics covered by the concept release, merit careful examination by the SEC and an appropriate reformulation of the proxy voting system.

²² See Eugenio De Nardis & Matteo Tonello, “Know Your Shareholders: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests,” The Conference Board, Director Notes, The European Series, No. DN-009, July 2010, at 1 (citing “The Global Derivatives Market: An Introduction,” Deutsche Börse/Eurex White Paper, Apr. 2008).

²³ De Nardis & Tonello at 6.

²⁴ H.R. 4173, 111th Cong. § 2 (2010). See also Schapiro Speech, July 9, 2010.

²⁵ Schapiro Speech, July 9, 2010.

²⁶ See SEC Press Release, July 14, 2010.