



Restoring Balance in Proxy Voting: The Case For “Client Directed Voting”

Posted by Scott Hirst, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Sunday February 14, 2010

Editor’s Note: This post comes to us from [Frank G. Zarb, Jr.](#), a Partner at Katten Muchin Rosenman LLP specializing in the federal securities laws, and John Edean, the President of the [American Business Conference](#).

It has become commonplace to hear the corporate proxy voting system described as “broken” or “dysfunctional,” yet its most fundamental defect is mostly ignored: the absence of retail investor participation. If the voters from an entire region of the country – say the Southwest – did not show up at the polls for presidential elections, most would agree that there was a problem. At the very time when shareholders are calling for greater access to the corporate proxy, it is more important than ever that proxy voting represent the views of all shareholder constituencies in rough proportion to their numbers.

Overall, the voting rate among individual investors hovers at the 20% level. Companies that mail their investors a notice that the materials are available on the internet – in lieu of mailing the all materials in paper – have seen even lower voting levels in the 5% range.

There are numerous theories as to why retail investors do not tend to vote. But we believe that the principal reason for such a low turnout is simple: Individual investors lead busy lives and the prospect of reviewing and completing multiple voting forms along with related materials is not a center ring concern for them. An individual investor made this point exactly in a letter to the Commission:¹

I am a busy man. In addition to full time practice of law I am raising twin preschoolers, involved in community and charitable activities and every so often get a few minutes to do something else. . . . If the choice comes down to reading to my children or working on proxy responses we will not be voting.

¹ Letter of Robert M. Stanton, March 25, 2009, Comment File, Proposed Amendment to New York Stock Exchange Rule 452.

At the same time, while institutional shareholders have proxy advisors to make voting easier and more efficient, individual retail voters typically do not. Thus, as compared to their institutional brethren, the task of voting is simply more burdensome. Viewed this way, low levels of retail shareholder voting seems an inevitable consequence of system design.

We propose to make a new tool available to retail investors designed to address this imbalance by making it easier for retail shareholders to vote: client directed voting (CDV).

Under CDV, a shareholder would be invited to provide his or her broker or bank custodian with advance standing instructions for the voting of certain types of proposals put forward by the company or by another shareholder. The shareholder would continue to receive proxy materials in the same time frames as in the past. However, the voter instruction form, or VIF, would indicate which proposals are the subject of standing instructions, and provide a means to override such instructions.

If the shareholder receives a notice card under the 'Notice and Access' model in lieu of paper proxy materials, the notice card would likewise indicate any standing instructions relevant to the indicated proposals. We believe that "personalizing" the notice card in this manner will tend to engage shareholders and result in increased participation in proxy voting.

Investors would only be permitted to provide standing instructions on specific types of proposals that are sufficiently clear that the broker would not have to interpret standing instructions when applying them to the proposal. An example is a company or shareholder proposal to de-stagger the board of directors.

CDV would also offer participants the option among three default elections on matters with respect to which the shareholder has not otherwise affirmatively cast a vote (whether on their VIF, on the proxy card, or through CDV), as follows: (1) in proportion to other retail shareholders; (2) in a manner consistent with the board's recommendation; or (3) in a manner that is contrary to the board's recommendation. If a participant did not choose one of these default elections, no vote would be recorded on matters with respect to which the shareholder has not otherwise affirmatively cast a vote.

The Society of Corporate Secretaries and Governance Professionals (the "Society") presented this model to the Staff of the SEC's Division of Corporation Finance, seeking the Staff's guidance on the model's consistency with the federal proxy rules (the Society's request, and related materials, are available [here](#)). A broker or bank's request for authority to vote a client's shares is a "solicitation" under those rules, and accordingly must fall within an exemption. The Society believes that the model fits within an exemption that covers brokers' and

banks” efforts to obtain voting instructions from their clients, Rule 14a-2(a)(1). As the “record holders” of the shares, brokers and banks retain voting rights over the shares, so must obtain voting instructions from their clients, who are the “beneficial holders.”

After discussions with the Staff, the Society withdrew its formal request for interpretive guidance but the withdrawal merely presaged further discussions. The SEC has indicated that client directed voting will be a topic in a “concept release” that it plans to issue in the near future, focusing on the proxy voting system. While it appears that the Staff does not believe that it has the flexibility to provide interpretive guidance on CDV, the matter could be addressed by the Commission interpretively, or by issuing new rules.

One concern that has been expressed about CDV is that it would permit retail investors to in effect “vote” by setting up standing instructions before the proxy materials are available. Thus, for instance, a shareholder could set up a standing instruction to vote “yes” on proposals to de-staggered the board of directors before XYZ company circulates its proxy materials explaining its rationale for putting forward such a proposal. However, as noted above, shareholders would have the opportunity to over-ride standing instructions after reviewing the proxy materials. In the example above, the shareholder could mark his or her VIF accordingly, and the standing “yes” vote would be over-ridden, and a “no” vote would ultimately be recorded.

Institutional investors furthermore have voted in this manner for decades. They provide their proxy advisors with standing instructions, or “guidelines,” which the advisor votes unless over-ridden by the client before the shareholders meeting. Individual investors have discretion over decisions to buy and sell their securities, to place limit orders, or to invest in derivatives. It stands to reason that an investor who has discretion to buy and sell securities – and to incur any related financial losses should also be able to decide how to vote, including whether to provide their broker with standing voting instructions.

CDV indeed will lead to voting that is more informed, not to voting that is less informed. Many if not most investors know how they normally vote on certain types of proposals. An investor, for instance, may normally vote against a shareholder proposal to split the roles of Chairman and CEO, voting in favor of such proposals only in a minority of instances, depending on the circumstances. Such an investor could set the default to vote “no” on all such proposals, but then focus his or her research and analysis on potentially overriding that default in the few instances he or she believes may be warranted.

Some have also expressed concern that CDV would operate in a manner similar to “broker discretionary voting” under the NYSE’s Rule 452. Under Rule 452, a broker is permitted to vote

its clients shares on certain “routine” matters if it has not received instructions from the client. “Broker discretionary voting” has been criticized – with some justification – because the votes are not actual votes in the sense that they are registered by the broker, not by the client. Unlike “broker discretionary voting,” CDV records actual votes pursuant to standing or express instructions registered by the client, and the broker has no role other than an administrative one.

The elimination of “broker discretionary voting” in director elections has, however, made more urgent the need to increase retail voting. While votes registered under Rule 452 are not actual votes, they nonetheless served a purpose of accurately reflecting retail shareholder sentiment. Broadridge Financial Services, Inc., estimates that, in 2007, more than 98% of retail shareholder who provided voting instructions to their brokers supported the boards’ nominees for director.

CDV will provide investors with one more tool to make their voices heard. That is good for corporate governance, and ultimately for the health of our financial markets.

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