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The Case For 'Client-Directed Voting'

Law360, New York (January 04, 2010) -- Each year, investors in public companies have a right to vote their shares on proposals offered by those companies' boards of directors. In some cases, too, proposals are submitted by other shareholders for consideration.

A typical board-sponsored proposal seeks support for nominees to serve on the board of directors for the following year. A typical shareholder proposal might seek a change in the way the company is governed, such as a mandate to separate the roles of the chairman and CEO.

Unlike institutional investors such as pension funds or mutual funds, many individual investors do not bother to vote. Overall, the voting rate among individual investors hovers at the 20 percent 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 percent range.

There are numerous theories as to why retail investors do not tend to vote. One theory is that retail investors "vote with their feet." That is, if they are unhappy with the management or governance of the company, they will simply sell their stock.

Another theory is that investors just don't understand the "complex" proxy voting process, and accordingly avoid participating in something that seems alien to them.

These theories have their merits, but probably miss the larger point that individual investors lead busy lives and that the prospect of reviewing and completing multiple voting forms along with related materials is not a center-ring concern for them.

If an investor has a diversified portfolio consisting of 20 to 40 different companies, the thought of completing dozens of different voting cards each arriving in the mail at different times — and conducting any necessary background research and analysis – is daunting.

If an investor spent only one hour on each company, the total time expenditure could come close to a standard full-time work week. Very few individuals have that kind of time. 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."

There ought to be a way to help this investor exercise his corporate franchise and, in fact, such a tool is immediately at hand: client-directed voting (CDV).

Economics and cost-benefit analyses do not explain all human behavior, and that is a good thing. But we all make numerous decisions every day prioritizing our schedules and tasks. Investor education is an important initiative, but this segment of investors may not need it, and it does not address the principal obstacle to their participation in proxy voting.

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. When the shareholder later accesses the proxy materials, he or she would be provided the opportunity to override any standing instructions, or allow the instructions to stand.

As a practical matter, 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 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.

In effect, CDV permits investors to focus their time and attention on those companies or proposals that merit more time and attention.

This is, indeed, how institutional investors have operated for decades.

Unlike retail investors, institutional investors are legally obligated to vote their shares because they owe fiduciary duties to their investors or participants. Faced with these obligations, institutional investors have come to rely on their own “efficiency tools,” and principally on proxy advisers, such as Risk Metrics Group Inc.

Institutional investors provide proxy advisers with “voting guidelines,” which reflect the investor’s normal voting patterns, but typically retain the right to override those guidelines in particular cases.

These investors have accordingly found efficiencies in setting defaults according to how they normally vote, so that they can focus their energy and time on the minority of instances where further research and analysis is warranted.

Some have asked whether it is good policy to provide investors a means to effectuate preconceived voting preferences. Would it not be better, they say, to encourage investors to look at each company individually, and to arrive each and every voting choice de novo without any preconceptions?

In a perfect world, that might be a good approach, but in the real world that is not what investors do – whether retail or institutional.

Indeed, investors’ preconceived preferences are not only inevitable factors in proxy voting, but they are legitimate and valid factors. They are based on experience, and in many cases years of experience.

They are also based on the numerous sources of information available today, ranging from the financial press to literally dozens of financially focused Web sites. The proxy materials are important, but there is also an entire world of information out there that is at least equally important.

More to the point, 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.

Of course, no single tool, even one with the utility of CDV, will likely result in a dramatic increase in retail investor voting. But short of dramatic, the potential impact could be material.

Small increases or decreases in the amount of effort it takes to vote seem to make a material difference in voting patterns, especially if accompanied by a stronger commitment to shareholder education by the U.S. Securities and Exchange Commission and companies.

A case in point: Companies that have provided investors with notice of the availability of their proxy materials on the Internet, rather than sending a full paper set of proxy materials, have experienced a drop in voting rates from about 20 percent to about 5 percent. Merely asking investors to take the few extra minutes to retrieve documents from the Internet has resulted in a 75 percent drop in participation.

Internet availability of proxy materials is the right direction, and it ultimately will bring out more rather than less voting, especially when coupled with tools like CDV. But the example illustrates the reasonable inference that making it marginally easier to vote (using CDV) should result in a material increase in voter participation.

The SEC has indicated that client-directed voting will be a topic in a forthcoming “concept release” that it plans to issue in the near future, focusing on the proxy voting system.

A “concept release” asks for guidance and input from the public when the agency is unsure of what direction to take. It is of the first importance for companies, individual investors and other interested parties to weigh in on CDV.

The current situation, in which comparatively few individual investors vote their stock, is unacceptable at a time when so many look to shareholders to take the lead on corporate governance issues.

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.

--By Frank G. Zarb Jr. (pictured), Katten Muchin Rosenman LLP, and John Endean, American Business Conference

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