Proxy Reform–
Be Careful What You Wish For

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Early next year, the five members of the U.S. Securities and Exchange Commission are expected to vote on an issue that for years has sparked fierce debate between companies and shareholder activists. The issue revolves around whether to make it easier for shareholders to nominate directors for corporate boards.

Policymakers, investors and industry leaders have long recognized the importance of modernizing U.S. proxy voting and communications. Momentum is gaining to help retail shareholders do just that. The proxy reform movement, which has been debated for years, received new life in the aftermath of the global financial crisis, which highlighted the need for boards to be more accountable. In a speech earlier this year, the Chairman of the Securities and Exchange Commission, Mary Schapiro, said, 'This crisis has led many to raise serious questions and concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders.' She believes that if a proxy access rule is adopted, it has a 'real chance of holding boards of directors accountable to company owners.'

The essence of the proxy reform proposal is to allow shareholders who own at least 1% of a company's shares to have their board nominees included in corporate proxy materials. This would apply to companies with a market capitalization exceeding $700 million. A 3% stake would be required for shareholders of midsize companies and a 5% stake for shareholders of smaller companies.

After releasing a detailed proposal in early June, the SEC received more than 500 sets of comments. The intensity of the response is not a surprise. As one attorney told *The Wall Street Journal*, 'It's the biggest change relating to corporate governance ever proposed by the SEC. Period. It gives activists the ultimate vehicle to express dissatisfaction with a board, the ability to replace board members at the company's expense.'

The all-out lobbying battle in Washington has pitted the Business Roundtable, U.S. Chamber of Commerce and National Investor Relations Institute against investor groups such as the Council of Institutional Investors and institutional-investing giant Capital Research & Management Co., as well as some large unions. All agree the present proxy system is too complex, but some argue the SEC isn't attacking the root of the problem, and instead is approaching reform in a piecemeal fashion that doesn't take into account how the interrelated parts need to work together.

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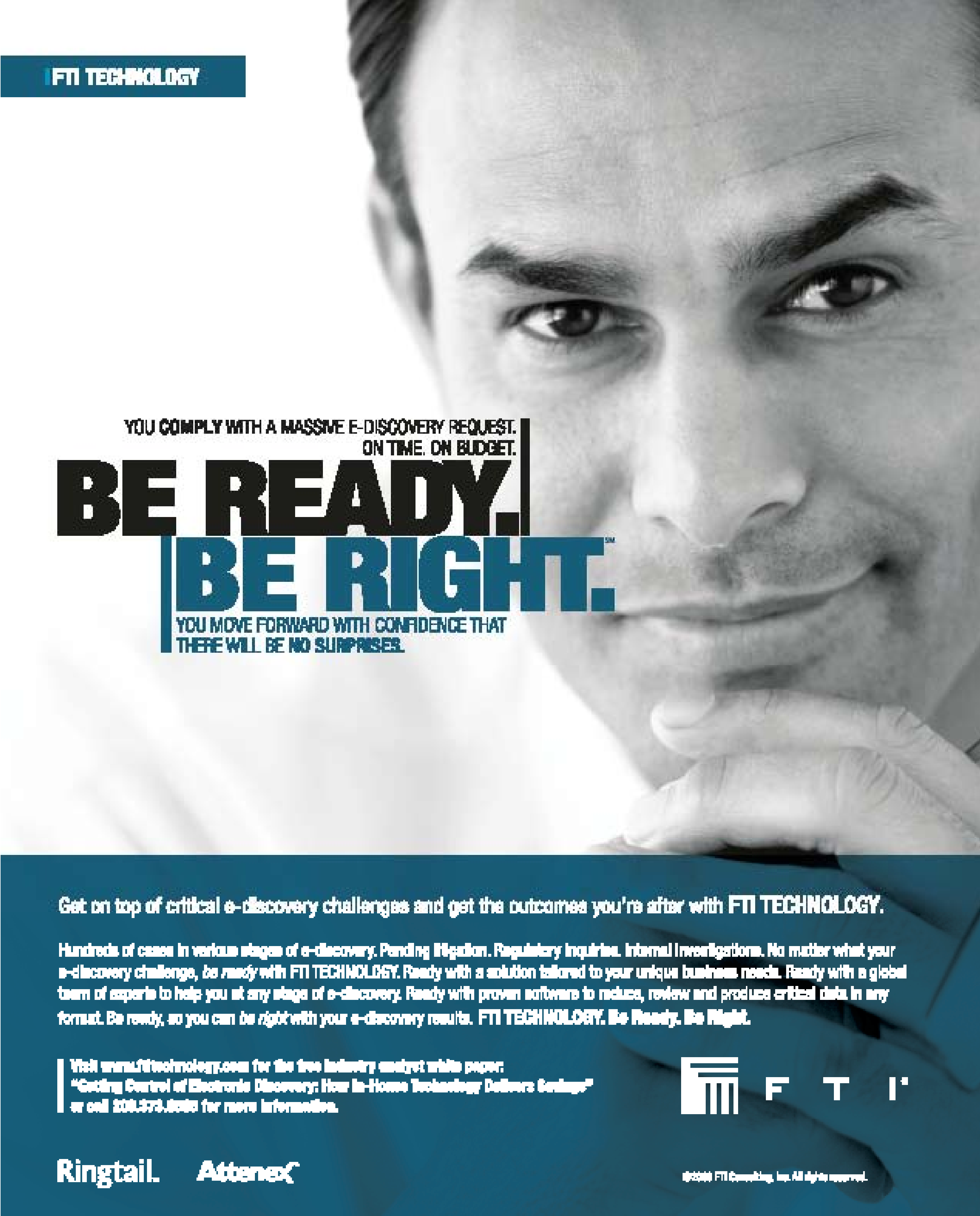
Critics of the SEC proposal argue more time is needed to ensure the technology is in place to support this new style of proxy voting, and to ensure that corporate issuers aren't hampered with excessive costs of materials printing, mailing and proxy solicitation firm engagement to get out the retail vote.

The real issue behind the proxy access rules is that it has the potential to simplify shareholder activism and reduce the costs associated with it. Lower turnout and support for board members this proxy season paves the way for bad press, hostile shareholders and heightened activism levels at target companies. The SEC's proposed rules put few limits on shareholder activists who will find it easier to advance their narrow interests at the expense of the broader shareholder goals.

The New York Stock Exchange's Rule 452, approved in July, provides a preview of how the proxy reform would work in practice, were it to be enacted. It is likely to cause short-term problems since it eliminates 'Broker Discretionary Voting' without providing an easy way for retail shareholders to vote. While the intention of removing brokers' ability to cast votes for shareholders who don't return voting material unless instructed to do so may be fine, the consequences could have major adverse impacts in practice. Without new technology to lower the cost for retail shareholders to vote, the rule will likely translate into lower voter participation rates. Board members may appear to get much less support than in the past, making them appear to have lost shareholder confidence when, in reality, there were simply fewer voters. This may have the unforeseen consequence of exacerbating the voting impact of the better coordinated activist or opposition group.

It remains an open question as to whether the SEC will approve changes to the proxy process. If it does, it could lead to a shake-up in corporate boardrooms. What's not clear is whether the shake-up will be for better, or for worse.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