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U.S. House of Representatives
Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515

August 1, 1989

MEMORANDUM

TO: Members and Staff, Subcommittee on Telecommunications and Finance

FROM: Subcommittee Staff

SUBJECT: Oversight Hearing on the Corporate Proxy Voting System

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SUMMARY

On Wednesday, August 2, 1989 at 11:00 a.m., or fifteen minutes following the close of the Democratic Caucus, in room 2123 Rayburn House Office Building, the Subcommittee on Telecommunications and Finance will hold an oversight hearing on the corporate proxy voting system. The hearing will examine whether the current proxy voting system functions fairly and effectively to assure shareholders a sufficient voice in corporate governance. The hearing will explore a range of alleged problems in the current system, but will focus in particular on the arguments for and against reforming the system by requiring confidential voting and independent tabulation.

The following witnesses will testify at the hearing:

Mr. Richard Foley, Employee-Shareholder Activist, and Chairman, Tucson Chapter, United Shareholder Association;

Mr. Dale Hanson, Chief Executive Officer, California Public Employee Retirement System (CALPERS);

Mr. James E. Heard, Managing Director, Analysis Group, Inc.;

Mr. Roderick Hills, Managing Partner, Donovan Leisure Newton and Irvine; Managing Director and Chairman, The Manchester Group, Ltd.; and,

Mr. John Wilcox, Managing Director, Georgeson and Company.

The corporate governance system has come under increased scrutiny in recent years as a result of several inter-related developments: the upsurge in takeover activity; the great increase in shareholding by institutional investors; and what Business Week (July 3, 1989) calls the explosion in shareholder litigation against corporate boards of directors. Critics of the current corporate governance system, many of whom are increasingly activist institutional shareholders, contend that the system lacks reasonable mechanisms to hold managements and boards accountable to shareholders on a day-to-day basis. As a consequence, it is alleged that shareholders are left with only extreme and costly options, i.e., shareholder suits and takeovers, for asserting their interests. These critics argue that the corporate governance system ought to provide shareholders with an effective avenue for making their case to corporate management on a consistent basis so that there is no need to resort to draconian financial measures, such as takeovers, defensive restructurings, and greenmail, which often leave companies with exorbitant debt levels. They contend that corporations in which management is truly accountable to shareholders will run more efficiently and be more competitive internationally. Furthermore, these shareholders believe that enhanced accountability would increase shareholder loyalty, thereby generating greater investor support for managers committed to long-term corporate strategies.

In this context, institutional shareholders and other shareholder activists trying to play a greater role in corporate governance have called attention to the corporate proxy voting system which they believe is a potentially significant, but presently ineffective, mechanism for increasing the accountability of management to shareholders. They argue that the current proxy voting system favors management and does not provide shareholders with a sufficient voice in corporate affairs. In particular, they have called for reforms requiring confidential voting, independent tabulation, and greater access to the proxy machinery to make the system more responsive to shareholders.

A strong opposing viewpoint is expressed by many in the business community, particularly by members of corporate management. Those opposed to confidential voting and other proxy reforms argue that the present proxy voting system does work to give shareholders a voice and to foster management-shareholder dialogue. If anything, they argue, confidential voting would undermine this dialogue as opposed to encouraging greater and more open communication. Furthermore, they contend that increasing the power of shareholders is more apt to force managers to think short-term as opposed to long-term because, they allege, it is shareholders, institutional investors as well as others, who are most guilty of thinking only in terms of the next quarter's profits.

Advocates of proxy reform have increasingly pushed for proxy reform at the corporate level by sponsoring shareholder proposals for confidential voting, independent tabulation, and greater access to the proxy machinery. They have also increasingly supported legislative efforts to bring about these reforms. The "Securities Trading Reform Act of 1987," introduced by Rep. Lent

and Repp. Rinaldo, contained provisions mandating all three of these pproxy reforms. The "Tender Offer Reform Act of 1987," introducced by Rep. Dingell and Rep. Markey, contained an equal access pprovision.

Thhis memo will describe briefly how the system currently works annd will then summarize the arguments surrounding the proposeed reforms mentioned above. Additionally, it will highlight other issues of concern pertaining to the proxy voting system.

HOW THE SYSTEM CURRENTLY WORKS

Thae corporate voting system falls under the regulatory jurisdiction of the Securities and Exchange Commission ("SEC") by virtue of Section 14(a) of the Securities Exchange Act of 1934 which mmakes it "unlawful for any person...in contravention of such rules aand regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investoors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any securityy...registered pursuant to Section [12] of [the Act]."

Not really - Pursuant Solicitation

Whhile the SEC has ample authority to regulate the corporate voting system, under the corporate voting procedures currently in place iin the vast majority of companies, virtually the entire proxy vvoting process is under the control of management. The key steps -- determining what is in the proxy statement, sending out the proxy cards to shareholders, receiving and counting the votes - are eessentially in the hands of management. Also, management has acccess to corporate funds to pay for the original proxy solicitation and any follow-up communications to shareholders.

A proposal made by a shareholder must be included in the proxy sstatement sent out by management provided it satisfies the requireements of Rule 14a of the Securities Exchange Act. A sharehoolder is limited to one proposal in the company's proxy statemeent. The shareholder's proposal, along with supporting argumennts, may not exceed 500 words. There is no word limitation on manaagement rebuttals and companies may omit shareholder proposaals from their proxy statement either for various procedural violatiions (such as missing filing deadlines, etc.) or on substanntive grounds (such as if the proposal deals with matters relatinng to an election to a corporate office or with matters relatinng to the company's "ordinary business operations"). If the sharehoolder proponent chooses to do his/her own proxy solicittation, the shareholder must bear all the expenses incurred.

Byy having access to the proxy cards returned by shareholders prior tto the annual meeting, management can know who has voted and how theey have voted. Management or its agents (most often proxy solicittors) can then contact directly those shareholders who have voted aagainst management to try to change their votes. This processs of targeting contact with shareholders who have not voted or havee voted against management is known as resolicitation. Unlikes management, the shareholder pushing a particular proposal has noo access to the ballots as they come in and are counted. The only exception to this is in "proxy contests" where, for example,

a shareholder dissident runs candidates for the board of directors in opposition to those nominated by the company. In such contests, management and the shareholder dissident both send out proxy solicitations and shareholders vote for a particular slate by marking that slate's card and sending it back to the party identified with that slate. Thus, in this instance, management does not have exclusive access to all the ballots cast.

CONFIDENTIAL VOTING AND INDEPENDENT TABULATION

Critics of the current system argue that it is "rigged" in favor of management and is unfair both to the specific shareholder dissident and to shareholder voters in general. As evidence they point to the consistent defeat of shareholder proposals on corporate governance issues which have been submitted under the present system. According to an Investor Responsibility Research Center ("IRRC") survey of annual meeting voting results recorded by May 18, 1989, there were 11 shareholder proposals to redeem or put poison pills up for shareholder ratification and 27 proposals to institute confidential voting. The survey indicated that, while the average vote in favor of these proposals has increased significantly since 1987, only two of these 38 proposals actually passed.

As a result of the obstacles shareholder activists perceive in the proxy voting system, many call for Congress or the SEC to mandate that the corporate voting system provide for confidential voting and independent tabulation. Under such a system, upon receiving the proxy materials and marking the proxy card, shareholders would send their ballots directly to an independent tabulator who would conduct the vote count. Neither management nor any shareholder dissident would know how particular shareholders had voted because the independent tabulator would be required to keep that information confidential.

A. Arguments for these reforms

First, proponents of confidential voting stress that the secret ballot should be the democratic right of every shareholder. They point out that in our democracy individuals have the right to a secret ballot in labor union elections and political elections; and they liken the existing corporate voting system to that of a dictatorship in which people are faced with only one slate, that of the dictator, and vote knowing that their ballot is exposed to government scrutiny.

Second, confidential voting and independent tabulation are essential, proponents say, to protect shareholders, particularly employee-shareholders and large institutional shareholders, from undue pressure brought to bear by management resolicitations prior to the annual meeting. Confidentiality proponents are concerned about the possibility of explicit and implicit threats of retaliation by management, as well as actual management acts of retaliation. These proponents contend that there is a pervasive fear of retaliation felt by many who vote proxies.

Employee shareholders are seen as particularly vulnerable

because of their dependence on management for their jobs. Similarly, the corporate sponsor of a particular pension fund may have client relationships with companies in which the pension fund has invested and may feel pressured to vote in favor of the managements of these companies so as not to endanger its business with these clients. Furthermore, if the fund farms out its investment business to outside money managers, these money managers may fear losing some of their accounts if they vote against management. (For an in-depth study of this, see Conflicts of Interest in the Proxy Voting System published by the IRRC.)

Summing up these concerns, one proponent of confidentiality, the Council of Institutional Investors, in its June 1989 newsletter, says confidential voting can "reduce the potential for pressure from management to vote in its favor, including particularly the resolicitation of votes initially cast against management. Currently, corporate management is able to monitor how shareholders are voting and there have been allegations that in some cases institutional investors and company employees have been subjected to pressure to cast or change their votes in favor of management. Several surveys of investment managers and other fiduciaries who vote proxies have documented that there is a great deal of contact between management and proxy voters and that many proxy voters have regarded some of these contacts to constitute improper pressure."

The 1988 survey by the New York Society of Security Analysts revealed that 22% of its members who had responsibility for voting proxies reported experiencing undue pressure to vote proxies in a certain way. A 1987 survey of ERISA funds by the Employee Benefit Research Institute indicated that 24% of those plan sponsors who handled proxy voting internally reported being exposed to pressure regarding their votes, and 65% of the fund investment managers and master trustees who voted proxies said they had experienced financial pressure to influence their votes.

The third argument proponents make for confidential voting and independent tabulation is that, even if management does not abuse its access to shareholders' ballots by applying improper pressure on those shareholders who are vulnerable, this unequal access still gives management an unfair advantage which distorts the democratic process and undermines its integrity. The exclusive access to voting information enables management to target its resolicitation efforts far more effectively than can any shareholder.

Fourth, proponents of reform argue that management control of the tabulating process provides inadequate protection against fraud. James Heard, in a recent article in Insights, says, "[Without an independent tally], there is no way for shareholders to verify results without resorting to expensive, time-consuming litigation. Even simple requests from shareholders to observe the counting of ballots...have been denied...[O]n votes where management alone solicits proxy cards, proxy solicitors and other experienced hands acknowledge the vulnerability of the voting process to fraud."

Finally, those favoring confidentiality and independent tabulation point out that a small, but significant, minority of companies, have already instituted these measures. Among these companies are the five largest public corporations (AT&T, Exxon, General Electric, General Motors, and IBM) and four of the largest American banks (Citicorp, Chase Manhattan, J.P. Morgan, and Chemical Banking). A recent IRRC survey of 22 corporations using confidential voting indicated that respondents found confidential voting neither particularly expensive to implement nor difficult to administer. These respondents also reported no problems in reaching quorums or in meeting supermajority requirements.

B. Arguments against these reforms

Opponents of confidential voting reject the analogy of a corporate vote to a political vote. They argue that the shareholder-management relationship is voluntary and economic, unlike the relationship between government and citizens. Georgeson's Wilcox, in a 1986 letter to the SEC, said, "The relationship between a corporation and shareholders is voluntary and shareholders are not subject to excessive powers of corporate management. Consequently, analogies to political and labor union elections are faulty."

Opponents of confidentiality and independent tabulation also contend that there is little, if any, evidence either of corporate managements exerting abusive pressure on shareholder voters or of proxy votes being fraudulently tabulated. Furthermore, they argue that shareholders really wishing to protect their privacy can do so by holding their securities in nominee or street name. Just how much protection these methods afford to shareholders, however, is called into question by evidence that proxy solicitors ultimately succeed in determining the identity of the vast majority of shareholders.

Furthermore, confidentiality opponents stress the importance of maintaining open communications between management and shareholders. They say that management must be able to know what its shareholders think, that resolicitation efforts are a crucial way for management to engage in dialogue with shareholders, and that confidentiality would undermine this open dialogue.

According to opponents, confidentiality not only is unnecessary and harmful to shareholder-management communication, but it also will cost companies more money. The estimates obtained by Subcommittee staff indicate that confidential voting and independent tabulation could add additional costs in the range of tens of thousands of dollars for an annual meeting, varying with the size of the company involved.

Another argument presented against confidential voting is that, as a practical matter, it would undermine the effectiveness of the proxy system. In a recent newsletter, John Wilcox, managing director of Georgeson & Company, a proxy soliciting firm, argues that the proxy voting system is already overly complicated due to the burdens created by aspects of the stock clearing and settlement systems such as multiple layers of ownership,

registration in depositories, and complex custodial arrangements. Wilcox says, "The system in its present form could not function effectively without the active involvement of corporate staff, proxy solicitors, and others who work closely on the mechanics of solicitation....It is likely that any system of confidentiality that restricts involvement by corporations and their agents would undermine the entire process. Confidentiality would...reduce voter turnout...and might even prevent some companies from achieving the votes necessary to constitute a quorum."

Finally, opponents point out that confidentiality conflicts with the goal of making sure that institutional proxy voters are held accountable to their beneficiaries. If institutional investors are shielded from having to disclose how they vote, there will be inadequate assurances that they are voting in accordance with their fiduciary duty?

EQUAL ACCESS TO THE PROXY MACHINERY

Shareholder activists also argue that, to increase management accountability, the proxy voting system should be reformed to provide shareholders with greater access to the proxy machinery. They point out that shareholders pay for the company's proxy solicitation, but have little access to it. In particular they call for the right to have their own nominees for director included in the company's proxy statement. Under the current system, only those candidates selected by management's own nominating process are listed on the company's proxy statement. Thus, in general, the only way shareholders can run their own nominees for director is by doing their own independent proxy solicitation which can cost hundreds of thousands of dollars or more.

Such "equal access" provisions were included last session in the Dingell-Markey Tender Offer Reform Act and in the Lent-Rinaldo Securities Trading Reform Act. The Dingell-Markey bill provided free and equal access to the proxy machinery to nominate candidates for director to any shareholder owning $500,000 worth or 3 percent, whichever is greater, of the outstanding voting stock of a corporation. The Lent-Rinaldo bill differed in that the ownership threshold was set at the lesser of 5 percent or $5 million worth of stock, but the right of access provided was not restricted to the election of directors.

Critics of equal access proposals argue that there is no reason for such reform. Furthermore, they say equal access provisions would increase the cost and complexity of proxy statements without really being of much assistance to shareholder dissidents. They contend that any shareholder challenger who is serious about getting his nominees elected to the board must and will have his own proxy materials as opposed to simply relying on the inclusion of his nominees in the company's proxy statement.

OTHER ISSUES

Critics of the current proxy voting system also point to the following issues as presenting other problems that need to be

addressed.

A. The problem of funding.

Shareholder activists are generally at a distinct disadvantage because, whereas management funds its proxy solicitation efforts from the corporate treasury, shareholders must pay all their expenses out of their own pockets.

Furthermore, with the exception of proxy contests for control, even if shareholders win the vote, they will find it difficult under state law to obtain reimbursement for their expenses.

B. The SEC's rules and procedures for allowing shareholder proposals on company proxy statements and for approving the language of shareholder proposals and proxy solicitations.

Based on the substantive grounds listed in Rule 14a-8, the SEC determines whether a company may properly exclude a shareholder proposal from its proxy statements. Some shareholder activists contend the SEC is overly broad in its interpretations of these substantive grounds for exclusion, thereby making it more difficult for shareholders to gain placement of their proposals on the company proxy statement. On the other hand, some in corporate management argue that the SEC should further broaden the scope of these exclusions to cover some of the shareholder proposals it presently refuses to exclude from company proxy statements.

The SEC also must approve the actual language used in both shareholder proxy solicitation materials and in shareholder proposals and supporting arguments included in the company's proxy material. Some shareholder dissidents contend that the SEC's requirements in this regard are overly technical and are more burdensome to shareholders than to management. These critics complain that shareholder proxy solicitation efforts have been unduly delayed by the SEC's process for approving specific language.

C. Obtaining the shareholder list.

Rule 14a-7 provides that in proxy contests, the issuer, at the shareholder dissident's request, must either (1) mail the dissident's materials to other shareholders, or (2) provide the dissident with a "reasonably" current list of shareholder names and addresses. Most companies choose to mail the shareholder's materials themselves which tends to be disadvantageous to the shareholder. Thus many shareholder dissidents are forced to resort to state law to obtain the shareholder lists. Under state laws, however, management generally is given the ability to obstruct and delay the process by which the shareholder lists can be obtained.

D. How votes are counted.

Critics of the way proxy votes are currently tabulated argue that, even aside from the danger of fraud, the system is flawed because of ambiguities surrounding how non-votes and abstentions

are counted in the final result. They point out that the treatment of these votes can be decisive in determining not only whether a particular shareholder proposal wins or not, but also whether proposals succeed in meeting the threshhold percentage of votes required under Rule 14a in order to be allowed back on the proxy statement at the following year's annual meeting. While state law governs how proxy votes are counted, proponents of reform suggest that federal law could at least require that companies disclose how they are treating abstentions and non-votes in their tabulating process.

E. The effectiveness of the system in getting proxy materials in a timely fashion to those shareholders entitled to vote.

Many shareholder voters and some representatives of corporate management express strong reservations about the actual ability of the present system to deliver the proxy materials to voters sufficently in advance so that marked ballots can be returned before the deadline for the receipt of votes. Some shareholder voters complain that they have received proxy materials just a few days prior to annual meetings. Much of this problem is attributed to the difficulties presented by the complex ownership layers and veils that hide the identity of shareholders.

Some critics also call for closer scrutiny of the Independent Election Corporation of America, the country's major proxy agent. IECA is paid by issuer companies to deliver proxy materials to and to collect the returns from shareholders who have registered their shares with brokers or banks. It is estimated to be responsible for soliciting and tabulating approximately 25% of all proxies for shares registered with brokers and banks (6.5 million proxy voting returns in 1985). Critics question the efficiency of its operations and say that presently no regulatory agency really oversees IECA's activity.

THE WITNESSES AT THE HEARING

Mr. Richard Foley is an experienced employee-shareholder activist. A brakeman/conductor with the Santa Fe Railroad, he founded an independent organization of employee shareholders that has filed numerous shareholder proposals relating to the corporate governance system of the Santa Fe Company. In 1988, their proposal against the company's poison pill became the first such shareholder proposal to win a majority of the vote.

Mr. Foley, Chairman of the Tucson Chapter of the United Shareholder Association, will testify about the difficulties shareholders encounter in the present proxy voting system and will speak in favor of confidential voting, independent tabulation, and equal access to the proxy machinery.

Mr. Dale Hanson is the Chief Executive Officer of the California Public Employee Retirement System (CALPERS). CALPERS has been one of the leading institutional investors pushing shareholder proposals to enhance shareholder democracy.

Mr. Hanson will testify about the difficulties CALPERS has encountered in using the proxy voting system with particular reference to their experience with proxy votes at US Air this year. Mr. Hanson will speak in favor of confidential voting, independent tabulation, and equal access to the proxy machinery.

Mr. James E. Heard is Managing Director of the Analysis Group. He previously worked for the the Investors Responsibility Research Center (IRRC) and for the United Shareholders Association. He is the author of the book Conflicts of Interest in the Proxy Voting System, published by the IRRC.

Mr. Heard will speak about his research on the proxy voting system and will testify in favor of confidential voting, independent tabulation, and equal access to the proxy machinery.

Mr. Roderick Hills is Managing Partner of Donovan Leisure Newton and Irvine, and Chairman of The Manchester Group, Ltd. He has served on the board of directors of numerous corporations, including Oak Industries, where he ultimately led a successful proxy contest for control of the company.

Mr. Hills will speak about the problems of the proxy voting system based on his experience as a director. He will testify that he does have concerns about the current system, but is opposed to requiring confidential voting.

Mr. John Wilcox is Managing Director of Georgeson and Company, one of the country's largest proxy solicitors. In this capacity, Mr. Wilcox has spoken widely regarding the corporate proxy voting system.

Mr. Wilcox will testify in opposition to confidential voting and independent tabulation.