John Endean President SR-NYSE-2006-92

65119077 RECEIVED 11

2007 JAN 16 AM 11:45

CHAIRMAN'S CORRESPONDENCE UNIT

American Business Conference *A Coalition of Growth Companies*

January 16, 2007

The Honorable Christopher Cox
Chairman
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-9303

Dear Chairman Cox:

The New York Stock Exchange (NYSE) recently submitted for Commission consideration a proposal to alter NYSE Rule 452. This proposal would end broker voting of uninstructed shares in the election of a company's board of directors. The vast majority of such elections are, of course, uncontested.

My organization, the American Business Conference (ABC), opposes this change in Rule 452. As we have argued, most expansively in the enclosed memorandum as well as in a forthcoming piece in *Directors and Boards*, we believe that the NYSE process that led to the proposal did not sufficiently take into account the perspective of midsize and smaller companies. We also believe that, if implemented, the denial of the use of the broker vote in director elections would exact large new costs on issuers, particularly smaller issuers, without a commensurate benefit for corporate governance.

Others have expressed concern about the costs of the NYSE's proposal. In an important report released last month, the Investment Company Institute (ICI) concluded that if the NYSE's proposal is put into effect, mutual fund expense ratios "could rise by approximately 1 to 2 basis points owing to higher proxy costs." Funds with "smaller average account balances and more than the normal difficulties in obtaining voted proxies," would be especially hard hit. According to ICI, they could see their expense ratios increase by as much as 5 basis points.

1828 L Street, NW Suite 908 Washington, DC 20036 (202) 822-9300 Fax (202) 467-4070
Website: www.americanbusinessconference.org

ABC does not deny that the broker vote is ripe for reform. Currently, the broker vote results in the casting of uninstructed shares exclusively on the side of management recommendations. Of course, it cannot be true that all the votes not cast in elections for the board would, had they been cast, have unanimously supported management recommendations. Yet that is the practical effect of the broker vote in its present incarnation.

Contrary to the recommendation of the NYSE, the answer to this problem is not to deny the use of the broker vote in director elections. A simpler, economical, and proven alternative is readily at hand, namely proportional voting, on a broker-by-broker basis, of uninstructed shares. For example, if those clients of XYZ Securities Firm who choose to return their proxies vote 80/20 in favor of a particular director, the uninstructed shares would be voted in the same proportion.

The advantages of moving to proportional voting of uninstructed shares are obvious. First, and this particularly applies to the handful of "just vote no" campaigns conducted each year, proportional voting would address activists' objection to the broker vote as a thumb on the scale in management's favor. Second, while providing for a fairer treatment for all shareholders, proportional voting would retain the cost advantages that the broker vote provides. Third, proportional voting could immediately be administered through the existing street side proxy system. Indeed, Charles Schwab, a brokerage company that is not a member of the NYSE, has already adopted a proportional voting policy. Additionally, it is common practice for many issuers to use proportional voting to vote the uninstructed shares held in company stock plans.

It is regrettable and puzzling that the NYSE did not embrace proportional voting. However, ABC has every confidence, given your demonstrated commitment, and the commitment of the Commission as a whole, to policies designed to protect investors while lowering the cost of issuer compliance, that the merits of proportional voting will be self-evident.

Accordingly, we hope that you and your colleagues will urge the Exchange to reconsider its proposal to alter Rule 452 in light of the superior advantages of proportional voting.

Sincerely,

John Endean

John Endean
President

cc: The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

American Business Conference *A Coalition of Growth Companies*

Memorandum

To: Friends of ABC
From: John Endean
Date: October 2006

Re: Report of the New York Stock Exchange's Proxy Working Group

In April 2005, the New York Stock Exchange (NYSE) established a working group to make recommendations with respect to NYSE proxy rules. The group's chair was Larry Sonsini, a noted corporate attorney, the chairman of the NYSE's Regulation, Enforcement, and Listing Standards Committee, and a former director of the Exchange. The group's members included representatives of NYSE listed companies, NYSE member organizations, institutional investors, representatives of the legal community, and the chairman of the NYSE Individual Investors Advisory Board.[1]

Last June, the working group issued its report. As a kind of case study of the current regulatory environment, the report deserves the careful attention of anyone interested in corporate governance, and the uses to which that malleable term can be put.

The purpose of the working group

In the United States, brokers and banks hold title to more than eighty-five percent of all publicly traded shares; these shares are said to be held in "street name." The beneficial owners of these shares, whether individual investors with brokerage accounts, or institutions, or mutual funds, or hedge funds, retain all of the economic rights of stock ownership, including, for example, the

[1]For a list of the working group members, see the appendix to this memorandum.

1828 L Street, NW Suite 908 Washington, DC 20036 (202) 822-9300 Fax (202) 467-4070
Website: www.americanbusinessconference.org

right to buy, sell, and vote the shares, as well as the right to receive capital gains and dividends.

Brokerage firms who are members of the New York Stock Exchange follow certain rules of membership. Among those rules are ones pertaining to the proxy process. It is through the proxy process that companies convene their annual meetings and shareholders exercise their voting rights on corporate matters at those meetings.

NYSE proxy rules involve three large matters crucial to corporate elections and shareholder communications: the broker or "10-day" vote (NYSE Rule 452), the definition of matters considered non-routine (and therefore ineligible for broker votes), and the setting of fees brokers charge issuers for distributing proxy materials and related communications (NYSE Rule 465). Although these are NYSE rules, *they apply to all public companies and their investors.*

When the working group's formation was announced last year, its creation was related to the larger decision of the NYSE to become a publicly traded business. It seemed reasonable for the Exchange to explore, through an informal working group, the extent to which a for-profit NYSE should continue to exercise regulatory oversight of the proxy process.

Among the possible changes that the Exchange suggested when it announced the formation of the working group were the elimination or, at least, the reforming of the broker vote rule, and the discontinuance of the NYSE's role as the administrator of proxy fees. In short, it appeared that in April 2005, the NYSE intended that the working group would provide some fairly focused ideas for relieving the Exchange of some of its regulatory responsibilities over the proxy process. This, at least, was my assumption when I made an informal presentation on the broker vote to the working group in May 2005.

I was wrong. By the time the working group issued its report last June, its sense of its mission had expanded markedly. For example, according to the report, "the single objective" of the group had somehow become the development of "recommendations which would create a more effective and efficient voting system for investors."

"As part of this objective," the report says, the working group "was encouraged" – by whom it is not clear – to consider the NYSE's broker vote and fee setting rules "within the broader framework of the proxy voting system" and "make such recommendations as it deems appropriate even where those recommendations *went beyond the specific regulatory authority of the* NYSE" [emphasis added].

To the objection that an informal working group ought not to rove at will beyond the regulatory authority of the body that created it, the report offers little in the way of justification. Rather, it simply points to the Exchange's leadership on corporate governance matters, a proposition not necessarily self-evident to everyone. It also assures readers that the members of the working group were "cognizant" that all companies and all shareholders "would be affected by any changes" in proxy rules.

The broker vote and the working group

By law, *institutional* beneficial owners of equity vote their shares in corporate elections. In contrast, *individual investors* with brokerage accounts often do not vote the shares they beneficially own. This can cause problems for firms with large numbers of individual street side shareholders. Although some large-cap companies fit this ownership profile, small and mid cap companies more typically have large amounts of their stock in the brokerage accounts of individuals.

The broker vote rule addresses the problem caused by the failure of many individual investors to vote their shares. Under the rule, when beneficial owners do not return their proxy cards, their brokers *may* vote those "uninstructed" shares on matters of routine business. Not all brokers avail themselves of this opportunity. Typically, when brokers do exercise their right to vote uninstructed shares, they vote in favor of management's recommendations.

Defining what constitutes routine business has been the responsibility of the Exchange, subject to the approval of the Securities and Exchange Commission (SEC). At present, the broker vote is used in regard to three matters: establishment of a quorum for shareholder meetings, approval of an independent auditor, and election of directors in uncontested elections.

The most basic service provided by the broker vote is allowing companies to achieve quorum for their annual meetings. Without a quorum, there is no meeting and no corporate business can get done. In 2004, had the broker vote not been in effect, 85 percent of NYSE companies would have been working to reach quorum in the final nine days before their meetings while 23 percent would not have reached quorum by the meeting date. In a world without the broker vote, companies uncertain of their ability to reach quorum in a timely way would be forced to hire proxy solicitors, at considerable cost, to round up votes simply to allow a meeting to proceed.

So far as I know, no one argues that companies should face greater expense simply to reach quorum. Instead, the controversy surrounding the broker vote tends to focus on director elections. Institutions and shareholder activists argue that in the election of directors, the broker vote functions as a thumb on the scale in favor of management in "just vote no" campaigns, which current NYSE rules fail to define as non-routine. On that point, they are surely correct.

The brainchild of former SEC Commissioner Joseph Grundfest, "just vote no" campaigns are a protest device by which unhappy shareholders withhold their votes for the board of directors or specific members of the board. It is not easy to get exact statistics on the number of "just vote no" campaigns waged each year. The best number I have seen suggests that there were only about twenty such efforts in calendar year 2004. They are typically waged against large corporations.

"Just vote no" campaigns cannot defeat board candidates since, as a legal matter, only one vote in favor of an unopposed candidate assures his or her election. Rather, the purpose is to embarrass management and the board and thereby force change. To that end, the higher the percentage of withheld votes, the higher the level of embarrassment. The broker vote works to lower that percentage because broker-voted shares favor management recommendations and, therefore, are cast in favor of the candidates for the board.

An obvious solution to this predicament is simply to refrain from using the broker vote in the handful of board elections subject to "just vote no" campaigns. In other words, such situations should be deemed contested races and, therefore, non-routine. Some argue that the task of identifying legitimate "just vote no" campaigns presents difficulties. It is certainly true that issuers would have a strong incentive to deny the validity of a "just vote no" campaign launched against them, thereby keeping their thumb on the scale. Similarly, for their part, activists would have an incentive to broaden the number of "just vote no" campaigns to include frivolous and unsubstantial protest gestures.

The good news is that neither side would have to define what constitutes a legitimate "just vote no" effort. ADP, the independent processor of the vast majority of street side voting, already administers the routine/non-routine criteria in consultation with the NYSE.[2] It could easily apply whatever criteria were established for identifying "just vote no" campaigns. Given ADP's neutral status, there is every reason to believe that an acceptable and reasonable process could be put in place to declare a "just vote no" campaign genuine, thereby making the director election in question non-routine and thus not subject to the broker vote.

Even if this sensible and targeted solution were adopted, the broker vote would still require reform. As it now exists, it is an absurdity. It cannot be true that all the votes not cast in elections for the board, for the appointment of an auditor, or, maybe even in the establishment of a quorum, would, *had they been cast,* have unanimously supported management recommendations. Yet that is the practical effect of the broker vote.

The American Business Conference believes, as I have noted in a number of places, including before the NYSE working group, that a better alternative would be the *proportional voting, on a broker-by-broker basis,* of uninstructed shares. In other words, if those clients of XYZ Securities Firm who choose to return their proxies vote 80/20 in favor of a particular director, the uninstructed shares would be voted in the same proportion. Such a system would provide fairer treatment for all shareholders while retaining the broker vote. One wide-awake brokerage company, Charles Schwab, has already adopted a proportional voting policy.[3]

I have come to think that proportional voting ought to apply to a great many matters, whether or not routine, that come before shareholders for a vote. Currently, adoption of many non-routine matters requires a majority of the outstanding shares for approval. This vote is inherently inaccurate since, absent the broker vote, all uninstructed shares are considered "no" votes. It would be more accurate, if not absolutely precise, to use proportional voting. Not incidentally, it would also be a way of removing the now for-profit NYSE from deciding in many cases what is routine and not routine – a task that, in my opinion, it should not be asked to fulfill.

When the working group issued its report in June, however, it quickly became clear that it had no intention of removing the NYSE from the administration

[2] Automated Data Processing (ADP) recently announced that it is spinning off its investor communications business into a separate company. When I use "ADP" in this memorandum, it is that business to which I am referring.

[3] I am told that it is also common practice for many issuers to use proportional voting to vote the uninstructed shares held in company stock plans.

of the broker vote -- quite to the contrary, in fact. Its chief recommendation was simply to declare all director elections non-routine while preserving the broker vote for quorum purposes and for the ratification of the board's appointment of an auditor.

Accompanying this recommendation were large claims for its significance for good corporate governance:

> ...[I]t is important to recognize that the election of a director, *even where the election is uncontested*, is not a routine event in the life of a corporation. Directors are simply too important to the corporation for their election to ever be considered routine. *While this is likely to result in some greater costs and difficulties for issuers*, it is a cost *required* to be paid for better corporate governance and transparency of the election process. [emphasis added]

I do not understand how requiring thousands of companies (really their stockholders) to pay more for uncontested director elections – and the overwhelming bulk of director elections are uncontested and not subject to "just vote no" campaigns – is a categorical imperative for better corporate governance. If we have a corporate governance problem in this country, the locus of that problem surely lies elsewhere. After all, declaring director elections non-routine does not confer to shareholders a new, fundamental right to vote for directors. They already have that right; it is their failure to exercise their franchise that is the predicament for issuers. [4]

What would be the long-term effect of declaring director elections non-routine? Two things come to mind.

First, as the report itself notes, there is already a movement to require that board candidates receive a majority of shareholder votes cast in order to serve. Some large companies have already voluntarily adopted one or another version

---

[4] The working group considered the merits of a broker-by-broker proportional voting system, concluding that the idea was "somewhat attractive" but not an "optimum result." Why only "somewhat attractive?" The working group report alleges that a proportional voting system "may be subject to abuse" if "one broker has a large number of uninstructed shares and an unusual vote by the instructed shares." The report does not explain how, practically, this sort of "abuse" could be pulled off and why. In the absence of such an explanation – one that the people at Charles Schwab should be demanding – I conclude that this vague and unsubstantiated "concern" was just a pretext to dismiss proportionate voting out of hand.

of this idea. It is possible that, in the coming years, changes in state law will make majoritarianism the default standard for all public companies.

If that happens, and if the broker vote no longer applies for director elections, the effect on issuers, as the report concedes, would be "significant" and adverse. To avoid a failed election, or an election of a director by a meager margin – no one with a normal ego wants to get only 50.1 percent of the vote in an uncontested race – companies would inevitably have to pay proxy solicitors a good deal of money and consume a lot of time to round up votes. How such an expensive paper chase would benefit corporate governance is not clear.[5]

Second, and this is the larger point, declaring all director elections as non-routine would endanger what would remain of the broker vote. Some shareholder activists, such as the Council of Institutional Investors, have in the past said they would tolerate the broker vote if it were used only to establish a quorum. The trouble is, under current state law, the broker vote probably could not be limited in that way. Most experts believe that in the absence of other routine matters to which the broker vote would apply, ***uninstructed shares could not*** *be voted by brokers to establish a quorum.* Thus, law firms are advising their corporate clients that, in the event that director elections become non-routine, issuers should, in the words of a memo by attorneys at King & Spalding, "ensure that each annual meeting has at least one routine matter on the ballot" in order to make use of the broker vote for quorum purposes.[6]

The only routine matter that would remain, if director elections were redefined as non-routine, is the ratification of the appointment of an auditor. It was not so very long ago that corporate critics regarded the relationship between an issuer and its accounting firm as anything but routine. I think it inevitable that this case will be made again, thereby threatening the continued existence of the broker vote.

---

[5] Embedded in this turn-out the vote mentality is, of course, a rarely examined assumption that corporate governance is or ought to be analogous to political democracy. A skeptical evaluation of this assumption can be found in A. Gilchrist Sparks, III, "Corporate Democracy – What It Is, What It Isn't, and What It Should Be." Gilchrist's paper was presented at the Spring 2006 meeting of the ABA Section of Business Law in Tampa, Florida. Sparks was co-chair, with working group member Margaret Foran, of the ABA task force on majority voting.

[6] King & Spaulding LLC, *Client Alert: Director Elections Would Be Impacted by NYSE Group Proposal*, June 9, 2006. Available on the firm's website, www.kslaw.com.

If adopted by the NYSE, the Working Group's recommendation to make board elections non-routine will set in motion forces that will needlessly raise costs to all issuers without any demonstrable improvement in issuer accountability or governance. As is so often the case, those costs will disproportionately be borne by smaller public companies.[7] That the working group shrugged off reforms such as proportional voting or making "just vote no" contests non-routine represents a missed opportunity to improve the broker vote without sacrificing the real benefits it provides.[8]

<u>The context</u>

Why did the working group narrow the application of the broker vote, thereby endangering its existence? One answer is that there was no one on the group who had a discernible stake in the vote's preservation and reform.

The representatives of the institutional investors were of course likely to be hostile to the broker vote, particularly as it pertains to director elections. One cannot expect them to have taken any other position. As for the representatives of the brokerage firms, while their companies administer the broker vote according to NYSE requirements, they have no financial stake in its preservation.

The real problem was with the issuer representatives. As professionally distinguished as they were, none were drawn from the 23 percent of NYSE companies that would not have made quorum in 2004 absent the broker vote. None, therefore, had a visceral commitment to forestalling its weakening.

Further, none of the issuer representatives came from the universe of smaller public companies. The smallest company by revenues on the working group

---

7 As the report of the working group concedes, the adverse cost and related consequences of making uncontested director elections non-routine "could fall most dramatically on smaller issuers, who have a smaller proportion of institutional investors and/or greater difficulty in contacting shareholders and convincing them to vote in uncontested elections."

8 The recommendation to make all director elections non-routine and the costs that would entail is an excellent example of what Professor Lynn Stout of the UCLA School of Law calls "the unintended consequences of top-down corporate governance 'reforms' that are not based on compelling evidence." Lynn A. Stout, "The Mythical Benefits of Shareholder Control," UCLA School of Law, *Law & Economics Research Paper Series, Research paper No. 06-19*, p. 15. Professor Stout's paper deserves broad attention for its learned and iconoclastic analysis of the claims made for shareholder democracy in regard to the election and removal of directors. It is available without charge at <u>http://ssrn.com/abstract=929530</u>.

was Amerigroup Corporation a Virginia-based managed care provider. In 2005, this midsize firm reported annual revenues of over $2 billion. According to its website, *99.4 percent* of Amerigroup's outstanding shares are held by institutions. Given that remarkably unusual ownership profile, the broker vote, for Amerigroup, is an irrelevancy.

The other three issuers represented on the working group – Pfizer, Exxon Mobil, and American Express – also have large institutional ownership.[9] And all three are members of the Business Roundtable (BRT), which limits its members to America's largest companies and is perhaps the most influential of all business associations here in Washington. One of the legal representatives on the working group, Amy Goodman, a partner at Gibson, Dunn and Crutcher, is counsel to the BRT on proxy issues.

This BRT connection is significant. In 2004, the Roundtable petitioned the Securities and Exchange Commission for a rulemaking in regard to street side shareholder communications. The BRT petition was an attack on the current street side proxy process. It alleged that the process was technologically backward, costly, dilatory, and an unnecessary barrier to good corporate-shareholder communications.[10]

Under the current single processor model, an independent, third-party processing service – ADP in most cases – forwards to beneficial owners, not all of whom wish to have their identity known to issuers, proxy materials relating to annual meetings, including proxy cards. The processor subsequently tallies, with audited controls, the street side vote and reports the results to issuers. ADP works under contract to the banks and broker-dealers who supply it with the names and addresses of beneficial owners. The banks and broker-dealers

---

[9] The approximate institutional holding as a percentage of outstanding stock of the three companies is as follows: Exxon Mobil, 52%; Pfizer, 66%; American Express, 83%. These data come from the Internet site Yahoo! Finance. Similar sites report slightly varying percentages.

[10] The 2004 BRT petition was supported by Georgeson, a proxy solicitation firm, and by the American Society of Corporate Secretaries (ASCS). ASCS, which recently "rebranded" itself as the Society of Corporate Secretaries and Governance Professionals. The latter group concerns itself, according to its website, www.governanceprofessionals.org, with, among other things, the "proxy process and the annual meeting of shareholders and shareholder relations, particularly with large institutional owners." The American Business Conference opposed the BRT's petition, as did the AFL-CIO, the Securities Industry Association, and other groups and individuals. It is not my thought to replay the details of this controversy. The petition and the various comment letters reacting to the petition are available on the SEC website (www.sec.gov).

subsequently invoice issuers for their proxy-related costs. The NYSE, in turn, sets the fees banks and broker-dealers charge issuers.

In its petition to the SEC, the Roundtable called for eliminating the role currently played by broker-dealers and ADP in street side proxy communication and voting, in favor of some sort of direct communication between companies and shareholders. This proposal raises a number of important matters that I have addressed elsewhere.[11] The one that concerns me here is that, obviously, the broker vote under the BRT's proposal would disappear with the elimination of broker-dealers from the proxy process. You can't have a broker vote without brokers.

Ironically, perhaps, since big issuers and institutional investors so often are seen as at odds, in regard to the broker vote the BRT and organizations representing institutional investors share a similar perspective. For different reasons, both seek, or (in the BRT's case) would tolerate, its elimination. And that means that neither would have much of an incentive to pursue intelligent reform of the broker vote, such as, for example, the establishment of proportional voting.[12]

In summary, the NYSE working group lacked issuer representatives committed to the broker vote. That fact, in the face of hostility from representatives of institutional investors or indifference from representatives of broker-dealers, made it unlikely that the maintenance and improvement of the broker vote would be an alternative thoroughly explored or ultimately recommended by the working group.

Study proposals

Just as it would preserve, in diminished form, the NYSE's administration of the broker vote, the working group's report assumes that, for the foreseeable

---

[11] See, *e.g.*, Letter of John Endean to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, Re: Rule No. 4-493, Business Roundtable Petition for Rulemaking Regarding Shareholder Communications, July 19, 2004. This letter is available on the SEC website, (www.sec.gov).

[12] I do not mean to suggest that the Roundtable actively opposes the broker vote. Instead, the BRT has argued that the vote is on its way out and the Roundtable for its part has not been inclined to do much about that. For example, in a 2004 presentation to the Securities Industry Association, Amy Goodman, the BRT outside counsel and NYSE working group member, noted that use of the broker vote had been curtailed in regard to shareholder approval of equity compensation plans. She added that "consideration" was being given to "further restrictions" of the broker vote. Ms. Goodman's PowerPoint presentation does not state who, exactly, was pondering these further restrictions.

future, the NYSE will continue to administer proxy fees through Rule 465. It does not examine the implications of having a for-profit entity exercise this kind of regulatory authority. Indeed, it recommends that the NYSE launch a series of studies that, taken together, would have the effect of *expanding* the Exchange's influence over the street side proxy process. Here is where the working group's "mission creep," described earlier in this memorandum, can be seen.

- The working group proposed that the NYSE hire an undesignated "independent third party" to analyze and make recommendations regarding "the structure and amount of fees paid pursuant to Rule 465." A parallel initiative would continually evaluate "the effectiveness and necessity" of the broker vote.

- The working group called on the Exchange to review brokers' contracts with ADP as well as to conduct "satisfaction surveys" of the "various constituents in the proxy voting process."

- The working group urged the Exchange to request that the SEC "study the role and influence" of shareholder advisory groups in the proxy system.

- Most expansively, the working group recommended a NYSE study to review "the entire shareholder communications and proxy voting system." It specifies that the study's authors will also "recommend a plan to evolve the current system into a free market model with competitors to ADP and unregulated fees."

In its lawyerly and measured way, the report is careful to cite the street side proxy system's benefits, calling it "a tremendous success." Yet it also notes, without comment, the BRT's claim that the system is "circuitous," "unnecessarily time-consuming," expensive, and an impediment to communication between issuers and their beneficial owners. Those don't sound like the elements of a "tremendous success" to me. I do not think they will sound that way to other readers, either, especially given the report's various study recommendations. While the report does not explicitly endorse the BRT's proposal to change the street side proxy process, with these studies it tiptoes right up to it.

As it happens, many of the matters the working group wishes to have studied have already been exhaustively examined by proxy review groups over the last twenty or so years. Most recently, in 2001, a Proxy Voting Review Committee (PVRC), initiated by the SEC *and independent of the New York Stock Exchange*, studied the street side proxy process, focusing on the appropriateness of the proxy fee structure and whether the entire beneficial proxy voting process served the interests of all constituencies. The PVRC included representatives of large, midsize, and small issuers, institutional investors and brokers.

The PVRC concluded that the cost of the proxy process to all issuers, not just big firms, was steadily coming down because the administered fee system combined with the single processor model created incentives for technological efficiencies. The committee's chairman summarized the views of the PVRC in calling the street side proxy process "the finest proxy system in the world," whose "integrity, efficiency, fairness, audit ability [sic] and reliability…must be maintained." [13]

To its credit, the working group report cites the PVRC's conclusions and its endorsement of the street side proxy system. It also notes the PVRC's finding that the street side proxy process enjoys a *400 percent* cost advantage over the registered side (registered shareholders do not own their shares through brokerage accounts).

Under these circumstances, it would seem hard to justify calls for further study of the street side proxy process with the aim of abandoning it for another model. To rationalize taking that course, the working group invokes everyone's favorite *deus ex machina*: technological change. Supposedly, new technological developments since 2001 have "provided the opportunity for easier and less expensive…communication between issuers and shareholders." The report

---

[13] The chairman of the PVRC was Steve Norman of American Express. Mr. Norman was also a member of the NYSE Working Group. Richard Koppes, another member of the working group, was secretary to the PVRC and wrote much of the latter's report. Since the working group report, in its recommendations, pretty thoroughly repudiates the PVRC conclusions and calls for studies that would replicate what the PVRC did only four years ago, it would be interesting to know if Messrs. Norman and Koppes have changed their minds about the excellence and accountability of the street side proxy process. More likely, the force of their views, like a counter current, explains the rather schizophrenic quality of the report's descriptive text which veers back and forth from praising the street side proxy process (*e.g.*, "it is impossible not to recognize the tremendous success of the existing system") to finding, with a characteristic lack of evidence, all sorts of problems (*e.g.*, "there is limited accountability in the current system"). This careful ambivalence perhaps takes the place of the publication of dissenting views. If so, it is regrettable. In my opinion, the publication of dissenting views, and a correspondingly less ambivalent majority report, would have resulted in a more serviceable report.

neither identifies those changes in technology nor explains why they have not been or could not be captured by the current system.[14]

Short end of the stick

It is no secret that big business, in the form of the BRT, has been frustrated with the SEC in regard to the Roundtable's petition to change the street side system. The BRT and its allies have complained to the Commission about the latter's lack of action.[15]

The working group's formation, a function of the Exchange's decision to become a for-profit, publicly traded entity, gave the BRT an opportunity to press its case in a friendly forum. While the working group did not embrace the BRT position, the report did provide a helpful boost by endorsing the paring back of the broker vote and calling for studies that seem, simply by being recommended, to subvert the legitimacy of the current system.

Presumably, if the BRT goes back to the SEC to again demand action on its original position, the report of the working group will figure prominently in the Roundtable's call for action – regardless of whether or not the Exchange actually accepts the report's recommendations.[16] The working group report will ultimately be most useful to the BRT and its allies as a counter to the PVRC report.

I find nothing nefarious about any of this. It is business as usual. Given that the NYSE's revenue model turns on listing fees and trading volume, the

---

[14] The only technological change I can think of – the SEC's push for the use of interactive data in financial reporting – has no obvious connection to the structure of the street side proxy process.
[15] See letter of John J. Castellani, Louis M. Thompson, Jr., Charles V. Rossi, and David Smith to Alan Beller and Annette L. Nazareth, July 29, 2005. At the time of the writing of this letter, Mr. Beller was Director of the Division of Corporation Finance at the SEC and Ms. Nazareth was Director of the Division of Market Regulation. Ms. Nazareth is currently an SEC Commissioner. The letter is available at http://www.governanceprofessionals.org/commentletters/coalitionviews.pdf.
[16] Thus Mr. Thomas J. Lehner, a senior official of the Business Roundtable, recently said that "it's imperative that the SEC resolve the shareholder communication issue," in light of the working group's recommendation to change the broker vote. See Kip Betz, "NYSE Extends Time Before Proposing Change on Voting of Uninstructed Shares," Bureau of National Affairs, *Daily Report for Executives,* October 4, 2006, pp. A-25 – A 26. As an aside, this piece incorrectly alleges that "of late" that there have been a "number of high profile instances" of "broker votes swinging the election of company officers." I know of no such instance, high profile or otherwise; indeed such an outcome would be impossible except in cases in which majority voting had already been put into place by a company. Otherwise, in an uncontested election, only one vote is needed to elect a director. In a contested board election, broker votes are not counted because such elections are not routine.

Exchange is naturally going to pay closest attention to the views and policy goals of its largest listed companies. That fact, and the NASDAQ's curious deference to the NYSE as the latter moves to change the proxy process for all public companies, is the central dynamic behind the report.[17]

Because smaller issuers with significant numbers of individual shareholders on the street side were not included in the working group's membership, they got the short end of the stick. By declaring that all director elections, most of which are uncontested, should be non-routine, the report kicked an important prop out from under the broker vote, which has served smaller public companies so well. And, in its calls for a study to develop a free market model for proxy fees, the report would grant big business the leverage to beat down the fees they must pay while handing smaller companies a bigger bill.

It is important to be clear about this second point. I bow to no one in my reverence for the free market or my prodigal use of free market rhetoric to justify my views on a host of issues. Nevertheless, the fact is, if proxy fees are not administered in an equitable way, smaller companies will pay more and bigger companies will pay less.

If one purpose of American public policy is to provide open competition for enterprises of all sizes, the case for scale in how regulatory costs are apportioned is unavoidable. Administered pricing of street side proxy fees is one way of doing this, while still insuring the introduction of technological efficiencies that have helped to secure a 400 percent cost advantage over the registered side.[18]

---

[17] To the best of my knowledge, the NASDAQ, which lists many smaller public companies, has not said anything publicly about the broker vote or about possible changes in the proxy fee structure. The NASDAQ has the same revenue model as the NYSE, and NASDAQ's largest listed issuers may be as indifferent to this matter as are their counterparts listed on the NYSE.

[18] My skepticism about the BRT's proposal for revamping the street side proxy process does not mean that I think all is well with shareholder voting. New investment vehicles and strategies may threaten the integrity of shareholder voting because of what Professors Henry Hu and Bernard Black have identified as the "decoupling of economic ownership of shares from voting rights to those shares." Hu and Black call this "new vote buying." It is a phenomenon that deserves careful study and, perhaps, new disclosure rules. Issuers of all size should be able to find common ground on this matter, rather than disagreeing over efforts to remove brokers from the street side proxy process. See Henry T.C. Hu and Bernard Black, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms," *The Business Lawyer,* Volume 61, May 2006, pp. 1011 – 1070.

The larger issue

As I noted at the beginning of this memorandum, the NYSE Proxy Working Group is best seen as a small case study of a larger issue. That larger issue is how very big institutions in American economic life – big business and big institutional investors – pursue their own ends in the name of greater accountability and improved corporate governance. Some good has resulted from this process. It has nonetheless been heedless of smaller public companies, which often face very different costs and governance challenges.

One sees the same themes in the current controversy over reforming Sarbanes-Oxley legislation (SOX). Earlier this year, the SEC's Advisory Committee on Smaller Public Companies released a report to assess "the current regulatory system for smaller companies under the securities laws of the United States and make recommendations for changes." This report represents the most searching and comprehensive examination available of regulatory costs on capital formation for smaller public companies. It documented how the costs of regulation, in particular the costs of new internal control and auditing requirements established by SOX, are "dramatically higher" as a percentage of revenues for smaller public companies than they are for larger public companies.

Shortly after its release, the Advisory Committee report was allowed to slip quietly overboard. I doubt that twenty people ever read the whole thing and, with a couple of exceptions, it stirred little Congressional interest. Indeed, the only attention that the Advisory Committee report received had to do with its proposal to temporarily relieve very small public companies from the internal controls provisions of SOX. The entire establishment jumped all over this idea. One part of the establishment -- big companies – found it preposterous that a carve-out from SOX would not include them. Of course, the corporate governance elite disliked it for the opposite reason: they feared any exception to SOX might eventually apply to big companies. Lost in this shuffle was any consideration of the merits of the idea itself.

By way of contrast, a new group calling itself The Committee on Capital Markets Regulation was recently founded, comprising, according to the Committee's press release, "U.S. business, financial, investor and corporate governance, legal, accounting and academic leaders." This group will be suggesting SOX-related "changes in regulation and legislation" to "improve the competitiveness of the U.S. public capital markets."

The Secretary of the Treasury has said that he wishes the Committee well and so do I. Looking at the Committee membership, though, I am struck by the absence of anyone who could remotely be considered a representative of smaller public companies or the venture capital community. Instead, I see that the President and Co-COO of the NYSE is on board, as are several Business Roundtable members such as the CEO of PriceWaterhouseCoopers and the CEO of Office Depot.

Now, The Committee on Capital Markets Regulation is, I gather, a privately funded group. No one says that room must be made in the club for smaller public companies or venture capitalists. What I do say is that to the extent that the Committee comes up with reform ideas, the capital formation problems of smaller American companies are not likely to be much addressed. This is the pattern we have already seen with the NYSE Working Group.

That pattern has implications for the future of smaller companies and how they finance their growth. As Professor William Carney recently wrote, in the *Emory Law Review*: [t]he relevant question today is whether regulation has gone so far as to force honest businesses, *at least those of modest size*, to consider abandoning public markets for less regulated private markets. [emphasis added]"[19] This is a real concern and, as the experience of the NYSE Working Group suggests, it is a function of a regulatory regime that, for now at least, remains indifferent to that prospect.

---

[19] Quoted in Peter J. Wallison, "The Canary in the Coal Mine: What the Growth of Foreign Securities Markets and Foreign Financing Should Be Telling Congress and the SEC," *Financial Services Outlook*, American Enterprise Institute for Public Policy Research, August 2006. Wallison's important piece is available on the Institute's website, www.aei.org.

Appendix

Members of the New York Stock Exchange Proxy Working Group

Larry W. Sonsini, Chairman

NYSE Listed Companies

- Jeffrey McWaters, CEO, Amerigroup Corp.
- Margaret Foran, Vice President and Corporate Secretary, Pfizer, Inc.
- Stephen Norman, Corporate Secretary. American Express
- James Parsons, Corporate and Securities Counsel, Exxon Mobil

NYSE Member Organizations

- Esta Stecher, EVP and General Counsel, Goldman Sachs (represented by Beverly O'Toole of Goldman, Sachs)
- Rosemary Berkery, EVP and General Counsel, Merrill Lynch
- Judith Smith, Managing Director, Morgan Stanley

Institutional Investors

- Gary Glynn, President, U.S. Steel Pension Fund
- Peter Clapman, SVP and Chief Counsel for Corporate Governance, TIAA-CREF
- Glenn Booraem, Principal and Assistant Fund Controller, Vanguard Group

Legal Community

- Richard Koppes, Of Counsel, Jones, Day
- Amy Goodman, Partner, Gibson Dunn & Crutcher

Individual Investors

- Kurt Stocker, Professor, Medill School of Journalism, Northwestern University and Chairman, NYSE Individual Investors Advisory Board