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Voting Rights and the Right to Vote

by

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The Development of the Right to Vote

When the modern corporation first developed in the 19th century, the shareholders, as residual owner of the corporation, typically were relatives or members of the local community. Shareholders' meetings were important because they provided a forum for discussion about the conduct of the business and a sharing of the collective wisdom. In that era, a shareholder's vote was considered a property right by the courts, so precious and personal that it could not be delegated. The increase in non-related shareholders led to statutory laws that gave shareholders the right to make proposals and vote at corporate meetings.

As corporate ownership became widely dispersed, with greater numbers of shareholders spread across a growing geographic area, it became more and more inconvenient for shareholders to attend meetings, and the absent shareholder was effectively disenfranchised. Thus, the delegation of one's voting right, or proxy, was developed to enable the shareholder to exercise his or her voting right in the corporation.

Growth in Abuse by Management

However, in contrast to the pre-proxy shareholder meetings where corporate information flowed freely, the absent shareholder was left in "dangerous ignorance" because statutes granting the right to vote by proxy did not provide that the shareholder was entitled to receive all the necessary information needed to make an informed decision about the corporation. The shareholder who could not attend the meeting in person was still effectively disenfranchised. This development, as well as the move from family controlled to publicly held companies with non-controlling management, allowed this new management to take advantage of an uninformed owner and entrench itself in corporate control.

Some commentators argue that since the proxy system for shareholder participation emerged, corporate directors have enjoyed virtually unfettered control of the company domain.¹ This power has resulted in some startling examples of abuse such as economic and political corruption, rushes of risky leveraged buy-outs for short-term gain, and excessive executive compensation.

Voting at shareholder meetings is generally the only means outside of laws and regulation that the shareholder has available to protect his status as residual owner of the corporation. Although laws and regulations often mandate that shareholder action by vote is necessary for certain corporation activities, the shareholder's vote has in some cases been rendered meaningless because of significant barriers to the proxy and voting process.

Growth in Abuses by Management

¹ Joseph E. Calio and Rafael X. Zahraiddin, The Securities and Exchange Commission's 1992 Proxy Amendments: Questions of Accountability, 14 Pace L. Review 459, 537-38 (1994).

The primary reason for shareholders lack of control is that management enjoys certain advantages once it comes to power, such as control over the proxy process, so that it is rare for a pro-management director to be removed from office. Management also enjoys significant advantages over the shareholder with regard to shareholder concerns.² Additionally, the judicial construct of the business judgment rule protects the Board from shareholder claims of negligent mismanagement. Thus insulated from the shareholder by seeming pro-management regulation and judicial deference, an incumbent Board has less incentive to be responsive to shareholder issues.

Compounding the phenomenon is shareholder apathy. As observed by Professor Palmiter³:

Public shareholders have little incentive to determine whether initiatives not supported by management have merit. The natural tendency is to assume that the proponent, a self-appointed representative of shareholder interests, has a personal agenda and that if the proposed reform were in the corporation's best interests management would already have initiated it. That is, the chance of an outright voting victory is slim even in the case of value-producing proposals

Is there really a need for increased shareholder participation?

Several benefits may be gained from increased shareholder participation. First, increased access to the corporate board and to more information would increase the value of the company and reduce the risk of poor or corrupt management.

In the contest for control, a Director faced with a real threat of being replaced by the electorate will tend to direct in a more beneficial manner. Inferior management will presumably be replaced by superior managers, thus increasing value. Also, group dynamics will be improved because more truly outside directors will be elected to the Board providing a check on insider interests.

Furthermore, in the context of issue contests, increased access will likely result in better decision-making in corporate policy. Similar to the electoral contest, directors faced with the threat of increased participation by the shareholders would rationally choose to be more responsive to shareholder issues and avoid self-interested actions such as excessive compensation increases. Thus, with either better performance before the contest, or beneficial change as a result of the contest, an overall increase in value insures not only to the shareholder but also to the public at large.

The primary argument of those opposed to increasing shareholder participation is the "Wall Street Rule," which provides that the stock market is the best check on management

² Mark J. Lowenstein, The SEC and the Future of Corporate Governance, 45 Ala. L. Rev. 738, 797-799 (1993)

³ Alan R. Palmiter, The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation, 45 Ala. L. Rev. 879, 917 (1994)

because dissatisfied shareholders will "vote with their feet" and sell their shares, thus driving the stock prices down.⁴

The "Wall Street Rule," however, has the unfortunate result of pressuring management to make ill-advised decisions to increase short-term gain at the expense of longer term concerns.

Over the last few decades, there has been an extraordinary shift in the pattern of stock ownership. Institutional investors now account for a substantial percentage of stock ownership in American companies, owning approximately one-half of the outstanding stock in public companies. The "typical" shareholder in the United States and most other countries is now an institutional investor, such as a pension plan or mutual fund. This contrasts sharply with earlier patterns of stock ownership.

The shift in ownership and economic power has been accompanied by a significant decrease in the average holding period for stocks. This phenomenon is clearly demonstrated by comparing the stock turnover rates experienced in the early 1960s with current turnover rates. In 1960, the rate of turnover for stocks traded on the New York Stock Exchange was between twelve and fourteen percent. To rephrase this statistic, if 1000 investors had each purchased one share of stock in 1960, approximately 860 of those investors would retain ownership of their shares one year later. In contrast, if 1000 investors each purchased one share of stock today, chances are that 900 or more of those shareholders would sell their shares within a year. In large part, institutional investors are responsible for this increased volatility; they account for nearly eighty percent of trading volume on the major American exchanges.⁵

Under the current proxy rules of most countries, which often deprive shareholders of the opportunity to participate in corporate governance, shareholders generally have no option but to sell if they are dissatisfied with management. This is likely to increase the turnover of corporate stock ownership, a phenomenon that is generally perceived as undesirable. Legal and news commentators, financial analysts, and members of management are complaining that the high turnover of stock ownership is producing a whole range of undesirable consequences. First, it increases volatility in the capital markets. Second, it forces management to make decisions that are profitable in the short term, even when other alternatives would produce superior long-term results.⁶

Of course, benefits such as improved decision making will be realized only if shareholders are both able and willing to assume an active role in corporate governance. Given that institutional investors have replaced individuals as the most common type of shareholder, it is now feasible for at least some shareholders to participate in corporate governance at a meaningful level if the barriers to such participation were removed.

From my perspective as Chief Investment Officer of an asset management company in Brazil, the following is a list of what I see as key proxy voting problems now faced by fund managers and other investors, along with some suggestions for improving this process.

⁴ Id. at 901-902.

⁵ Carol Goforth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late, 43 Am. U. L. Rev. 379, 403-404 (1994).

⁶ Id. at 407.

Key Problems and Policy Recommendations

1) Institutional investors need to take a more active role.

Consider voting a fiduciary duty

Shareholder passivity regarding the exercise of their right to vote is a major problem in both developed and developing markets. Procedural changes to facilitate voting will not result in improved governance practices unless shareholders exercise their rights.

For U.S. institutional investors, exercising their voting rights not only makes good economic sense, it is also their fiduciary responsibility. In 1994, the U.S. Department of Labor formally extended the legal stipulations of proxy voting requirements for public pension funds to proxies for non-US corporations.

We believe that the fiduciary duty to vote, should be extended to all countries and, where possible, should be enforced legally.

Institutions should develop proxy voting policies

Institutions with voting authority--for instance, pension plan sponsors, mutual funds, investment managers, trustees, and custodians should develop proxy policies that reflect both overall investment goals and local market practices. Many institutions have already implemented a proxy review and research system, in which they determine how to vote in routine situations. They analyze non-routine issues for their financial impact and send them to a senior analyst or policy committee for approval. In an effort to impel managers to rigorously monitor corporate governance guidelines, some institutions offer voting guidelines and ask for global voting reports.⁷

Institutional Investors should disclose their proxy voting policies

We also favor efforts to force institutional investors, specifically fund managers, to disclose their proxy voting policies so that shareholders know why a manager voted a certain way on a given corporate issue. SEC Commissioner Paul Carey is a key supporter of heightened fund manager accountability. He recently stated: "In a great number of cases, fund managers are simply voting with management. That isn't in and of itself wrong. But are these managers living up to their fiduciary responsibilities to their shareholders? The answer remains to be seen".⁸

We believe managers should disclose their policy regarding: compensation, share issues, Board seats, stock options, etc.

Vanguard Group founder John Bogle, a longtime advocate of shareholder activism, answered Commissioner Carey's rhetorical question by stating that "mutual funds have abandoned their responsibility for corporate citizenship". He noted that many fund managers choose to either rubber stamp the wishes of corporate

⁷ see Stanley Dubiel, Corporate Governance: Pushing Ahead Without Best Practices, CIPE (November 1999).

⁸ Fund Managers Pressured to be "Better Corporate Citizens", Mutual Fund News (March 7, 2000).

management, or to simply abandon a poorly managed company altogether by selling its stock. While these strategies may prove advantageous in the short-term, particularly for actively managed funds in search of quick gains, Bogle sees the practice as short sighted and a dereliction of fund managers' responsibilities as corporate citizens.⁹

Index funds should vote

We are also in complete agreement with Mr. Bogle's view that shareholder activism is especially important to fund companies managing passive index funds. Index fund managers are obligated to invest in whatever companies are included within the index the fund is attempting to mirror. That obligation eliminates the ability to jump in and out of stocks in an effort to produce short-term gains. As a result, those restrictions place an added responsibility on index fund managers to participate responsibly in the management of the companies in which they invest.

2) Proxy voting rules should be modified

Practices should be simplified and standardized

Proxy voting in many markets remains hindered by archaic voting practices such as share blocking, unreasonable voting deadlines, the need for power of attorney signatures, high fees, disclosure of little or no information concerning how votes are carried out, voting by a show of hands as opposed to ballot and three to four levels of intermediaries between shareholders and the company. Institutional investors must take a leadership role in encouraging parties involved in cross-border voting--companies, market regulators, as well as global and sub-custodians--to adopt simplified voting procedures.

The role of Global Custody

Global custody banks play an important role in facilitating US institutions' global voting programs. In each market, a global custodian bank usually has a relationship with a sub-custodian bank which holds the record for their clients' shares. These sub-custodian banks are entitled to receive proxy materials from foreign issuers. Therefore, US pension funds and investment managers have relied on their global custodians to gather proxy material from their sub-custodians and deliver it to them in time to vote.

US global custodians have responded to these requests from investment managers, although current SEC shareholder communication rules do not cover global proxies. A number of leading US banks now offer their larger clients translated meeting notices. They do not deliver a physical proxy card to the US client for a global security. Instead, they deliver a meeting notice which may include the time, date, location, and agenda of the meeting, as well as any additional information available from the issuer.

Upon review, the bank's client will return its voting instruction to the global custodian, which will then relay the voting instruction to its sub-custodian, which is responsible for executing the vote. Depending on the country, execution may mean

⁹ Id.

returning a proxy card, physically attending the meeting, or hiring a third party to act as a proxy for the bank.

The Power of Proxy Voting Services

The use of specialized proxy voting services can also provide an effective means for receiving notice of upcoming shareholder assemblies and proxy initiatives, analyzing the merits of the issues in question, and exercising the right to vote. One such service, Institutional Shareholder Services (ISS), provides global proxy coverage for the Franklin Templeton Group, including the Bradesco Templeton offshore funds. ISS currently serves more than 700 institutional and corporate clients, and each year recommends votes on ballot issues for more than 17,000 shareholder meetings around the world.

According to ISS Vice President, Stanley Dubiel, “when examining global proxy voting guidelines, ISS's philosophy is rooted in two fundamental premises: informed proxy voting can enhance long-term shareholder returns in all markets; and basic corporate governance principles should be applied across national boundaries. Such guidelines must be applied flexibly, as long as the basic principles of governance are not compromised. The purpose of corporate governance, and hence of proxy voting, is to enhance long-term shareholder returns.”

Two important issues for which ISS provides proxy voting guidelines are director elections and compensation policies. Dubiel notes that ISS considers director elections to be one of shareholders' most important voting decisions, particularly because shareholders are given the opportunity to review their companies' operations only once a year at the company's annual general meeting. Therefore, ISS rigorously analyzed detailed information, if available, on boards or nominees. Because directors function as the ongoing representatives of shareholders, they are a crucial avenue to influence management.

Although disclosure on employee or manager compensation in most countries is not as extensive as in the US, compensation plans are becoming more common on meeting agendas of foreign companies. The structures of these plans are of vital interest to shareholders. ISS reviews three main types of compensation plans: stock option plans, incentive plans and share purchase plans. ISS supports plans that motivate employees and managers to focus on long-term shareholder value and returns, encourage employee stock ownership and align more employee interests with those of shareholders.

For individual investors, however, the use of a proxy voting service is too costly to be a realistic alternative to effective reforms that facilitate voting by all shareholders. Electronic means of voting and disseminating information may provide the most cost-effective proxy reform for individual investors. [see proposal #7 below]

3) Shareholders should be provided with adequate notice of shareholder meetings and sufficient information regarding the issues to be voted upon.

Adequate notice is needed

Inadequate notice of shareholder meetings is a serious problem, even when using a specialized proxy voting service. In Brazil, for example, a shareholder meeting can be called with only 8 days notice. If the meeting is postponed due to lack of quorum (often contrived by the controlling shareholders), only 5 days notice is required for the second meeting. This limited time is often inadequate for analyzing the issues on the agenda, communicating with shareholders, receiving instructions and voting according to the restrictive proxy voting rules in place in Brazil. It is encouraging to note that the Brazilian Securities and Exchange Commission (CVM) recently increased the notice period for shareholder meetings at companies with ADR programs to 15 days.¹⁰

No open issues on the agenda

Information regarding the issues on the agenda for a shareholder meeting often consists of a few lines in a newspaper announcement, if provided at all. It is not uncommon for the company to include an item called "other business", or another similarly vague title, in the agenda. Such an open-ended item effectively eliminates the possibility for minority shareholders to properly analyze the issues eventually raised by the controlling shareholders under this agenda item. In our opinion, NO issues should be voted upon at a shareholder meeting unless they have been fully described and listed on the agenda at the time is given for convocation of the meeting.

4) Within reasonable limits, companies should include shareholder-initiated proposals on the agenda of shareholder meetings.

In the United States, the corporation must include shareholder proposals in the corporate proxy materials, provided certain conditions are met. [Rule 14a-8]. To be eligible under this rule, the proponent must be a record or beneficial owner of at least 1% or \$1,000 in market value of securities entitled to be voted on the proposal. The proposal and its supporting statement may not exceed 500 words.

To avoid frivolous proposals, corporations are not required to include shareholder proposals involving the redress of a personal claim or grievance, operations accounting for less than 5% of the company's assets or business, matters relating to the ordinary conduct of business operations, etc.

5) Shareholders should be able to communicate with each other, especially with regard to issues on the agenda of upcoming shareholder meetings.

Shareholders should communicate

Shareholders must be able to communicate with each other to effectively evaluate shareholder meeting agenda proposals, including those proposals opposed by management. Under U.S. law, any shareholder who wants to send proxy soliciting material (usually in opposition to management) must either (i) be given access to

¹⁰ See ISS News Release: Key Changes Simplify Brazilian Proxy Voting Process, (July 28, 2000)
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the registrant's shareholder list, or (ii) the registrant must mail the materials to its shareholders on behalf of the requesting shareholder. [Rule 14a-7]

Communicate on the Internet

The utility of the Internet for rapid, wide and low-cost distribution of information should become an important tool for communications between company and shareholders, as well as among shareholders. Most corporations now have hompages on the Web, and can easily create a shareholder page to be used as a message board and communication channel. To ensure that only registered shareholders can access this page, it will be necessary to set up a "firewall," or a security gate. This gate can be set up by registering the shareholder's unique IP address and assigning her a password when she invests. When a shareholder attempts to access the page, the corporation host computer will recognize the IP address and correlate it to the proper user through the password.

A record of discussions among shareholders can be maintained for the review of shareholders and management alike. The ability for an Internet discussion facilitates communication among shareholders and alerts management to potential shareholder concerns. Management may decide to respond to concerns raised in this discussion. In preparation for a shareholder meeting, the annual report may be published on the page ahead of time, allowing every shareholder to read it at her leisure. Proposals may be made electronically either through the messaging system or on the page itself.¹¹

This system has the advantage of enhancing information flow to both the shareholder and to management at a substantially lower cost than present systems, which will in turn promote more efficient decision-making. It allows shareholders to communicate with each other without high transactional costs and it allows management to communicate more directly with shareholders than under current communication channels. It also provides avenues for increased shareholder activism and for increased management responsiveness to shareholder issues. (see internet voting below)

6) Proxy voting rules should facilitate rather than hinder shareholder participation.

Proxy voting rules are often designed to discourage rather than facilitate shareholder participation in meetings. In Brazil, for example, shareholders must vote in person, duly producing proof of shareholder status, or be represented by a proxy, who may be a shareholder, a corporation officer, or a lawyer; in a publicly held corporation, the proxy may also be a financial institution. The power of attorney must be no older than one year. Legal representatives of shareholders are also entitled to vote at general meetings, while telephone and electronic voting are not permitted.

In response to complaints by foreign investors, the CVM recently dropped the requirement of annual renewal and consularization of the power-of-attorney necessary for proxy voting at ADR-listed companies. However, we favor extending

¹¹ see George Ponds Kobler, Shareholder Voting Over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance, 49 Ala. L. Rev. 673 (1998).

this treatment to all shareholders and all companies, along with other measures that will facilitate and encourage shareholder participation via proxy voting.

Under current rules, the local Brazilian shareholder is left with the impractical and expensive alternatives of voting in person, not infrequently at a distant location and inconvenient time, or paying an attorney to represent him via proxy, thereby incurring attorney and document fees plus travel expenses.

7) New, convenient methods of proxy voting such as internet voting should be required.

Move to Paper and Internet Voting

In emerging markets such as Brazil, the use of paper proxies delivered by mail would represent a huge improvement over the current restrictive proxy voting procedures. However, these markets should consider moving directly to the most advanced and shareholder-friendly technologies such as telephone and internet voting. Emerging markets could thereby bypass the more expensive and less effective paper voting still widely used in the United States.

Internet shareholder voting has grown steadily since it began four years ago (see table). In 2000, 9.2% of all shareholder votes by brokerage house clients were cast over the Internet, according to Mary Ann Butera, senior vice president for ADP Investor Communications Services, a unit of **Automatic Data Processing (ADP) Inc.**, Jersey City, NJ.¹²

% of Shareholder Votes Cast Over the Internet

<u>1997</u>	under 2
<u>1998</u>	3
<u>1999</u>	6.1
<u>2000</u>	9.2

An Internet shareholder vote saves a company the cost of printing, postage and the paper ballot. The real savings are in delivering proxy documents via the Internet. This practice is not nearly as popular among companies as Internet voting is among shareholders. Of 14,000 corporate proxies ADP handled from May 1, 1999 to May 1, 2000, less than 500 were delivered electronically, Butera says.

¹² Adrienne Baker, E-lections, Investor Relations (September 2000).

Proponents of e-mail voting say it's easier, faster and cheaper. But critics, especially recalcitrant senior management, are afraid of the convenience of web voting will increase shareholder participation in proxy votes, and thus opposition to management. In the past year, the US has seen a dramatic increase in the number of registered and beneficial shareholders participating in proxy votes. Evidence shows the rise in number is directly related to the increase in shareholders using the internet to cast their ballots. Like all new practices, the speed at which e-voting catches on will differ from place to place according to each country's cultural landscape. In the US, e-voting has been in place for the last three years, while the UK has been a bit slower to adopt. In Latin America, e-mail voting is not yet a consideration while in Asia the idea is slowly coming to fruition.

The reason for the dramatic increase in e-mail voting, according to ADP's Butera, is its instantaneous form'. Once the e-mail goes out, the internet votes start coming in within a day or two,' she says. 'It's very reactionary: people go home, retrieve their e-mail, click to the site, look at the information, look at the ballot, execute their vote and are off to the next e-mail.'

On the other side of the Atlantic, UK shareholders are now just beginning to use e-mail to cast their proxy ballots. In late May, an electronic communications bill received royal assent. Written as a broad bill to regulate e-commerce, the legislation opens the doors to registered shareholders using web voting in the UK. However, before the bill can be fully instituted, there is a waiting period. 'The bill identifies electronic communication as a best practice guideline and now each individual company will have to make that practice legal for themselves,' says Barton Hill, ADP's vice president of global business development. According to Hill, this is a process that could take up to a year.¹³

Although it was not in effect for this past season, Japan is thinking of legalizing electronic voting. The Japanese Ministry of Justice is planning to draft commercial code provisions which will allow public companies to offer shareholder notification and voting via the web. Given Japan's long history of corporate governance cronyism, the news demonstrates a long-overdue move to change the country's image and facilitate shareholder rights.

'The writing is definitely on the wall,' says John Taylor, manager of project development in the global shareholder service at Washington DC's Investor Responsibility Research Center (IRRC). According to Taylor, the main drive for the legislation is coming from issuers. 'An increase of foreign ownership combined with the fact that issuers have very strict quorum requirements is causing change,' he says. Stock issuers in Japan often notify shareholders two weeks before the annual meeting, which makes it very difficult for foreign shareholders to participate. As a standard wisdom up until ten years ago was that proxy voting for foreign investors in Japan just wasn't possible,' Taylor admits. Japanese observers say the ministry is committed to submitting the legislation for approval in time for the 2002 proxy season. And while the legislation will allow for electronic proxy voting, it will not legalize electronic signatures.¹⁴

¹³ Id.

¹⁴ Id.

While the US market is ahead of the game in electronic voting, there are still some changes to be made before the gap between regulation and internet innovation is filled. SEC guidelines still prevent proxy battles from being resolved electronically. And while it's fairly easy to find loopholes in the legalese, most US companies are still shying away from any contested proxy voting via e-mail. Also, electronic communications are still regulated state by state, so while many companies are reaping the benefits of e-voting, others are restricted to old methods like mail delivery and telephone.

Beyond internet voting, video teleconferencing could provide virtual face-to-face real time meeting capability via personal computer. This would permit any shareholder with access to a computer to "attend" and participate in shareholder meetings. These meetings would become accessible to more people and eliminate the cost of traveling to a central meeting location.

Under this system, the meeting could be conducted as it is now and the shareholders in attendance would be entitled to the same rights as they enjoy now as meeting attendees, such as making proposals from the floor and nominating directors. Proposals could also be limited in the same way as they are in current meeting procedure, making the meeting run smoothly.

This method could also be used to increase shareholder communication among colleagues and facilitate shareholder-initiated proposals. Management, on the other hand, would be able to receive more information on shareholder concerns because more shareholders can participate. For the same reason, this system promotes increased shareholder activism. This method has another advantage in that because shareholders may attend meetings virtually in person, the need for proxies and the morass of regulation and cost associated with them is eliminated.

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