

# COMPLIANCE WEEK

## The Individual Investor: A Potential 'Swing' Voter

By Louis M. Thompson, Jr., *Compliance Week Columnist* — May 22, 2007

As many of America's publicly held companies have emerged from the 2007 proxy season, we've seen a number of trends: proposals dealing with say-on-pay, majority voting for election of directors, shareholder proxy access, the independent board chairman, and much more. We are also witnessing the growing role of activist institutional investors and "empty voting" by hedge funds casting votes with shares they don't actually own. It's clear that the shareholder democracy era is in full swing.

While the primary initiative for a greater say in corporate governance is coming from the institutional investors and hedge funds, the sleeper in this process may well be the growing potential of millions of individual investors to play a more significant role in proxy voting.

Over the past several proxy seasons, evidence has accumulated that individual investors provided the "swing vote" to push some of the dissident proxy proposals over the hump to gain a majority vote. Even though these issues are largely nonbinding, that concept is taking on a new meaning. A nonbinding proposal is an obvious expression by a majority of a company's shareowners—large and small—that is difficult for a board to ignore.

As the market became "institutionalized" over the past two decades, many companies turned their attention to the actively managed mutual funds, away from their individual investors. From an investor relations perspective, that makes sense; if 85 percent of your company's outstanding shares are held by institutional investors, it seems a lot more important to spend your limited resources talking with investors who own several hundred thousand shares than an individual with fewer than 100.

To compensate for the focus on the institutional side, companies have come to rely on their Web sites as a primary means for communicating to individual investors. Many of the individual investor's needs may be handled through interactive means along with a well-prepared investor relations section. Individuals are also able to listen to the quarterly conference calls and other Webcast investor events.

Still, the time for companies to court their individual investors actively is now. And key to this is the ability to communicate with the individual investors.

Under current rules, such communication is limited largely because the identity of an estimated three-fourths of individual beneficial owners is "hidden" from the company. The 1985 Shareholder Communications Act created a system of Objecting Beneficial Owners (OBOs) and Non-Objecting Beneficial Owners (NOBOs). Individuals who held their stock through brokerage firm ("Street-name") accounts were supposed to have been given an opportunity to designate themselves as an OBO or NOBO. If they didn't affirmatively declare themselves as an OBO, the default was to become a NOBO.

A company could request a list of its NOBOs for a fee from an intermediary like Automatic Data Processing. However, a company could only communicate with its OBOs *indirectly* through the brokers. And the brokers were only obligated to forward proxy materials to the beneficial owners. Over time, many companies decided that it was not cost effective to communicate with individuals, given the limited number of identifiable beneficial owners.

### OBOs No More

This is about to change. The New York Stock Exchange, through the recommendations of its Proxy Working Group, and the Securities and Exchange Commission are expected to support regulatory efforts to improve the ability of issuers to communicate with beneficial owners. The NYSE presented a series of proposals to the SEC last October, but the SEC's consideration of these recommendations is on hold pending a series of corporate governance roundtables the Commission held in May.

The NYSE last year contracted with the Opinion Research Corp. to determine, among other things, the desires and behaviors of individuals who are Street-name holders. Despite three-fourths of them being classified as OBOs, 54 percent said they wanted to receive communications directly from the companies related to proxy issues, and not through an intermediary. Why the difference? Many of those surveyed had no recollection of having made an OBO/NOBO decision—most likely meaning that the broker made it for them. Another finding in the Opinion Research survey was that two-thirds of the respondents said they opened their proxies, and 40 percent said they voted them.

One of the recommendations before the NYSE is to require all brokers to resolicit their beneficial owners to determine whether they want direct communications from the issuers or want to withhold their identity from the company. Communications (other than those related to proxy matters) under the proposal would not be permitted. It could also be a double-edged sword in that dissidents in a proxy contest would also have access to a company's shareholder list and could communicate with them directly.

One recent development in the proxy-voting arena has been the increased use of "empty voting." Hedge funds, in particular, will go to a broker or a pension fund to borrow shares for a fee in advance of a company's record date—but only for voting rights, not an economic interest. They may use these votes, normally as dissidents, to sway a proxy vote in their favor or may use them as clout to gain access to boards where they would voice their opinions on how the company could increase its stock price. As of March 31, the California Public Employee Retirement System made a reported \$124 million in fees over the past year from loaning shares.

Beneficial owners should read their brokerage firm contracts carefully since those whose shares are held in margin accounts are generally unaware that the firms can make money by lending their shares to other entities such as hedge funds. Meanwhile, the beneficial owners of the borrowed shares lose their voting rights. These loaned shares can also result in double voting since the records of these transactions can be delayed.

#### ABOUT THE AUTHOR



Louis Thompson Jr. is an internationally recognized expert on corporate governance and disclosure, having served for more than two decades as president and chief executive officer of the National Investor Relations Institute until his retirement earlier this year. An adviser to the Securities and Exchange Commission and the New York Stock Exchange, Thompson is currently serving a second term on the NYSE Individual Investor Advisory Committee.

Prior to joining NIRI, Thompson was assistant White House press secretary to President Gerald Ford.

A veteran of the U.S. Command in Vietnam and the Office of the Secretary of Defense, Thompson has held executive communications positions for a number of organizations, including the American Enterprise Institute for Public Policy Research, and the National Council for Economic Education.

A former journalist and news anchor, Thompson remains chairman of the advisory council for the Greenlee School of Journalism and Communication at Iowa State University, where he was the 2001 recipient of the James W. Schwartz Award for Distinguished Service in Journalism and Communication conferred by the Greenlee School.

A former member of the Harvard University New Foundations Working Group on corporate governance, Thompson is a partner with business consultancy Genesis, based in Denver. He is also a managing director of Washington, D.C.-based Kalamora Partners, the advisory firm founded by former SEC Chairman and Compliance Week Columnist Harvey Pitt.

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Why is it important to communicate with individual investors?

1. Shareholder activism by pension funds and the growing role of activist hedge funds requires that companies broadly and consistently communicate their position on contested proxy issues to *all* investors, including individuals. This is particularly important for the small- and mid-market companies with a higher percentage of individual investors than the large-market companies.
2. Individual investors have typically been the longer-term shareholders of all those in a company's investor mix even though their holdings are relatively small. Because of this assumed loyalty, individuals have for years been taken for granted. Now that they are dealing with issues such as pay for performance, that loyalty can no longer be assumed.
3. Investors need to hear the company's position on issues like say-on-pay, linking executive pay to performance, majority voting for directors, and the independent board chairman. A well-crafted Compensation Discussion & Analysis filed with the proxy statement can go a long ways toward explaining executive compensation issues.
4. As the SEC adopts new rules to improve the ability of issuers to communicate with their individual investors, these shareowners will play an even more important role in the proxy voting process.

The advancing shareholder democracy movement creates not only an obligation for companies to communicate more effectively with their individual investors but an opportunity to demonstrate that they really care about their long-term loyalty by embracing them as part of the company's comprehensive shareholder communications program. As a potential "swing voter," you will want them to swing your way.

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