ALERTS AND UPDATES

SEC Issues Concept Release on the "Plumbing" of the U.S. Proxy System

July 28, 2010

The U.S. Securities and Exchange Commission (SEC) recently issued a broad concept release on the U.S. proxy system (the so-called "proxy plumbing release"), Release Nos. 34-62495, IA-3052, IC-29340. To determine whether to update the current proxy system rules for publicly held companies, the SEC is soliciting comments on three major areas:

- accuracy, transparency and efficiency of the voting process;
- communications and shareholder participation; and
- the relationship between voting power and economic interest, including whether the current disclosure requirements provide investors with sufficient information on this issue.

Comments should be received by the SEC no later than October 20, 2010.

Accuracy, Transparency and Efficiency of the Voting Process

Investors and issuers have expressed concerns regarding the accuracy, transparency and efficiency of the current proxy system. Specific areas of concern are: (1) the potential for over-voting and under-voting, (2) the inability to confirm votes, (3) proxy voting by institutional investors, and (4) the equitable distribution of fees associated with the solicitation of proxies.

Over-voting and Under-voting

Over-voting occurs when vote tabulators receive more votes from a securities intermediary than the number of votes that the securities intermediary is entitled to vote. Conversely, under-voting occurs when the number of votes the vote tabulators receive from a securities intermediary is less than the number of votes the securities intermediary is entitled to vote. Most imbalances are a result of either securities-lending transactions or "fails to deliver" in the clearance and settlement system of the National Securities Clearing Corporation (NSCC).

Currently, neither the SEC nor any other self-regulatory organization (SRO) regulates the reconciliation or allocation of shareholder votes. Organizations now utilize three different reconciliation methods: (1) pre-mailing reconciliation, known as pre-reconciliation; (2) post-mailing reconciliation, known as post-reconciliation; and (3) a hybrid of the pre-reconciliation and post-reconciliation methods.

The SEC is considering whether it would be helpful to require each broker-dealer to disclose to investors the allocation and reconciliation method it uses, as well as the effects of that method on the investor's voting instructions. Alternatively, the SEC is considering whether it would be beneficial to require broker-dealers to use a specific allocation and reconciliation method.

Vote Confirmation

Many investors and securities intermediaries have raised concerns regarding the inability to confirm whether their shares have been voted in accordance with their instructions. The inability to confirm whether shares have been voted properly is

mainly the result of insufficient information and transparency among the many parties involved in the voting process. Often, no one person possesses all of the information necessary to determine whether each vote was timely received and accurately recorded. Furthermore, there is no current requirement that proxy service providers, transfer agents or vote tabulators share this information with other parties.

The SEC has advised that it believes this information should be readily available to both shareholders of record and beneficial shareholders and also recognizes the complexity of the issue and that the costs and benefits of requiring the availability of the information should be weighed. The SEC has proposed one solution that would require all participants in the voting chain to supply certain information relating to voting records for the limited purpose of enabling shareholders and securities intermediaries to confirm their votes were properly recorded.

Proxy Voting by Institutional Securities Lenders

It is common practice for institutions with investment portfolios to engage in securities lending as a way to earn additional income on securities that would otherwise sit idle in their investment portfolios. When an institution lends its securities, ownership rights typically transfer with the securities to the borrower for the duration of the loan, including the right to vote the securities. In some instances, institutional investors have policies that require them to vote their securities on material matters. In order for the lender to vote the securities, the loan has to be terminated and the securities recalled prior to the record date. Sometimes, there is insufficient advance notice of a meeting agenda, and the institutional securities lender is unable to retrieve the securities in advance of the record date.

The SEC is seeking comment on how to improve the timeliness and accuracy of information provided to institutional securities lenders for matters to be voted upon at shareholder meetings. One potential response is to ask the NYSE to revise its current rules[1] to require public dissemination of a notice of a shareholders' meeting that includes specific descriptions of the matters to be voted upon in advance of the record date. An alternative may be to require public disclosure of the meeting agenda in a current report on Form 8-K.

The SEC is also considering whether investment companies registered under the Investment Company Act of 1940 should be required to disclose the number of shares for which proxies were voted as well as when the fund is not entitled to vote proxies for securities on loan. Currently, these investment companies are required to disclose only those matters the securities entitle the companies to vote upon. The SEC is seeking comment on whether enhanced disclosure should be required to promote accuracy and transparency for shareholders.

Proxy Distribution Fees

The SEC recognizes that the costs incurred from proxy distribution are a common concern for issuers. SEC rules currently require broker-dealers and banks to distribute proxy materials to their customers who are beneficial owners of securities of an issuer, provided that they receive assurances from the issuer that they will be reimbursed for their "reasonable expenses."[2] The SEC recognizes that it did not define "reasonable expenses" in adopting these rules and relied on SROs and the NYSE to implement rules and regulations that were fair and equitable to both broker-dealers and issuers. The SEC is examining whether NYSE Rule 465, which sets the fee structure for proxy distribution, and other similar SRO regulations reflect reasonable rates of reimbursement and is seeking comment on this topic.

Communications and Shareholder Participation

Issuer Communications with Shareholders

It has long been accepted that the large volume of securities transactions in the United States indicates a need for the NSCC to act as a centralized clearance and settlement system, for efficiency. However, holding securities in bulk also makes it difficult for issuers to identify the beneficial owners of their securities and impedes direct communication between the issuer and the beneficial owner. Recent changes in corporate governance rules, including the elimination of discretionary voting by broker-dealers in uncontested director elections, have elicited increases in contested shareholder votes and have led the SEC to consider certain changes to its rules to facilitate direct communication between issuers and the beneficial owners of their securities.

Currently, the SEC requires broker-dealers and banks to provide issuers, at their request, with lists of names of non-objecting beneficial owners (NOBOs). However, a beneficial owner can object to the disclosure of its name and then can be contacted only by the securities intermediary that maintains a client relationship with that beneficial owner. Objecting beneficial owners (OBOs) include many large institutional investors, thereby making it potentially challenging and expensive for issuers to communicate directly with many of the owners of their beneficial securities.

Several potential responses to the issue have been discussed previously, including the 2004 Business Roundtable rulemaking petition, which recommended that the SEC require broker-dealers and banks to execute an omnibus proxy on behalf of their underlying beneficial owners and effectively eliminate the ability of their beneficial owners to elect OBO status. Another approach would be to implement a system by which issuers could obtain a list of all beneficial owners, but only as of the record date for a particular shareholder meeting. A more limited approach would be to educate investors about the need for beneficial owner information and the differences between NOBO and OBO status.

Neither the SEC nor SROs currently require disclosure explaining the consequences of electing OBO versus NOBO status. In an effort to increase the ease with which issuers can communicate with their investors, the SEC is seeking comment on whether such disclosure should be required; whether there should be a default to either NOBO or OBO status; and suggestions in general for facilitating direct communications between issuers and their investors.

Retail Investor Participation

Retail investor participation in shareholder voting is an historical area of concern for investors. The SEC is seeking feedback on several proposals it is considering to increase the participation of retail investors in shareholder voting. These proposals include:

- developing programs that educate investors on the proxy voting process and the importance of voting[3];
- enhancing brokers' Internet platforms;
- facilitating investor-to-investor communications; and
- improving the use of the Internet for distribution of proxy materials.

The SEC is soliciting comment on these proposals and whether issuers and investors believe these proposals would enhance participation in shareholder voting by retail investors.

Data-Tagging Proxy-Related Materials

Issuers soliciting proxies are currently required to distribute a proxy statement and disclose the results of shareholder votes within four business days after the end of the meeting at which the vote was held. The SEC is considering a requirement that this data be available to investors in an interactive data format. The SEC recognizes there may be significant costs associated with this requirement and is interested in receiving comments on the topic.

Relationship Between Voting Power and Economic Interest

Finally, the SEC is seeking to analyze the perceived misalignment between voting power and economic interest and the three specific areas in which concerns have been expressed on this topic:

- proxy advisory firms;
- dual record dates; and
- "empty voting."

Proxy Advisory Firms

Proxy advisory firms have become prevalent in the U.S. proxy system over the last 25 years. A proxy advisory firm often evaluates a significant number of shareholder matters and advises investors on how to vote their shares. Proxy advisory firms present several issues, including the two main areas of concern:

- conflicts of interest; and
- a lack of accuracy and transparency in formulating voting recommendations.

Many proxy advisory firms have both institutional investors and issuers as clients. One goal of a proxy advisory firm for an institutional investor client is to maximize the value of that client's investment. For issuers, proxy advisory firms provide consulting services on matters such as corporate governance and executive-compensation proposals. Conflicts of interest can arise when a proxy advisory firm provides voting recommendations on matters submitted for a shareholder vote while also offering consulting services to the issuer or a proponent of a shareholder proposal on that same matter, or when the proxy advisory firm provides corporate-governance ratings on issuers to institutional clients while providing consulting services to that same issuer regarding its corporate governance rating. The only existing requirement for these relationships to be disclosed to the clients of the proxy advisory firm is the rule that any person furnishing proxy-voting advice to another person must disclose "any significant relationship" it has with the issuer.[4]

Another area of concern is the lack of accuracy and transparency in formulating vote recommendations by proxy advisory firms. Currently, no rules are in place that require using specific procedures to conduct research or to ensure the accuracy of the research and analysis of proxy advisory firms.

The SEC is analyzing two instances in which proxy advisory firms may be subject to federal securities laws. First, under the broad definition of "solicitation,"[5] proxy advisory firms may be subject to the SEC's proxy rules because they provide recommendations to investors that result in the procurement, withholding or revocation of a proxy. Second, a proxy advisory firm may become subject to federal securities laws when the firm offers certain services that fall under the definition of an investment adviser.[6] The SEC's analysis indicates that proxy advisory firms should have to register as investment advisers,

which may result in their being subject to further regulation that may decrease the concerns addressed above. At this time, most proxy advisory firms are unlikely to have the assets under management necessary to require their registration with the SEC as investment advisers.

The SEC is seeking comment on whether it should enhance disclosure requirements regarding potential conflicts of interests among proxy advisory firms to increase transparency among investors and issuers. In addition, the SEC is considering whether the activities of proxy advisory firms are what the Investment Advisers Act of 1940 was designed to regulate – thereby creating a need for changes in the Act – so that all proxy advisory firms would be subject to the Act's regulations. In general, the SEC is seeking comment on whether further regulation of proxy advisory firms is necessary.

Dual Record Dates

Recently, several states have enacted laws that permit corporations to use separate record dates to determine the shareholders entitled to notice of a shareholders' meeting and the shareholders entitled to vote. Historically, the same record date has been used for both determinations. By setting a record date closer to the meeting date, issuers may decrease the likelihood that persons entitled to vote at the meeting would no longer have an economic interest in the issuer. However, under SEC Rule 14c-2(b), if an information statement regarding a shareholders' meeting is being distributed to shareholders, it must be distributed at least 20 calendar days before the meeting date. Therefore, the voting record date cannot be set any closer than 20 calendar days before the meeting date. In the case of proxy materials, the SEC requires that "the materials must be mailed sufficiently in advance of the meeting date to allow five business days for processing. . . ."[7] The SEC is therefore considering revisions to these rules to enhance the flexibility for issuers in setting the voting record date closer to the meeting date. The SEC recognizes the competing concerns regarding aligning economic interests and providing investors with adequate time to review the proxy materials.

"Empty Voting"

"Empty voting" occurs when a shareholder's voting rights substantially exceed the shareholder's economic interest in the company. Empty voting techniques include hedging-based strategies, such as executives entering into transactions where they retain full voting rights despite having hedged a portion of their economic interest; the use of credit derivatives; and trading between a voting record date and the actual voting date so that the economic interest transfers when the shares are sold, but the previous investor is still entitled to vote the shares at the meeting.

The SEC indicated that it needs to further analyze the issue of empty voting and how it affects the proxy system, but it is considering requiring disclosure that makes empty-voting strategies transparent to investors. The SEC is also soliciting comment on this topic.

Conclusion

This concept release signifies the first step in a process that may eventually result in significant changes in the U.S. proxy system. Depending on the changes that are implemented, these potential measures may have considerable effects on all participants, public companies, institutional investors, retail shareholders, proxy advisory firms and others.

For Further Information

If you have any questions about the foregoing discussion, the U.S. proxy system in general or how these issues may impact your organization, please contact one of the members of the Securities Law Practice Group or the lawyer in the firm with whom you are regularly in contact.

Notes

1. Section 401.02 of the *NYSE Listed Company Manual* requires NYSE-listed issuers to provide the exchange with notice of the record and meeting dates for shareholder meetings at least 10 days prior to the record date for the meeting, unless it is impossible to do so.
2. Rules 14b-1 and 14b-2 promulgated under the Securities Exchange Act of 1934.
3. The SEC has recently created a section on its investor site, www.investor.gov/proxy-matters, that provides educational materials about the proxy process.
4. Rule 14a-2(b)(3) promulgated under the Securities Exchange Act of 1934.
5. Rule 14a-1 promulgated under the Securities Exchange Act of 1934 defines the solicitation of proxies to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."
6. Section 202(a)(11) of the Investment Advisers Act of 1940 defines an investment adviser as any person who, for compensation, engages in the business of providing advice to others as to the value of securities; whether to invest in, purchase, or sell securities; or issue reports or analyses concerning such securities.
7. Timely Distribution of Proxy and Other Soliciting Material, Release No. 34-33768 (Mar. 16, 1994).