

July 19, 2010

SEC Issues “Concept Release” on the U.S. Proxy System

At an open meeting of the U.S. Securities and Exchange Commission (the “SEC”) held on July 14, 2010, the SEC Commissioners voted unanimously to publish a “concept release” soliciting public comment on various aspects of the U.S. proxy voting system.¹ In the nearly three decades since the SEC’s last comprehensive review of the proxy voting infrastructure, there have been significant changes affecting the manner in which shares are held and voted, including “technological changes, changes in the nature of stock ownership, the consolidation of proxy distribution service providers, growth in other types of proxy service providers, and new financial products.”² As Chairman Schapiro noted in her opening statement, as a result of all of these changes, it is time to “ask the fundamental policy questions that led to the development of the current infrastructure, as well as to examine issues that, three decades ago, either did not exist or were not considered significant.”

To set the stage for the diverse and somewhat technical issues involved, the Concept Release begins with a detailed description of the current proxy system, including the types of share ownership and voting rights that exist today, the proxy solicitation and voting process and the nature and roles of the numerous third parties that participate in the U.S. proxy voting system.

Against this background, the Concept Release addresses a broad range of issues, organized around three main areas of concern: (1) the accuracy, transparency and efficiency of the voting process; (2) shareholder communications and participation in the voting process; and (3) the relationship between economic interest and voting power. The specific issues addressed under each of these main areas are briefly summarized below. Given the workload at the SEC relating to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC is unlikely to implement any changes to the proxy system arising from the Concept Release in the near future. Also, issues related to proxy access and the SEC’s proposed rules on proxy access are not addressed in the Concept Release.

I. Accuracy, Transparency and Efficiency of the Voting Process

A. Over-Voting and Under-Voting of Shares

In some instances, imbalances arising from the way in which securities transactions are cleared and settled in the U.S. markets may lead to a securities intermediary casting either more or fewer votes than it actually holds. Although such

¹ SEC Release No. 34-62495, available online at: <http://www.sec.gov/rules/concept/2010/34-62495.pdf> (“Concept Release”). Comments must be received by the SEC on or before 90 days after publication in the Federal Register.

² Press Release, “SEC Votes to Seek Public Comment on U.S. Proxy System” available online at: <http://www.sec.gov/news/press/2010/2010-122.htm>.

circumstances are not currently regulated by the SEC, some securities intermediaries, particularly broker-dealers, have developed various allocation and reconciliation methods to balance the aggregate number of shares they are entitled to vote with the aggregate number of shares credited to their customers and their proprietary accounts.

In the Concept Release, the SEC raises the possibility of additional disclosure requirements that would provide customers of such intermediaries and the general public with the ability to determine whether a particular method is appropriate. In addition, the SEC seeks comments on the advantages and disadvantages of the various allocation and reconciliation methods used, the current scale and impact of over-voting and under-voting, whether requiring broker-dealers to disclose their allocation and reconciliation processes would be beneficial and whether the current system of clearance and settlement of securities transactions creates any other problems or inefficiencies in the proxy system besides over-voting and under-voting.

B. Vote Confirmation

It is currently not possible to confirm whether a shareholder's shares have been voted in accordance with their instructions, since none of the participants in the system have access to all the information necessary for such confirmation. Thus, issuers are not able to verify that the votes they receive from securities intermediaries on behalf of beneficial shareholders accurately reflect such shareholders' voting instructions and beneficial shareholders themselves are not able to confirm whether their votes have been timely received and recorded. This inability to confirm the accuracy and timeliness of votes creates uncertainty and calls into question the integrity of the proxy system as a whole.

The Concept Release suggests, as one possible solution, that all participants in the voting system grant issuers (or their transfer agents or vote tabulators) access to information relating to voting records for the limited purpose of enabling a shareholder or intermediary to confirm with the issuer how a shareholder's shares were voted. In order to protect the privacy of any objecting beneficial owners, such a system could assign each beneficial shareholder a unique code.

In the Concept Release, the SEC seeks input on a number of questions, including the extent to which participants in the proxy system have had difficulty confirming votes, the extent to which investors believe their votes have not been accurately recorded, whether all participants should grant access to their voting records to issuers (or their transfer agents or vote tabulators) and the best way to preserve the anonymity and privacy of any investors who choose not to disclose their identities.

C. Proxy Voting by Institutional Securities Lenders

The current prevalence of securities lending gives institutional securities lenders a significant role in the proxy voting process as shares that have been loaned cannot generally be voted unless recalled. Some institutional lenders have proxy voting policies that require them, in the event of a material vote, to recall their loaned securities in order to vote. Such institutional lenders face the challenge, however, of trying to confirm sufficiently in advance of a record date for a meeting what matters might be voted on in order to determine whether to recall their loaned securities in advance of the record date.

Although the NYSE Listed Company Manual requires all NYSE-listed issuers to provide at least ten days notice of the record and meeting dates and the matters to be voted upon, such notices are often not sufficiently specific or widely

disseminated for securities lenders to be able to secure their ability to vote. The SEC Concept Release raises the possibilities of refining the NYSE rules, asking other SROs to adopt similar rules or, perhaps, requiring issuers to disclose their agenda in advance of the record date by some public means, such as filing a report on Form 8-K or by means of a press release or corporate web site posting.

The Concept Release requests data to assist in the SEC's examination of whether decisions to recall loaned securities in connection with shareholder votes might be more timely and better informed and seeks comments on whether and how alternative rules should be proposed and implemented and whether increased disclosure of votes cast by institutional securities lenders would further enhance the transparency of the proxy system.

D. Proxy Distribution Fees

The maximum fees that a broker-dealer is permitted to charge an issuer as "reasonable reimbursement" for forwarding proxy materials are established by stock exchange rules that were last revised in 2002. The SEC has in the past urged the NYSE and the other SROs to identify ways to move to a market-based system for establishing fees for proxy distribution services. In the Concept Release, the SEC solicits comments to assist in determining whether the current fee schedule should be revised or whether it should be eliminated in favor of a market-based fee system.

II. Shareholder Communications and Participation in the Voting Process

A. Issuers' Ability to Communicate with Beneficial Owners of Securities

According to the Concept Release, most participants in the proxy system agree that the practice of clearing and settling securities transactions through a central netting facility (the National Securities Clearing Corporation) with the assistance of a central depository (the Depository Trust Company) has produced significant efficiencies, lower costs and risk management advantages. At the same time, this centralization makes it more difficult for issuers to identify and communicate with the beneficial owners of their shares. Under current rules, beneficial owners may object to the disclosure of their identity to the issuer (often referred to as "objecting beneficial owners" or "OBOs"). According to one estimate cited in the Concept Release, more than half of all public issuers' shares are held by OBOs. In light of recent corporate governance changes that directly impact the voting system, including majority voting, the elimination of broker discretionary voting in uncontested director elections and the drop in retail voting that has appeared to accompany the adoption of the notice and access model, there is an ever increasing need for issuers to enhance their ability to communicate with their shareholders more directly. Among other things, the Concept Release seeks comments on whether and how the SEC might choose to preserve, limit, discourage or even eliminate the ability of beneficial owners to choose "OBO" status.

B. Potential Means to Facilitate Retail Investor Participation

In order to improve participation in the proxy voting system by retail investors, the Concept Release presents and seeks comments on a number of different areas identified for potential improvement, including improved investor education,

enhanced broker internet platforms, opportunities for retail investors to submit voting instructions in advance, enhanced investor-to-investor communications and increased use of the Internet for the distribution of proxy materials.

C. Data-Tagging Proxy-Related Materials

“Data-tagging” refers to the process of labeling certain subsets of data, such as a section in a proxy statement, using specific computer markup language (*e.g.* eXtensible Business Reporting Language or “XBRL”) in order to make such data interactive, meaning it can be retrieved, searched and even analyzed using automated tools. At present, XBRL requirements tend only to apply to financial or other numerical data (such as stock ownership information by insiders). Proxy statement information, including information related to executive compensation and director qualifications, is neither required nor permitted to be provided in interactive data format. As a result, shareholders and other participants cannot use automated tools to retrieve, search or analyze proxy statement information.

In the Concept Release, the SEC seeks views on whether proxy statement and voting information should be permitted or even required to be provided in an interactive data format, which types or subsets of information should be considered for interactive data treatment and whether the provision of interactive data would result in more informed voting decisions.

III. Relationship Between Economic Interest and Voting Power

A. Proxy Advisory Firms

With the rise in institutional investors over the last three decades, most of whom have a fiduciary duty to vote the shares they hold on behalf of their beneficiaries, the use of proxy advisory firms has increased substantially. Proxy advisory firms perform a variety of functions, including analyzing and making voting recommendations on matters presented for a shareholder vote, assisting with executing votes and performing various other tasks related to the exercise of voting rights and the making of voting decisions and providing research related to corporate governance more generally in order to assist institutional investor clients in formulating and maintaining voting policies and procedures.

At the heart of the issues related to the role of proxy advisory firms is the argument of some that proxy advisory firms are controlling or significantly influencing shareholder voting without appropriate oversight and without having an actual economic stake in the issuer. In the Concept Release, the SEC seeks input on improving disclosure related to potential conflicts of interest, enhancing regulatory oversight over proxy advisory firms, generally, and over their issuance of voting recommendations, in particular, and on whether the SEC should consider requiring some level of public disclosure by proxy advisory firms of their voting recommendations (which are often currently only available to their paid clients).

B. Dual Record Dates

In order to identify shareholders and distribute proxy materials in advance of a meeting, record dates are typically set several weeks in advance of the meeting, by which time many shareholders as of the record date have frequently sold their shares. The result is a disconnect between the right to vote and the economic interest of the underlying shares being

voted. In 2009, Delaware law was amended to address this issue and to permit separate record dates for notice and voting. In light of these changes, the Concept Release requests comment on whether the proxy rules should similarly be revised.

C. “Empty Voting” and Related “Decoupling” Issues

“Empty voting” occurs when a shareholder exercises voting rights that exceed its economic interest in a company’s shares. In today’s securities marketplace, many investors use hedges or other investment strategies that allow for the separation of economic interests from voting interests. In addition, the share lending practices and the record date discrepancies described above further contribute to situations where voting interests in shares are “decoupled” from the economic interests of such shares. The Concept Release seeks comments on the scope and significance of empty voting, the competing costs and benefits of the investment practices that decouple voting and economic interests and how the SEC might be able to address concerns through additional disclosure of such practices or other regulatory action.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.