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Proxy Plumbing: SEC Considers Extensive Renovation Job to the Proxy System

On July 14, 2010, the Securities and Exchange Commission (SEC) voted unanimously to issue a concept release seeking public comments on a variety of facets of the U.S. proxy system.¹ Termed “proxy plumbing” because of the extensive nature of its review, the concept release covers the accuracy, reliability, transparency, accountability, and integrity of the proxy system. This current effort to modernize the proxy system marks the SEC’s most comprehensive review of the proxy system in 30 years and is primarily in response to growing shareholder concerns about the accuracy of voting results. Given the recent increase in shareholder activism and the fact that more than 600 billion shares are voted at approximately 13,000 annual meetings in the U.S. each year, the accuracy of voting results has become an increasingly significant matter.

The SEC already has a full plate. The recently passed Dodd-Frank Act requires the SEC to implement up to 95 separate rules and grants the SEC authority to make rules providing investors with greater access to include nominees on issuers’ proxy materials.² Accordingly, proxy rules in response to the issues set forth in the concept release likely will not come to a final vote until next year, with implementation expected for the 2012 proxy season. All interested parties have until October 12, 2010 to submit comments on the concept release.

The concept release cites three general areas for improvement in the U.S. proxy system, including:

- Accuracy, transparency, and efficiency in the voting process;
- Improving shareholder communications and participation; and
- The relationship between voting power and economic interest.

Within these general areas, the concept release provides detailed analysis of the following particular issues:

- Over-Voting and Under-Voting
- Vote Confirmation
- Proxy Voting by Institutional Securities Lenders
- Proxy Distribution Fees
- Issuers’ Ability to Communicate with Beneficial Owners
- Retail Investor Voting Participation
- Data-Tagging Proxy-Related Material
- Role of Proxy Advisory Firms
- Empty Voting

¹ The 151-page concept release may be accessed at: <http://www.sec.gov/rules/concept/2010/34-62495.pdf>.

² See Legal Alert: “It’s Signed, Now for the Hard Part: What your Board Needs to Know About Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act” issued by Sutherland Asbill & Brennan LLP on July 22, 2010.

A more detailed review of the matters addressed in the SEC proxy plumbing concept release is provided below.

Over-Voting and Under-Voting

The concept release inquires whether broker-dealers may be casting more or less votes than the shares they actually own. The SEC attributes the imbalance to the way securities transactions are cleared and settled in the U.S., particularly, through a complicated, multi-party network. Some broker-dealers, which often hold shares in fungible bulk, reconcile their records to improve vote allocation among shareholders, but the SEC notes that at least one popular reconciliation method may result in under-voting.

The concept release requests input on the practical effect of over-voting and under-voting, and the advantages and disadvantages of various reconciliation methods. Also, it asks whether one particular reconciliation method should be required, or whether public disclosure of broker-dealers' reconciliation methods would aid investors.

Vote Confirmation

Similar to the SEC's over-voting and under-voting concerns, the concept release notes that market participants have expressed concern that the proxy system provides no manner of confirming whether an investor's shares have been voted in accordance with the investor's instructions. The SEC attributes the problem to the fact that no one participant in the voting process possesses enough information to confirm that an investor's vote is accurately recorded. The release proposes requiring all participants in the voting process to provide certain information to issuers so that investors and issuers may confirm that votes were tallied according to investors' instructions. Further, the concept release questions the costs/benefits to sharing such information, whether certain investor's anonymity could/should be preserved throughout the process, and the appropriate role of issuers in confirming the accuracy of shareholders' votes.

Proxy Voting by Institutional Securities Lenders

When shares are loaned, the power to vote the shares shifts from the lender to the borrower. Accordingly, the lender must terminate the loan and recall the shares prior to the record date if the lender wishes to vote on proxy matters (for a discussion regarding the borrower voting the shares, see "Empty Voting" below). The concept release addresses the concern that securities lenders may not have sufficient notice of important agenda items to recall their shares prior to the record date. To solve this issue, the release proposes that issuers disclose their meeting agendas in a current report on Form 8-K in advance of the record date to allow securities lenders time to recall their shares if they desire (for a similar proposal, see "Dual Record Dates" below). Currently, New York Stock Exchange (NYSE) rules require listed issuers to provide the NYSE with notice of record and meeting dates, including matters to be voted upon, at least 10 days prior to the record date.³ Such a rule could be more widely adopted by exchanges and include a public dissemination requirement.

The concept release notes the difficulty in identifying agenda items in advance of the record date, particularly because of board consideration of management initiatives and SEC review of no-action requests regarding shareholder proposals, and seeks input on how much notice securities lenders would

³ See Section 401.02 of the NYSE Listed Company Manual.

need to recall shares. The release also considers the value of allowing issuers to publish an agenda that is subject to change. In addition, the release asks whether management investment companies should be required to disclose the total number of shares voted on a particular matter on Form N-PX so that investors know how many shares were on loan and not voted.

Proxy Distribution Fees

Stock exchange rules set the maximum fees that broker-dealers may charge issuers as “reasonable expenses” for forwarding proxy materials.⁴ The concept release expresses concern that these fees may not reflect current reasonable rates, because they have not been formally reviewed since 2002. In response, the release proposes such a review to assess the current fee schedule or even to eliminate the fee schedule in favor of allowing the market to determine reasonable rates.

Issuers’ Ability to Communicate with Beneficial Owners

The concept release notes the difficulty that issuers have identifying and communicating with their beneficial owners. Due to the multi-party network in which shares are cleared and held, shareholders often do not directly own their shares, but are instead beneficial owners that own a right to shares held by a third party. In addition, some beneficial owners “object” to the issuer learning their identity (an objecting beneficial owner, or OBO), and may only be contacted by an intermediary. Current SEC rules permit intermediaries to provide issuers, upon request, with the names only of non-objecting beneficial owners. As a result, issuers argue that they need more direct access to their shareholders in light of lower retail investor participation and recent changes in corporate governance rules, such as a shift to majority voting of directors and the elimination of broker discretionary voting in uncontested elections.

To improve issuers’ access to shareholders, the SEC requests comments on whether the OBO election should be abolished and the implications of such changes on shareholder privacy, whether broker-dealers should better educate investors on the implications of choosing to be an OBO, whether OBO should be the default status of new investors, and whether OBOs should bear the additional expenses of distributing proxy materials.

Retail Investor Voting Participation

The SEC also expressed concern that retail investor participation in proxy voting is at an all-time low. The SEC believes that retail investors must vote if the proxy process is to adequately protect shareholders’ interests. The SEC has focused in the past year on the issue of investor participation, for example, through its modification to the Notice and Access rules. The release discusses a number of potential methods to increase retail investor voting participation, such as:

- Educating investors by providing internet materials, or requiring issuers and brokers to provide such materials, which discuss the voting process and the importance of voting;
- Enhancing broker’s internet platforms so that investors do not have to go to different web sites to download proxy materials and cast proxy votes;
- Permitting the distribution of advance voting instructions, or client-directed voting, so that investors may instruct their shares to be voted in accordance with others, such as with the board

⁴ See, e.g., NYSE Supplementary Material to Rule 465.20.

of directors' recommendation, against the board of directors' recommendation, with recommendations of proxy advisory firms or specified interest groups, or proportionally with the brokers' other customers;

- Facilitating investors' ability to communicate with each other; and
- Improving the use of the internet for distribution of proxy materials, including revising the notice-and-access model.

Data-Tagging Proxy-Related Material

The concept release seeks comments on whether data-tagging, now required for financial statement data submitted to the SEC, should be extended to proxy statement data to increase its usefulness. Data-tagging is achieved by attaching unique identifiers to various numbers so that the numbers can be analyzed and compared automatically by computer programs. For example, data-tagging executive compensation amounts in proxy statements might allow shareholders to more easily obtain specific information about issuers (e.g., ratio of CEO salary to total company assets), compare information across different issuers, and analyze changes in an issuer's proxy data over time. Data-tagging proxy data could be more complicated than data-tagging financial statement data because proxy statement numbers do not typically follow a standard format and are not as readily comparable across companies. This inconsistency may result in significant cost and time if issuers are required to produce and tag proxy data.

Role of Proxy Advisory Firms

In the last few decades, the influence of proxy advisory firms has substantially increased as a result of the growth in institutional investors and the recognition that these investors have a fiduciary duty to vote shares in the best interests of their clients. Indeed, provisions in the Dodd-Frank Act (for example, among others, those relating to Say on Pay and broker discretionary voting) will further magnify the influence of proxy advisory firms going forward. Some issuers have expressed concern over the lack of transparency behind proxy advisers' methodology for forming recommendations. Further, if issuers wish to question recommendations based on potentially flawed information, proxy advisers may be hesitant to engage in discussion for policy reasons. The concept release questions whether proxy advisers should be required to provide more background information on their recommendations, publicize procedures for communicating with issuers, or file their voting recommendations with the SEC to facilitate independent review.

Another primary concern focuses on conflicts of interests within proxy advisory firms, particularly the dominant firm, MSCI, Inc.⁵ Proxy advisers sometimes provide consulting services on a particular proposal and then issue voting recommendations on the same proposal. They also may provide overall corporate governance ratings on issuers and then offer consulting services to improve those ratings. Most firms that provide such conflicting services have some type of policy aimed at mitigating resulting conflicts, although the concept release questions whether such policies are satisfactory. The concept release offers a number of ways that proxy advisory firms could be subjected to greater SEC scrutiny, and requests comments on solutions such as prohibiting certain types of conflicts, providing more wholesome disclosure on conflict policies, or requiring disclosure of specific conflicts.

⁵ MSCI, Inc. acquired RiskMetrics in June 2010; RiskMetrics acquired Institutional Shareholder Services (ISS) in 2007.

Empty Voting

The concept release notes that shareholders' voting rights may sometimes be different, or decoupled, from their economic interests. This phenomenon, dubbed "empty voting," may threaten the basis of the U.S. proxy system whereby shareholders protect their economic interests by voting on corporate matters. For example, the following voters likely have no stake in the well-being of the company: (1) a voter that held shares at the record date but sold them prior to the meeting date, (2) a shareholder that has hedged the economic risk of holding shares, by entering into put or swap transactions or otherwise, or (3) a shareholder that is merely holding the shares as a borrower.

To mitigate the first problem, the concept release discusses the dual record date system recently adopted in Delaware.⁶ The dual record date system allows companies to choose one date for providing meeting notice to shareholders (notice record date) and another later date for determining the shareholders entitled to vote at the meeting (voting record date). A voting record date closer to the meeting date reduces the window in which shareholders may sell their shares and become empty voters. The concept release welcomes comments on the impact and necessity of current SEC and exchange rules requiring proxy materials to be sent well in advance of the meeting date,⁷ as well as the costs associated with sending proxy materials at the notice record date and ensuring new investors obtain such materials prior to the voting record date.

To mitigate the second and third problems, the concept release proposes requiring disclosure to expose empty voters, some of whom only hold shares long enough to influence the vote. Such disclosure would allow issuers to increase solicitation efforts and inform other shareholders of the potential importance of their votes. Going further, the release contemplates restricting proxy votes to only shareholders with a true, long position in an issuer's shares.⁸ In addition to the foregoing points, the release requests comments on the prevalence and impact of empty voting.

Conclusion

This concept release is an initial step in a process that may result in significant changes to, and have a substantial impact on the participants in, the U.S. proxy system. While it is premature to predict which of the above regulatory initiatives, if any, will actually be implemented by the SEC, it is important to be aware of these issues and to consult with counsel on the appropriate steps to take in response to these developments. Meanwhile, anyone who wishes to comment on the concept release must do so by October 12, 2010.

⁶ Companies are not required to use dual record dates, but have the option, under Delaware General Corporation Law. Del. Code Ann. tit. 8 sec. 213(a).

⁷ See 17 CFR 14b-1 and 14b-2, Rule 14c-2(b), Release No. 34-33678 (March 16, 1994) [59 FR 13517], and Section 401.02 of the NYSE Listed Issuer Manual (recommending a 30-day window).

⁸ Regulation T, under which certain securities loans are restricted to permitted purposes, curbs this practice to an extent.



If you have questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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