

July 22, 2010

Proxy System Modernization

SEC Issues Concept Release Seeking Comment on Perceived Deficiencies in the U.S. Proxy System and Potential Regulatory Responses

SUMMARY

On July 14, 2010, the SEC issued a concept release seeking public comment on various aspects of the proxy solicitation and voting system for U.S. public companies. In its release, the SEC, noting that it had not conducted a comprehensive review of the proxy system in nearly 30 years, identifies three general topics, consisting of ten detailed sub-topics, on which it requests comment to assist it in determining whether to propose changes to the system. The release also poses a multitude of possible changes to address perceived proxy system deficiencies, as well as inviting comment on alternative approaches. The topics and sub-topics on which the SEC requests comment are as follows:

Accuracy, Transparency and Efficiency of the Proxy Voting Process

- Over-voting and under-voting of shares.
- Allowing shareholders to confirm how their shares were voted.
- Securities lending issues, including whether issuers should provide earlier notice of matters to be voted on at shareholder meetings to permit lenders to recall shares before the relevant record date.
- Reasonableness and competitiveness of proxy distribution fees.

Communications and Shareholder Participation

- Issuers' ability to obtain information about and communicate with shareholders.
- Encouragement of retail investor voting participation.
- Data-tagging (e.g., XBRL) of proxy-related materials.

Relationship Between Voting Power and Economic Interest

- Role of proxy advisory firms, including conflicts of interest, the process for formulating recommendations, and the accuracy of data utilized.

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- Mechanical and practical issues relating to dual record dates.
- Decoupling of voting and economic interests, including “empty voting.”

Comments must be received by October 20, 2010.¹

BACKGROUND

Because most shareholders of U.S. public companies do not attend shareholder meetings to vote, but rather vote their shares via proxy, the proxy system largely governs shareholder voting. The Concept Release provides a detailed description of the various parties involved in the proxy solicitation process, and the steps undertaken to obtain and implement shareholder votes.

Proxy System Participants

In the current proxy system, there are relatively few “record owners,” meaning shareholders whose names are listed in the company’s shareholder records, and who can directly grant a proxy with respect to, or vote at, a shareholder meeting. The vast majority of shareholders of U.S. public companies are “beneficial owners,” meaning they hold their shares in customer accounts with a securities intermediary (typically a broker-dealer or bank) and give voting instructions to their securities intermediary or to a proxy service provider retained by the securities intermediary. As a complicating factor, shares are often held through multiple layers of securities intermediaries. A securities intermediary will execute proxies² for shares held in customer accounts to reflect the beneficial owners’ voting instructions.³ At the shareholder meeting, vote tabulators collect and tabulate the proxy votes, together with votes submitted in person at the meeting, and confirm outstanding share numbers and record owner identities with the issuer’s transfer agent. In addition to issuers, securities intermediaries, shareholders, proxy service providers, vote tabulators and transfer agents, a number of other parties may be affected by changes in the proxy voting system, including proxy solicitors, which are hired to encourage shareholders to vote their proxies either for or against the matters up to a vote, and proxy advisory firms, which provide analysis and voting

¹ The SEC’s concept release (the “Concept Release”) was published as *Concept Release on the U.S. Proxy System*, Rel. Nos. 34-62495, IA-3052, IC-29340 (July 14, 2010), 75 Fed. Reg. 42,982 (July 22, 2010), available at <http://www.sec.gov/rules/concept/2010/34-62495.pdf>.

² The “record owner” for shares held through a securities intermediary is typically “Cede & Co.,” the nominee for the Depository Trust Company, which is the registered clearing agency where most publicly-traded shares are held. The securities intermediary executes the proxies for beneficial owners pursuant to an omnibus proxy granted by Cede & Co.

³ If the securities intermediary is a stock exchange member firm and does not receive voting instructions from the beneficial owner, it may be permitted under stock exchange rules to use its discretion to execute a proxy for the shares, depending on the nature of the matter on which it is voting. See NYSE Rule 452. See also Section 6(b) of the Securities Exchange Act of 1934, as amended by Section 957 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), enacted July 21, 2010.

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recommendations to institutional investors (which typically own securities positions in a large number of issuers).

SEC Review of the Proxy System

Last year, the SEC and its staff began a comprehensive review of the U.S. proxy system, with the goal of promoting efficiency, transparency and confidence in the voting system and enhancing the accuracy and integrity of the shareholder vote. In the nearly three decades since the SEC last reviewed the proxy system, substantial changes affecting the system have emerged, including technological innovations, new financial products, changes in the nature of stock ownership and the growth of third-party participation in the proxy system. The Concept Release is an outgrowth of, and a part of, the SEC's ongoing review. Comments received by the SEC on the Concept Release may help guide the development of future proposals for rule-making.

CONCEPT RELEASE TOPICS

The SEC is requesting comment on the following topics:

A. ACCURACY, TRANSPARENCY AND EFFICIENCY OF THE PROXY VOTING PROCESS

1. Over-Voting and Under-Voting

The Concept Release indicates that securities intermediaries occasionally cast more or fewer votes than the number of shares they actually hold. This may occur for a number of reasons. For example, in a securities lending transaction, the borrower of securities typically obtains the voting rights with respect to the borrowed securities. However, since shares are typically fungible, it may not be clear to the lending party's securities intermediary which beneficial owners' shares have been lent, and all beneficial owners may be asked to provide voting instructions for all shares. Since the borrower may be voting these shares also, this could lead to over-voting. In addition, if a broker-dealer fails to deliver purchased securities on a timely basis, the shares are nevertheless usually credited to the purchasing customer's account, which can also result in over-voting. The extent to which votes are accepted in an over-voting situation depends on instructions from the issuer, state law and the vote tabulator's internal policies, and may result in none of the shares held by that intermediary being voted.

Securities intermediaries and vote tabulators have devised different approaches to allocate votes among customer accounts when a vote imbalance occurs. This approach is often influenced by whether the intermediary's customers are primarily retail or institutional investors. Neither SEC nor stock exchange rules mandate the manner in which vote imbalances are reconciled or otherwise addressed by securities intermediaries or vote tabulators. The Concept Release, which describes the most common types of reconciliation methods used, seeks comment on, among other things:

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- whether over-voting and under-voting is a problem that should be addressed (including a request for empirical data as to the extent of the problem, which might also indicate whether a particular method of reconciliation works better);
- whether the allocation methods used by securities intermediaries should be disclosed to investors; and
- whether a particular method of allocation should be mandated.

2. Vote Confirmation

Because the current proxy voting system involves a number of parties in addition to the issuer and the shareholder, including vote tabulators, proxy service providers, securities intermediaries and transfer agents, no single participant in the process possesses the information necessary to confirm whether a specific shareholder voting instruction has been timely received and accurately recorded. Such a confirmation would require coordination and communication between the multiple participants of the proxy voting process. However, some participants in the proxy voting process are unwilling or unable to disclose voting information in their possession, and there are no regulatory requirements to compel such information-sharing. The SEC's view, as expressed in the Concept Release, is that the inability of shareholders to obtain confirmation of their votes creates uncertainty regarding the accuracy and integrity of votes cast and could impair confidence in the proxy system. The Concept Release seeks comment on, among other things:

- the extent of the need for confirmation;
- whether all participants in the voting chain should be compelled to provide issuers, their transfer agents or their vote tabulators with access to voting records in order to allow a shareholder to confirm how its shares were voted;
- whether each beneficial owner should be assigned a unique identifier to maintain anonymity and permit use of an automated system;
- whether issuers and securities intermediaries should be required to reconcile and verify voting at the beneficial owner level; and
- whether participants in the process should periodically evaluate and test the effectiveness of their voting controls and procedures.

3. Proxy Voting by Institutional Securities Lenders

a. Advance Notice of Meeting Agendas to Permit Termination of Loans

Many institutional investors lend the securities in their portfolios to generate additional income. Because the right to vote the borrowed shares typically transfers to the borrower, a lender that wants to vote the shares at a shareholder meeting (or that is required under its proxy voting policies to vote the shares) must recall the borrowed securities prior to the record date for the vote. However, public disclosure of the matters to be voted on is generally not made until the mailing of the proxy materials following the record

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date,⁴ at which point it would be impossible for the lender to recall the loan and be entitled to vote the shares. The Concept Release seeks public comment on, among other things:

- whether the SEC should require issuers to publicly disclose the meeting agenda sufficiently in advance of the record date to permit securities lenders to determine whether any of the matters warrant a termination of the loan;
- if so, the number of days that would constitute sufficient notice;
- the advantages and disadvantages of such advance notice, particularly given the uncertainty as to the outcome of no-action relief on shareholder proposals;
- whether issuers could publish a preliminary meeting agenda as “subject to change;”
- the appropriate medium for any such advance notice; and
- the effect of more loan recalls on the capital markets.

b. Disclosure of Voting by Mutual Funds

Management investment companies registered under the Investment Company Act of 1940 are required to disclose on Form N-PX how they vote proxies relating to their portfolio securities. However, Form N-PX does not require registered investment companies to disclose the number of actual shares voted and the number of shares not voted due to securities lending practices or other reasons. The Concept Release seeks comment on whether this disclosure should be required.

4. Proxy Distribution Fees

Existing stock exchange rules establish the maximum fees that a member broker-dealer may charge the issuer as reasonable reimbursement for forwarding proxy materials to beneficial owners of securities, which the proxy rules require them to do. Broker-dealers typically engage a proxy service provider to distribute proxy materials, with the service providers typically charging issuers an “incremental fee” in the case of electronic “notice and access” delivery. Broadridge Financial Services, Inc., as the service provider for most U.S. broker-dealers, distributes the vast majority of proxy mailings to beneficial owners. According to the Concept Release, Broadridge charges issuers (on behalf of broker-dealers) the maximum fees allowed under stock exchange rules for their proxy mailing services. However, Broadridge sometimes charges its larger broker-dealer clients a lesser amount. As a result, after Broadridge nets its own fees, funds may be remitted from Broadridge to its larger broker-dealer clients, which have not clearly incurred any costs requiring reimbursement. This raises the issue as to whether such fees are, as required by stock exchange rules, “reasonable reimbursement” for expenses of the broker-dealer.

⁴ In some cases, Rule 14a-6 under the Exchange Act may require the filing of a preliminary proxy at least 10 days before the mailing of definitive proxy materials. However, this will typically occur after the record date also.

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In light of concerns expressed by issuers and others relating to the structure and size of proxy distribution fees, the Concept Release seeks comment on a number of fee-related matters and alternatives, including:

- whether the current fee structure reflects reasonable expenses;
- what factors are affecting the level of competition in the proxy service market, and steps could be taken to enable fees to be based on competitive market forces, and what are the potential benefits and drawbacks of such a system;
- the feasibility and advisability of creating a central data aggregator to facilitate market competition, with the aggregator given the right to collect beneficial ownership information from securities intermediaries, but required to give that information to a proxy material delivery service selected by the issuer;
- the impact on proxy distribution costs of permitting issuers to solicit proxies directly from beneficial owners; and
- a number of other specific aspects of the present fee structure, such as continued assessment of an “incentive fee” once paper mailings have been eliminated, billing to accounts where multiple beneficial owners delegate voting decisions to a single investment manager, establishment of fees for notice and access, and the need for an independent third-party audit of fees.

B. COMMUNICATIONS AND SHAREHOLDER PARTICIPATION

1. Issuer Communications with Shareholders

In order to promote direct communications between issuers and their beneficial owners, the SEC adopted rules in the 1980’s to require securities intermediaries to provide issuers, at their request, with the names and addresses of beneficial owners who did not object to having such information provided, otherwise known as “non-objecting beneficial owners” or “NOBOs.” Shareholders that object to such disclosure are known as “objecting beneficial owners” or “OBOs.” According to studies cited by the SEC in the Concept Release, 52% to 60% of all public company shares are held by OBOs. As a consequence, issuers are not able to communicate directly with most of their shareholders and must rely on securities intermediaries to forward communications to shareholders. The SEC notes that issuers have cited several corporate governance concerns that make it important for issuers to be able to communicate directly with their shareholders, such as the elimination of the broker discretionary vote in uncontested elections of directors and the move to majority voting of directors, as well as the considerable expense in communicating with beneficial owners through securities intermediaries. An additional concern is that the uniform appearance of proxy materials forwarded by proxy service providers may be a cause of the low return of retail voting instructions. The Concept Release seeks comment on, among other things:

- whether existing rules inappropriately inhibit issuers from effectively communicating with investors, or significantly raise the cost of doing so;
- whether investors consider the degree and manner of communication with issuers to be adequate;

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- whether to eliminate the use of OBO status and make all beneficial ownership information available to the issuer;
- whether less comprehensive approaches could be taken that would adequately facilitate direct communication between issuers and beneficial owners, such as making the list of all beneficial owners available only as of the record date, shifting the cost of distributing proxy materials to broker-dealers to OBOs, selecting a default option as to status, or requiring periodic reaffirmation of OBO/NOBO status; and
- whether eliminating OBO status raises privacy concerns for investors, and how these concerns could be addressed.

2. Means to Facilitate Retail Investor Participation

The Concept Release notes the SEC's concern that retail investor participation rates in the proxy voting process have historically been low. The Concept Release seeks comment on a variety of proposals aimed at encouraging retail investor participation:

- **Improving investor education:** The Concept Release seeks comment on whether investor education efforts, such as improved investor information on the SEC and issuer websites, greater use of plain English, and enhanced disclosure and education by broker-dealers upon opening brokerage accounts, can alleviate confusion among investors regarding the proxy voting process.
- **Enhancing brokers' internet platforms:** The Concept Release seeks comment on the usefulness and effectiveness of utilizing brokers' websites to provide information on upcoming issuer corporate actions and to provide proxy materials.
- **Permit advance voting instructions:** The Concept Release seeks comment on whether to adopt rules to facilitate "client-directed voting," which would allow a retail investor to give a securities intermediary revocable, general guidelines on how to vote on particular topics (e.g., for or against board recommendations or particular types of proposals) in advance of the receipt of proxy materials. The Concept Release requests comment on whether such advance voting instructions should be limited to only certain types of proposals, whether the investor would be permitted to instruct the intermediary to vote in accordance with the recommendation of a specified entity or person, how often such instructions should be reaffirmed, and whether the grant of such broad voting authority could actually promote uninformed retail investor votes.
- **Enhance investor-to-investor communications:** The Concept Release seeks comment on whether investor interest in matters presented to shareholders is affected by the extent to which investors are able to communicate with other investors, and whether and how such communication can be encouraged.
- **Improve the use of the internet for distribution of proxy materials:** The Concept Release seeks comment on whether revisions to the notice and access model of proxy dissemination (which some have suggested has led to reduced retail voting participation) should be implemented, such as requiring issuers to provide full sets of proxy materials to certain retail investors or to permit inclusion of proxy cards or voting instruction cards with the issuer's Notice of Internet Availability of Proxy Materials.⁵

⁵ In February 2010, the SEC adopted rules designed to increase retail participation in the proxy voting process, including changes that provide flexibility regarding the format and content of the Notice of Internet Availability of Proxy Materials and that permit issuers and other soliciting persons to

3. Data-Tagging Proxy-Related Materials

The Concept Release seeks comment on whether issuers should be permitted or required to release proxy-related information, such as executive compensation, director qualifications and related party transactions, in an interactive data format (such as XBRL, as is required for certain SEC periodic reports) and whether such information would improve the efficiency and quality of investor proxy voting.

C. RELATIONSHIP BETWEEN VOTING POWER AND ECONOMIC INTEREST

1. Proxy Advisory Firms

Issuers and investors have raised concerns relating to the role, practices and legal status of proxy advisory firms, including concerns about their level of influence, lack of regulatory oversight, the potential for undisclosed conflicts of interest and the use of inadequate, erroneous or incomplete data in forming voting recommendations. With respect to conflicts of interest, proxy advisory firms may receive fees both for giving voting recommendations to investors on matters presented to shareholders and also for providing consulting services to issuers, such as assistance in developing proposals to be submitted for shareholder approval. The Concept Release notes that some proxy advisory firms are unwilling to enter into discussions with issuers prior to issuing a final report, even for the limited purposes of ensuring accurate issuer data. The release also notes the concern that proxy advisory firms may base their recommendation on a one-size-fits-all governance approach that might be unsuitable for some issuers. The Concept Release seeks comment on, among other things:

- whether additional regulation of proxy advisory firms (for example, through the Investment Advisers Act of 1940 and/or the proxy solicitation rules) is necessary or appropriate for the protection of investors;
- to what extent do proxy advisory firms face conflicts of interest and, if so, are these conflicts appropriately disclosed and otherwise appropriately addressed under existing law, regulation and industry practice;
- what policies and procedures, if any, do proxy advisory firms use to ensure that their voting recommendations are independent and not influenced by fees they receive for services to corporate clients or shareholder proponent clients;
- do issuers modify or change their proposals to increase the likelihood of favorable recommendations by proxy advisory firms or adopt particular governance standards solely to meet the standards of a proxy advisory firm and, if so, why;

accompany the Notice with an explanation of the reasons for the use of the notice and access model and the process of receiving and reviewing proxy materials and voting, as discussed in our memorandum, dated February 24, 2010, entitled "SEC Adopts Amendments to E-Proxy Rules Permitting Inclusion of Explanatory Materials and Greater Flexibility in Drafting Notice of Internet Availability of Proxy Materials." See Rel. Nos. 33-9108, 34-61560, IC-29131, *Amendments to Rules Requiring Internet Availability of Proxy Materials* (Feb. 22, 2010), available at <http://www.sec.gov/rules/final/2010/33-9108.pdf>.

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- should proxy advisory firms be required to publicly disclose their decision models for approval of executive compensation plans, and would this alleviate concerns about potential conflicts of interest when issuers pay consulting fees to the firm for access to these models;
- what is the competitive structure of the market for proxy advisory firms, and does this structure affect the quality of the recommendations;⁶
- how do institutional investors use the voting recommendations of proxy advisory firms;
- what criteria and processes do proxy advisory firms use to formulate their recommendations and corporate governance ratings;
- are existing procedures followed by proxy advisory firms sufficient to ensure that their reports are materially accurate and complete; and
- do proxy advisory firms control or significantly influence shareholder voting without appropriate oversight and, if so, what action should the SEC take.

2. Dual Record Dates

As of August 2009, the Delaware General Corporation Law has allowed Delaware corporations to designate dual record dates—first, for determining who is entitled to notice of a shareholder meeting and, second, for determining who is entitled to vote at the shareholder meeting. The Concept Release points out the logistical difficulties, including those arising from its proxy rules, with implementing dual dates and seeks comment on whether the SEC or stock exchanges should promulgate new or revised rules to accommodate, promote or discourage separate record dates under Delaware law.⁷

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

The Concept Release notes that the U.S. proxy voting system is based, conceptually, on the expectation that a “shareholder” possesses both voting rights and an economic interest in the company. However, there are a number of ways in which the voting interest in shares can be “decoupled” from the economic interest. The Concept Release focuses primarily on the phenomenon of “empty voting,” whereby a shareholder’s voting influence outweighs its financial stake in the issuer. Empty voting and other “decoupling” of voting and economic interest can be achieved by a variety of techniques, including hedging activity and securities lending. The Concept Release seeks comment on, among other things:

- how decoupling can occur, whether it raises policy concerns and how prevalent it is;

⁶ In this regard, the SEC notes that Institutional Shareholder Services (a subsidiary of RiskMetrics Group) has a significantly larger market share than other proxy advisory firms.

⁷ Additional discussion of the logistical difficulties arising from a dual record date system under the SEC proxy rules and stock exchange requirements is contained in our memorandum, dated April 28, 2009, entitled “Delaware Adopts Amendments to the Delaware General Corporation Law Relating to Corporate Governance.”

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- whether SEC rules should provide greater disclosure and transparency of decoupling, such as through the disclosure requirements of Sections 13(d), 13(f) and 13(g) under the Exchange Act;⁸
- whether there are instances in which empty voting was determinative of the outcome of a shareholder vote;
- whether proxy voters should be required to certify on proxies the extent of their economic interest in the shares being voted; and
- whether only persons who possess unhedged economic interests in the company should be allowed to vote, or whether empty voting should be outright prohibited.

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⁸ Section 766 of Dodd-Frank seeks to address this “decoupling” by providing that a person may in some instances acquire beneficial ownership of a registered class of equity securities for Section 13 and Section 16 reporting purposes through the purchase or sale of a security-based swap. In addition, Section 929X of Dodd-Frank amends Section 13(f) of the Exchange Act to direct the SEC to require monthly disclosure of short positions by institutional money managers. See our memorandum, dated July 2, 2010, entitled “Dodd-Frank Bill Imposes Substantial New Requirements and Restrictions, Addresses Systemic Risk and ‘Too Big to Fail’ Issues and Significantly Reforms Regulation of the Securities Industry; Expected to Become Law by End of July.”

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