

## SEC Issues “Proxy Plumbing” Concept Release to Seek Comment on the U.S. Proxy Voting System

July 27, 2010

On July 14, 2010, the Securities and Exchange Commission (the “SEC”) voted unanimously to issue a concept release to solicit public comment on a variety of issues involving the U.S. proxy voting system.<sup>1</sup>

The last comprehensive review by the SEC of the proxy voting system dates back nearly 30 years. Last year, the SEC directed its staff to take a fresh look at the proxy voting system in light of the many new developments over the years that have affected the operation of the system, including technological innovations, changes in the nature of stock ownership, new financial products, consolidation of proxy distribution service providers and the expansion of other types of proxy service providers.

The concept release focuses and seeks comment on the following three broad categories:

- Accuracy, transparency and efficiency of the voting process
- Communications with shareholders and shareholder participation and
- Relationship between voting power and economic interest.

Comments on the concept release are due by October 20, 2010.

### **Accuracy, Transparency and Efficiency of the Voting Process**

#### *Over-voting and under-voting of shares*

In order to facilitate the processing of the large volume of transactions in securities in the U.S., most securities are held in “street name,” which means that securities intermediaries, such as brokers or banks, and not the beneficial owners, are holders of record. Beneficial owners hold their securities through securities intermediaries who, either directly or through other securities intermediaries, hold the securities in accounts with The Depository Trust Company (“DTC”), the central

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<sup>1</sup> SEC Release No. 34-62495 (Concept Release on the U.S. Proxy System) (July 14, 2010), available [here](#).

repository for securities in the U.S. DTC holds deposited securities in “fungible bulk,” which means that the securities held by its participants are not specifically identifiable.

Over-voting or under-voting of shares can occur when a broker-dealer casts more or fewer votes than the total number of shares credited to the broker-dealer’s customers’ accounts, because of a mismatch between the total number of shares of an issuer held by a broker-dealer at DTC and the shares credited to the customers’ accounts. These imbalances can occur because ownership of individual securities is not tracked in the clearance and settlement system. Potential sources for imbalances are

- Securities lending transactions, where a broker-dealer lends out customers’ margin securities or borrows investors’ securities in stock loan arrangements and
- Fails to deliver in the clearance and settlement system, which occur when a broker-dealer fails to make timely delivery of securities to the National Securities Clearing Corporation, a registered clearing agency that acts as the central counterparty for its members’ securities trades.

When imbalances occur, broker-dealers must allocate the votes among their customers. A number of different reconciliation methods are used to allocate votes among customer accounts. Their selection is often driven by whether the broker-dealer has an institutional or retail customer base.

The concept release seeks comment on whether:

- Over-voting or under-voting is a problem
- The method used by a broker-dealer to allocate votes to its customers should be disclosed and the likely effect of that method on whether the customers’ voting instructions would be reflected in the vote sent to the tabulator and
- The SEC should prescribe the use of a particular reconciliation method.

#### *Vote confirmation*

Currently, vote tabulators, transfer agents, securities intermediaries and proxy service providers are not required to share vote data with each other to ensure that votes have been received and tallied in accordance with investors’ voting instructions. The SEC believes that

record and beneficial owners should be able to confirm that their votes were actually cast and accurately recorded and that issuers should be able to confirm that the votes they receive from securities intermediaries, proxy advisory firms or proxy service providers on behalf of beneficial owners properly reflect the votes of the beneficial owners. The concept release seeks comment on whether vote confirmation should become a requirement and how this could be implemented.

#### *Proxy voting by institutional securities lenders*

Many institutional investors with investment portfolios of securities lend securities for additional income. In securities lending arrangements, incidents of ownership, including the right to vote, generally transfer to the borrower. If the lender wishes to vote the loaned securities, it must terminate the loan and recall the securities prior to the record date. However, lenders generally do not receive notice about the matters to be voted on before the record date and therefore cannot determine whether to terminate the loan, recall the shares and exercise their voting rights.

The concept release seeks comment on whether issuers should be required to disclose, and the policies and practical issues relating to such disclosure, the agenda items for shareholder meetings sufficiently in advance of the record date to enable lenders to terminate their loans, recall their shares and vote on matters they consider important. It also explores the possibility of requiring mutual funds and closed-end funds to disclose the number of shares voted and not voted by the fund at a particular meeting, in addition to the currently required disclosure of how the fund voted the shares.

#### *Proxy distribution fees*

SEC rules require broker-dealers and banks to forward proxy materials to their customers who are the beneficial owners of the securities if the issuer provides assurance that it will reimburse the reasonable expenses of distribution. Stock exchange rules establish the maximum fees the broker-dealer may charge the issuer of the securities for distributing proxy materials. Most broker-dealers have outsourced the distribution of proxy materials to Broadridge, a proxy service provider. Broadridge generally bills issuers, on behalf of its broker-dealer clients, the maximum fees allowed under the exchange rules, which in some cases exceed the fees contractually agreed to between Broadridge and its broker-dealer clients, resulting in funds being remitted from Broadridge to some of its broker-dealer clients.

The concept release seeks comment on the reasonableness of the current fee structure and potential changes to the fee structure, including replacing the current system in which the maximum fee is set by

the exchanges with a system in which the fees are determined competitively by market forces.

## **Communications with Shareholders and Shareholder Participation**

### *Issuers' ability to communicate with beneficial owners*

The system of holding securities in “street name” and the separation—often by several layers of securities intermediaries—of record and beneficial ownership limit the ability of companies to identify their beneficial owners and to communicate with them. Companies can request brokers and banks to provide a list of the names and addresses of “non-objecting beneficial owners” (“NOBOs”), which are beneficial owners who do not object to having their names and contact information provided to the issuer. However, a majority of beneficial owners falls into the category of “objecting beneficial owners” (“OBOs”), who object to the disclosure of their names and contact information to the issuer and can be contacted only through their securities intermediaries.

The concept release seeks comment on whether regulatory action is needed to make it easier for companies to communicate with their beneficial owners, including whether the OBO/NOBO distinction should be eliminated or modified.

### *Potential means to facilitate retail investor voting participation*

As a result of recent amendments to New York Stock Exchange Rule 452, brokers can no longer vote shares in uncontested director elections absent specific instructions from their customers. Section 957 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the NYSE to prohibit brokers from uninstructed voting on executive compensation and other “significant matters,” as determined by the SEC. These changes, in addition to the use of the “notice-only option” of “notice and access,” may contribute to a further decline in retail investor voting.

The concept release seeks comment on several ideas that potentially could improve retail investor voting, including:

- Improving investor education on the voting process
- Enhancing issuers' and brokers' web sites to include information on upcoming votes and to allow shareholders to provide voting instructions
- Permitting securities intermediaries to solicit advance voting instructions on particular topics from retail investors in advance of their receipt of proxy materials

- Enhancing investor-to-investor communications and
- Improving the use of the internet for distribution of proxy materials, including possible revisions to “notice and access.”

#### *Data-tagging of proxy-related materials*

In February 2010, the SEC’s Investor Advisory Committee recommended that the SEC staff consider the costs and benefits of mandating a standardized tag-data format for proxy and certain other filings. The concept release seeks comment on the costs and benefits of tagging proxy-related data, such as information about executive compensation, director qualification and corporate governance.

### **Relationship between Voting Power and Economic Interest**

#### *Role of proxy advisory firms*

Many institutional investors today rely on the services of proxy advisory firms in exercising their voting rights. Concerns have been raised about potential conflicts of interest, which can occur, for example, when proxy advisory firms provide consulting services to issuers on matters to be submitted for shareholder approval and voting recommendations to institutional investors on the same matters. In addition, concerns have been raised about the lack of accountability of proxy advisory firms for accuracy of their information and transparency in the development of their voting recommendations, as well as the significant influence of these firms on shareholder voting, without appropriate oversight and without an actual economic stake in the issuer.

The concept release seeks comment on:

- Requiring additional oversight of proxy advisory firms
- Improving disclosure about potential conflicts of interests of proxy advisory firms and
- Requiring public disclosure by proxy advisory firms in SEC filings of their voting recommendations.

#### *Dual record dates*

Since August 2009, Section 213(a) of the Delaware General Corporation Law has permitted Delaware corporations to set separate record dates for determining shareholders entitled to notice of a shareholders’ meeting and for determining shareholders entitled to vote at the meeting. Previously, Delaware corporations could set only one record

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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date, which determined shareholders entitled to notice of the meeting and to vote at the meeting. The consequence of a single record date is that shareholders who sell their shares after the record date (and prior to the meeting) are still entitled to vote at the meeting even though they no longer have an economic stake in the outcome of the vote. Dual record dates help prevent this result, but the SEC's proxy rules do not currently accommodate dual record dates.

The concept release seeks comment on whether the SEC's proxy rules should be revised to accommodate dual record dates.

### *Empty Voting*

"Empty voting" occurs when a shareholder's voting rights exceed the shareholder's economic interest in the company. This can occur, for example, where a shareholder hedges the economic interest in his shares by buying a put option or using credit derivatives or where a shareholder sells his shares after the voting record date for a shareholders' meeting and before the date of the meeting. In these situations, the vote is viewed as "empty," because the person voting lacks an economic interest in the shares or may have a negative economic interest in the shares. Voting rights and economic ownership of the shares have been "decoupled."

The concept release seeks comment on any public policy concerns relating to decoupling and on whether disclosure of decoupling activities should be required.

*This client alert was prepared by Elizabeth W. Powers and K. Oliver Rust. For more information, please contact your Dewey & LeBoeuf relationship partner or:*

*Michael F. Fitzpatrick at +1 212 259 6670 or [mfitzpatrick@dl.com](mailto:mfitzpatrick@dl.com)*

*Steven Lund at +1 212 259 6630 or [slund@dl.com](mailto:slund@dl.com)*

*Aileen C. Meehan at +1 212 259 6910 or [ameehan@dl.com](mailto:ameehan@dl.com)*

*Elizabeth W. Powers at +1 212 259 8662 or [epowers@dl.com](mailto:epowers@dl.com)*

*Linda E. Ransom at +1 212 259 6570 or [lransom@dl.com](mailto:lransom@dl.com)*

*K. Oliver Rust at +1 212 259 8571 or [krust@dl.com](mailto:krust@dl.com)*

*J. Anthony Terrell at +1 212 259 7070 or [jterrell@dl.com](mailto:jterrell@dl.com)*