OLSHAN
OLSHAN GRUNDMAN FROME ROSENZWEIG & WOLOSKY LLP

Client Alert

Corporate Department August 2010

SEC Seeks Public Comment on Proxy System

Broad and Comprehensive Review Focuses on Accuracy, Reliability, Transparency, Accountability and Integrity of the U.S. Proxy System

On July 14, 2010, the U.S. Securities and Exchange Commission (the "SEC") published a "concept release" intended to solicit comment on various aspects of the U.S. proxy system. Broad in scope, the release reviews and seeks public comment on issues relating to the system's accuracy, reliability, transparency, accountability and integrity. These issues are being reviewed at a time when the dissemination of proxy materials and the casting and tabulation of votes is extremely complex, in large part as a result of a vast majority of shareholders owning securities through broker-dealers, banks and other intermediaries (or "in street name"). The SEC is concerned that the role of third parties such as broker-dealers, banks, custodians and transfer agents and other service providers such as proxy solicitors, proxy advisory firms and vote tabulators in today's modern proxy voting infrastructure "adds complexity to the proxy system and makes it less transparent to shareholders and to issuers." While the concept release does not propose the enactment of any new laws, it is likely the SEC will target the issues addressed in the release with future regulation.

"Empty Voting"

The SEC seeks comment on so-called "empty voting" by investors, which refers to situations where a shareholder's voting rights exceed his economic interest in a company. In its most basic form, empty voting could arise in situations where investors who sell shares after a record date for a shareholder meeting retain the right to vote the shares. Empty voting can also be accomplished by buying put options, engaging in swap arrangements or entering into other hedging transactions, which result in the decoupling of economic risk from voting rights. This raises the theoretical concern noted by the SEC that the assumption that investors vote at shareholder meetings in the interest of protecting or maximizing shareholder value is attenuated when investors "have little or no economic interest or, even worse, have a negative economic interest" in the shares they vote. In response, the SEC is exploring whether to require more robust disclosure from investors regarding the potential for empty voting in their Schedules 13D and 13G and is even seeking comment as to whether empty voting should be prohibited or more strictly regulated in certain circumstances.

Role of Proxy Advisory Firms

Proxy advisory firms, who provide institutional investors with advice on how to vote their shares at company meetings and other services, are being scrutinized due to

concerns over potential conflicts of interest and the lack of transparency with respect to how the firms formulate voting recommendations. A conflict of interest could arise when advisory firms offer voting recommendations to institutional investors with regard to the same issuers to which they are providing consulting services. Another area of concern is that proxy advisory firms may be making voting recommendations based on flawed, outdated or incomplete information without giving issuers an opportunity to correct or supplement this information. The SEC is therefore considering, among other things, whether to require enhanced disclosure by proxy advisory firms of potential conflicts of interest and the scope of research involved in formulating voting recommendations.

Proxy Voting by Institutional Securities Lenders

Many institutions with investment portfolios engage in securities lending to earn additional income on securities held in their accounts. When an institution loans its portfolio securities, the voting rights associated with those securities generally pass to the borrower for the duration of the loan. Thus, some institutions have proxy voting policies that require them to recall loaned securities in advance of an upcoming material vote in order to reclaim their voting rights. As such, these institutions face the challenge of learning what matters will be voted on at shareholder meetings sufficiently in advance of the record date for the meetings so they can determine whether to recall the loaned securities. The SEC asked for comment on whether it should require public disclosure (*e.g.*, in a Form 8-K) of a description of all matters to be brought to a vote sufficiently in advance of a meeting record date.

Over-Voting and Under-Voting

In certain situations, principally as a result of securities lending to margin accounts and "fails to deliver" in the settlement of securities trades, securities intermediaries (*e.g.*, broker-dealers) on occasion cast fewer or more votes on behalf of underlying beneficial holders of an issuer's securities than they are actually entitled to vote. In response to the over-voting and under-voting phenomenon, the SEC is exploring the possibility of requiring intermediaries to publicly disclose the voting allocation and reconciliation method used by a firm when there is an imbalance between the voting instructions it receives from underlying beneficial owners and the number of securities the firm is permitted to vote with the issuer. The SEC is also seeking comment as to whether investors would benefit if broker-dealers were required to use a particular reconciliation method. Currently, neither federal securities laws nor the rules of the major stock exchanges require reconciliations to be performed or the use of a particular reconciliation methodology.

Vote Confirmation

The SEC is seeking comment regarding the inability of beneficial owners to confirm whether their shares have been voted in accordance with their instructions. Because there are numerous unrelated participants in the proxy voting process, and no one participant has the ability to confirm whether a beneficial owner's vote has been properly cast, it can be impracticable if not impossible for an investor to obtain such a vote confirmation. Similarly, securities intermediaries lack the ability to confirm to their customers that their votes have

been properly cast and issuers cannot confirm that votes received from intermediaries properly reflect the votes of the underlying beneficial owners. To address this problem, the SEC has asked for comment on, among other things, whether it should require participants in the voting chain to grant issuers access to certain information relating to voting records for the purpose of vote confirmation. Issuers could then, in turn, confirm to their shareholders that their shares have been voted as instructed.

Issuer Communication with Beneficial Owners

As discussed above, the vast majority of securities owned today are held by investors in "street name" through a broker-dealer or other intermediary who holds the securities for the account of the beneficial holder. While some beneficial holders elect to allow their broker-dealers to provide issuers with their names and addresses, other holders (referred to as "objecting beneficial holders" or "OBOs") do not. The SEC has noted that OBOs have become an impediment to issuer communication with shareholders and do not promote the desired level of shareholder participation in the proxy voting process, particularly in contested situations. Issuers have indicated to the SEC that recent changes in corporate governance practice and rules, such as the movement towards majority voting instead of plurality voting in elections of directors and the elimination of broker discretionary voting in uncontested elections, call for issuers to have the ability to communicate directly to their shareholder base—at the very least to allow issuers to establish a quorum. The SEC is seeking comment on several possible solutions, including elimination of OBO status and a promotion of the selection of non-objecting beneficial owner status by investors. The SEC acknowledges the obvious privacy concerns that would need to be considered in addressing this issue.

Dual Record Dates

In accordance with state law, companies are required to set a "record date" for the purpose of determining which investors are entitled to receive notice of a shareholder meeting and to vote at that meeting. Under this regime, shareholders can generally still vote their shares held as of the record date for a meeting even if they sell the shares after the record date, thus allowing shareholders without an economic interest in the matter to influence the outcome of a vote.

Recent changes to Delaware law allow for dual record dates, one for determining who is entitled to receive notice of a meeting and a later date for determining who can vote at the meeting. While it may be desirable that companies set a voting record date as close as possible to the meeting date, therefore increasing the likelihood that only shareholders with an economic interest in the company have the ability to vote at the meeting, SEC rules and certain logistical matters currently prevent companies from setting a voting record date close to or as of the meeting date. The SEC is therefore considering whether to modify its rules in order to accommodate issuers that wish to use separate record dates where permitted by state law. Any rule modification will need to balance the desire to allow issuers to set the voting record date as close as possible to the meeting date, thus avoiding the disenfranchisement of shareholders who purchase their stock after the notice record date, and the need to provide

adequate time for shareholders entitled to vote to receive and review proxy materials prior to the meeting.

Proxy Distribution Fees

Pursuant to SEC rules, broker-dealers and banks must distribute proxy materials received from an issuer to their customers, who are the underlying beneficial owners of the issuer's shares. In return, the issuer must reimburse the broker-dealers or banks for their reasonable expenses. Broker-dealers and banks generally outsource their delivery obligations to proxy service providers. Because they are receiving reimbursement from the issuer, broker-dealers and banks have little incentive to negotiate with their service providers to reduce costs. To address certain inefficiencies inherent to this model, the SEC is seeking comment on, among other things, the creation of a central data aggregator that would be given the right to collect beneficial owner information from securities intermediaries and then provide that information to a proxy service provider designated by the issuer. Theoretically, by making the beneficial owner information available to all service providers, market forces would then create competition among the service providers for the distribution of proxy materials and eventually drive down costs.

* * *

Please feel free to contact any of the partners listed below or any corporate partner with whom you work if you would like to discuss any of the matters highlighted in this alert.

Steve Wolosky
swolosky@olshanlaw.com
212.451.2333

Kenneth M. Silverman
ksilverman@olshanlaw.com
212.451.2327

Kenneth A. Schlesinger
kschlesinger@olshanlaw.com
212.451.2252

Ron S. Berenblat
rberenblat@olshanlaw.com
212.451.2296