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## CLIENT ALERT

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### Implications for Corporate Issuers of the SEC's Concept Release on the U.S. Proxy System

#### INTRODUCTION:

The SEC's concept release on the U.S. proxy system, which was issued on July 14, 2010, is part of an on-going review process at the Securities and Exchange Commission that is likely to result in both major changes to the proxy voting system and substantial corporate governance challenges.<sup>1</sup> As the Commission explained in its release: "It has been many years since we conducted a broad review of the system, and we are aware of industry and investor interest in the Commission's consideration of an update to its rules to promote greater efficiency and transparency in the system and enhance the accuracy and integrity of the shareholder vote." The SEC is exploring a major overhaul of the proxy voting system because, as the SEC explained in the release: "commentators (have) raised concerns about the proxy system as a whole. In addition, the Commission's staff often receives complaints from individual investors about the administration of the proxy system. We believe that these concerns and complaints merit attention." The Commission also noted that "recent developments, such as the revisions to Rule 452 of the New York Stock Exchange ('NYSE') limiting the ability of brokers to vote uninstructed shares in uncontested director elections and other corporate governance trends such as increased adoption of a majority voting standard for the election of directors have highlighted the importance of accuracy and accountability in the voting process."

The Altman Group has examined the 151-page release and previously published an executive summary, which is available on our website.<sup>2</sup> There are a number of "potential regulatory responses" discussed in the SEC's concept release that could have a substantial impact on the ability of issuers to manage corporate governance risks. While our executive summary covered all of the concepts mentioned in the release as "potential regulatory responses," this *Client Alert* will highlight only those critical issues that merit both detailed study and potential comments to the Commission. The following text will start each section by detailing the SEC's stated "potential regulatory responses" (with headers in bold), and then present our views on each concept. The issues are presented below in the same order as they are raised in the text of the SEC's concept release.

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<sup>1</sup> The SEC's announcement is available at <http://www.sec.gov/news/press/2010/2010-122.htm>

The text of the release is available at <http://www.sec.gov/rules/concept/2010/34-62495.pdf>

<sup>2</sup> <http://www.altmangroup.com/pdf/ExecSumProxyMechanicsTAG.pdf>

**Vote Confirmations.** In the Commission's view, "both record owners and beneficial owners should be able to confirm that the votes they cast have been timely received and accurately recorded and included in the tabulation of votes, and issuers should be able to confirm that the votes that they receive from securities intermediaries/proxy advisory firms/proxy service providers on behalf of beneficial owners properly reflect the votes of those beneficial owners." The release indicated that the Commission is examining whether all participants in the voting chain should "grant to issuers, or their transfer agents or vote tabulators, access to certain information relating to voting records, for the limited purpose of enabling a shareholder or securities intermediary to confirm how a particular shareholder's shares were voted...This process could be fully automated such that a vote confirmation could be provided by the issuer (or its agent) to the record owner or, in the case of beneficial owners, to the securities intermediary or proxy service provider and sent by email to the beneficial owner."

***TAG.*** A key issue is who should bear the costs of constructing such a system. An automated process generating instantaneous and "real-time" updates and confirmations would be significantly more expensive to implement than one in which the process is designed for confirmations/reviews conducted on a selective or delayed basis.

**Lack of Advance Notice of Meeting Agendas.** The Commission is exploring whether the NYSE should be "asked" to "revise its rules to require public dissemination of a notice, in advance of the record date, that contains information about the record and meeting dates as well as specific descriptions of all matters to be voted upon. Other SROs could also be asked to adopt similar rules." An alternative solution would be "a requirement for all issuers subject to our proxy rules to disclose the agenda by public means, such as by filing a report on Form 8-K (or as an alternative to such a filing requirement, permitting the issuance of a press release or a posting on a corporate Web site)." In this context, please note that the Commission has recently issued new disclosure requirements for companies (via Form 8-K), including registered investment companies, as part of the SEC's new rules enabling "proxy access" (see our *Client Alert* on the new proxy access rules). Those new requirements are designed primarily to provide timely transparency regarding anticipated meeting dates and deadlines for filing proxy access notices.

***TAG.*** This part of the concept release is being driven, in part, by the Commission's exploration of ways to improve the ability of institutional investors (and their advisers) to manage voting processes (including recalling shares on loan in a timely manner). Of course, the "solution" (beyond what has already been imposed through the new rules on proxy access) being examined by the Commission could impose a significant new regulatory burden on corporate issuers. The Altman Group argued in a letter to the SEC in Oct. 2009 that any such system should be voluntary.<sup>3</sup>

**Disclosure of Voting by Funds.** The Commission is examining "whether Form N-PX should be amended to require disclosure of the actual number of votes cast by funds." The Commission describes the issue as one of "fundamental rights" and promoting transparency concerning securities on loan. In particular, the release notes that when the SEC adopted the requirement for mutual funds to generate Form N-PX disclosures, it did so because investors in "mutual funds have a fundamental right to know how the fund casts proxy votes on shareholders' behalf."

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<sup>3</sup> Kenneth L. Altman, President, The Altman Group, Inc., "Practical Solutions to Improve the Proxy Voting System," October 21, 2009. <http://www.altmangroup.com/pdf/PracticalSolutionTAG.pdf>

**TAG.** The proposed change to Form N-PX disclosures will provide no timely information and offer few actionable insights. Thus, we must ask: why impose more of a regulatory and reporting burden on funds subject to disclosures via Form N-PX when there will be little tangible value in the results? If the Commission is to increase the burden of disclosures on investment managers, then it should be directed more widely at generating a level of transparency that all market participants would find useful. In this context, The Altman Group has previously proposed to the Commission that it should consider requiring more comprehensive disclosures on total votes controlled by institutions through 13(f) and other (potential event-based) filings.<sup>4</sup>

**Proxy Distribution Fees.** The Commission has concluded that: “given developments in the securities market overall and proxy solicitation rules, such as the notice and access model, it appears to be an appropriate time for SROs to review their existing fee schedules to determine whether they continue to be reasonably related to the actual costs of proxy solicitation.” The Commission is considering changes to regulated fees on the grounds that “without a competitive market, there may be a continued need for regulated fees” (specifically citing lack of implementation by the NYSE of suggestions from the Proxy Working Group to “re-evaluate the NYSE’s current fee structure”). Concepts under consideration include: “the creation of a central data aggregator that is given the right to collect beneficial owner information from securities intermediaries, but is required to provide that information to any agent designated by the issuer”; and changes in fee structures driven by “some of the other potential regulatory responses discussed” in the release (“For instance, adopting a system under which securities intermediaries grant proxies to underlying beneficial owners...would permit issuers to negotiate fees and services with proxy service providers because the issuers would be directly soliciting proxies from those beneficial owners”).

**TAG.** The language of the release was remarkable for its concession that there is a less than “competitive market” when it comes to communications with beneficial shareholders. The release even poses the question: “what steps would be necessary to enable prices to be based on competitive market forces?” The release openly pressures the NYSE to “reevaluate” its current fee structures, and notes that the NYSE has not implemented key recommendations from the Proxy Working Group, such as conducting “cost studies, commission audits and surveys of various constituencies involved.” The SEC backs up that challenge to the NYSE by noting that it is considering alternative structures involving either the “creation of a central data aggregator that is given the right to collect beneficial owner information” from intermediaries or a system in which beneficial owners are granted proxies, which “would permit issuers to negotiate fees and services with proxy service providers.”

The release asks companies not only for input on how rates should be revised, but also whether the current “rebates” between Broadridge and larger broker-dealers should even be permitted and whether rules for notice and access fees should be set by the NYSE and other Self-Regulatory Organizations

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<sup>4</sup> <http://www.altmangroup.com/pdf/PracticalSolutionTAG.pdf> . Some of the proposals in that original paper were expanded and elaborated on in Kenneth L. Altman’s position paper on “Modernizing the Proxy Voting System: Setting Priorities” dated March 2, 2010. See <http://www.altmangroup.com/pdf/ProxyMechanicsTheAltmanGroup1.pdf> .

(SROs). The Commission even goes so far as to raise the question of whether issuers should “have more control over the selection and payment” of proxy service providers used by broker-dealers.

The SEC has opened the door for issuers to gain “more control” over the costs of proxy communications, in particular with beneficial shareholders. If history is to be any guide, it is already quite clear that little progress is likely if the Commission simply asks the NYSE to exercise more control over the proxy-related costs imposed on issuers by many member firms, who have turned former proxy service (cost) centers into profit centers through arrangements with Broadridge (involving financial arrangements that the SEC is now openly raising questions about, including certain fee structures for notice and access).

Companies should also consider whether more sweeping structural changes to the communications process, as proposed by the Business Roundtable and the Shareholder Communications Coalition (SCC),<sup>5</sup> will be necessary to promote truly “competitive” options for proxy communications and the management of associated costs.

**Issuer Communications with Shareholders.** One of the most significant steps that can be taken to improve corporate communications with shareholders would be to modernize the OBO/NOBO (Objecting vs. Non-Objecting Beneficial Owners) system. The Commission indicated that it is considering proposals from the Business Roundtable and SCC to enable issuers to communicate directly with their beneficial owners by requiring broker-dealers and banks to execute an omnibus proxy in favor of their underlying beneficial owners and by eliminating OBO status (and driving those who want to retain a level of “anonymity” to “bear the costs” by registering shares in nominee accounts). However, while the Commission is exploring sweeping concepts, our view is that such radical change is very unlikely at this time. Efforts to find a middle ground, one that “balances interests” between issuers and investment managers, are likely to shift the focus of the debate onto alternative options discussed in the concept release, including:

1. An “annual NOBO” (ANOBO) system that is based on a proposal submitted to the SEC in October 2009 by The Altman Group (which we called an event-based ABO, or All Beneficial Owners, system).<sup>6</sup> In this system (quoting from the release): “an issuer would be entitled to a list of all beneficial owners, but only as of the record date for a particular meeting...At any other time during the year, objecting beneficial owner information would not be available to the issuer or any other party. An annual NOBO system would enable issuers to communicate directly with all of their shareholders, both registered and beneficial owners, for purposes of a shareholder meeting, while minimizing the possibility that the investor information will be used for purposes other than proxy solicitation, such as determining an investor’s trading strategies.”
2. Steps to “promote” the “selection of NOBO status,” such as “educating investors about OBO and NOBO status when they open their accounts or periodically.” The Commission is examining: whether the default agreement used by all broker-dealers should be NOBO status and whether broker-dealers should “contact customers who elect OBO status periodically to re-elect their

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<sup>5</sup> See <http://www.shareholdercoalition.com/BRTPetition4-16-04.pdf> and <http://www.sec.gov/comments/s7-10-09/s71009-294.pdf>

<sup>6</sup> Acknowledged by the Commission in Footnote 163 (Pg. 71). The latter includes a link to The Altman Group’s Oct. 2009 proposal titled “Practical Solutions to Improve the Proxy Voting System.” The original proposal from The Altman Group is available at <http://altmangroup.com/pdf/PracticalSolutionTAG.pdf>

OBO/NOBO status.” In March 2010, The Altman Group proposed to the SEC that the: “Commission...consider creating a process that will fully inform all investors about their OBO/NOBO status and clarify which account holders truly want to maintain their OBO status. That process would involve conversion of all accounts to a NOBO ‘default’ status, while providing time before the effective conversion date...for all existing OBOs to renew their OBO status.” We also asked that “brokers” be “prohibited from making an OBO selection on behalf of an account holder unless explicitly directed to by the account holder.”

**TAG.** While The Altman Group sees some advantages to more sweeping reforms, such as eliminating OBO status altogether, we have helped steer the debate through our proposals and position papers to the Commission to include concepts, such as ABO/ANOBO, that are more likely to be “workable” in the current environment (as steps that “balance” the interests of all parties). In this context, we would ask that clients consider the merits of an ABO/ANOBO system, as detailed in the SEC’s concept release and position papers posted on our website.<sup>7</sup>

**Investor Education.** The Commission is considering various steps to improve investor education concerning the proxy voting process and “the importance of voting.” The concept release cites the possibilities of: 1) having “more proxy-related educational materials located on an issuer’s or broker’s Web site”; 2) improvements to the “presentation of information on the proxy card or VIF” [the release notes that “although some explanation of how the proxy process works is often included on the back of the proxy card (or on the VIF), that information can be difficult to read and is often presented in small print”]; and 3) information about the shareholder voting process in “communications between brokers and their customers that occur in connection with opening customers’ accounts.”

**TAG.** The Altman Group has long been a public advocate of more investor education about the proxy voting process, and encourages clients to consider the advantages of all three options under consideration by the Commission. The value to issuers of concepts #1 and #3 are largely self-evident, and can be implemented without additional costs for companies. The second concept (improving the “presentation of information on the proxy card or VIF”) should be driven more by the preferences and interests of each issuer (we always favor greater flexibility in design) rather than relying on rule-making to standardize the presentation of such information.

We urge the Commission to consider still more options for educating investors, such as including information in communications between brokers and their customers not only when they open their accounts (as mentioned above), but also on a regular basis (e.g., sending materials out along with account statements). After all, the long history of declining retail voting participation rates indicates that education on proxy/voting matters should be a continuous process: one that will require at least annual reminders and updates before each proxy voting season.

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<sup>7</sup> <http://www.altmangroup.com/pdf/PracticalSolutionTAG.pdf> . Some of the proposals in that original paper were expanded and elaborated on in Kenneth L. Altman’s position paper on “Modernizing the Proxy Voting System: Setting Priorities” dated March 2, 2010. See <http://www.altmangroup.com/pdf/ProxyMechanicsTheAltmanGroup1.pdf> .

**Advance Voting Instructions (“Client Directed Voting”[CDV]).** The Commission, citing both its interest in increasing investor participation in the voting process and the potential value of “providing retail investors with a component of the services now made available to institutional investors by proxy advisory firms,” is exploring options for “client-directed voting.” The Commission is reviewing CDV options, but the release itself points to how complicated, and problematic, implementation of the concept could be. The release asks such questions as “whether...instructions should be reaffirmed on a periodic basis...(and) each time an investor purchases additional shares of an issuer’s stock for which that investor has already submitted voting instructions...or whether brokers can seek from investors advance voting instructions that vary by company.”

***TAG.*** The complexity of the processes that may be required to implement CDV is revealed by the Commission’s questions about whether to require that instructions be reaffirmed on a “periodic basis” and “each time an investor purchases additional shares.” Of course, any CDV system should enable investors to establish and change instructions at will, and in a manner that varies by company.

The Commission is already grappling with the need to educate retail investors on proxy matters, and is familiar with the impact on retail voting participation rates that the introduction of a new process, such as notice and access, can have. In this context, implementation of CDV would likely create a far more difficult challenge in terms of educating retail investors on an entirely new approach for exercising their voting power. The Commission would need to ensure that a CDV system does not end up leading to confusion on the part of holders who may, depending upon whether CDV instructions relate exclusively to routine business items or to all items being considered, incorrectly assume that they would no longer need to take an active role in voting after declaring their instructions (creating risk that a poorly designed CDV system could actually lead to a decline in voting on some important proposals).

Some advocates of CDV, who see it as an avenue for potentially constructing a block of pro-management retail votes, should also consider that the CDV system that may result from the SEC’s current review of the proxy system might also end up being structured in such a way as to lead to a substantial increase in the reach and influence of proxy advisory firms.

**Improving the Use of the Internet for Distribution of Proxy Materials.** Although the Commission has opened the door to further review of the notice and access model, the text of the release suggests a bias against additional changes. While the concept release cites the “possible option” of permitting “the inclusion of a proxy card or VIF with the Notice of Internet Availability of Proxy Materials,” it goes on to note that the SEC previously decided that “physically separating the card from the proxy statement...may lead to the type of uninformed voting that the proxy rules are intended to prevent.”

***TAG.*** The Altman Group has previously considered the SEC’s concerns and proposed a workable solution -- in comments submitted to the SEC on Nov. 20, 2009, on “Amendments to Rules Requiring Internet Availability of Proxy Materials” (“Notice and Access Model” [File Number S7-22-09]).<sup>8</sup> In that letter, we urged the SEC to: “consider enabling issuers to send proxy cards (and business reply envelopes) along with first Notices. We believe that the voting system should be directed at providing shareholders with options suitable to engage them in the process, not additional hurdles to participation. The proxy

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<sup>8</sup> <http://www.sec.gov/comments/s7-22-09/s72209-17.pdf>

card sent with Notices should include the following language: 'I have made my decisions with full knowledge of the availability of a proxy statement.' We would also support the inclusion of a legend on Notices indicating that the form should not be used for voting on matters, and that only a separate proxy card or Voting Instruction Form should be used for submitting votes...The SEC may also want to consider allowing the Notice and proxy cards to be accompanied by a new 'short summary' of issues to be voted on (allowing excerpts from the full proxy statement filed with the SEC). This short summary would be similar in scope to the Summary Prospectus that the SEC is now permitting investment companies to send to shareholders...Since the Commission already allows a summary prospectus to be used in place of a mutual fund's complete prospectus, the same standard should also be applied to proxy statements."

**Proxy Advisory Firms.** The Commission is examining reforms designed to address uncertainties about potential conflicts of interest at proxy advisory firms, and to "provide additional guidance, if necessary, on the fiduciary duty of proxy advisors who are investment advisers to deal fairly with clients and prospective clients, and to disclose fully any material conflict of interest." The concept release also raised the issue of a need for increased "transparency in the formulation of voting recommendations by proxy advisory firms," including potential standards for "ensuring the accuracy of issuer data" and the disclosure of policies "for interacting with issuers, informing issuers of recommendations, and handling appeals of recommendations." Among the many questions posed by the Commission was this rather broad-reaching one: "If...proxy advisory firms do control or significantly influence shareholder voting, is that inappropriate, and if so, should the Commission take action to address it?"

***TAG.*** In addition to imposing greater supervision and regulation of proxy advisory firms designed to prevent even the appearance of conflicts of interest, the Commission should promote greater transparency with regard to the formulation of voting recommendations by proxy advisory firms. A major step in the right direction would be a proposal discussed in the concept release: "requiring proxy advisory firms to file their voting recommendations with us as soliciting material, at least on a delayed basis."<sup>9</sup>

**"Empty Voting" and Related "Decoupling" Issues.** The Commission is examining options to promote transparency with regard to the net "economic interests" of shareholders (after adjusting for equity or credit derivative-based hedging or short positions), while also addressing concerns about "empty voting." The Commission even goes so far as to raise the possibility that they may "*prohibit* empty voting, especially in situations where there is a negative economic interest." The SEC notes in the release that "by improving transparency...issuers also may be in a position to take responsible and appropriate action in response to disclosure of empty voting strategies, such as increasing their solicitation efforts."

The Commission recently approved rules for "proxy access" that require nominating shareholders to disclose information on new Schedule 14Ns concerning their "voting and investment power," in particular ownership histories adjusted for shares sold short.<sup>10</sup> The adopting release for proxy access rules commented at footnote 277 (page 100): "a number of commenters suggested that we adopt a beneficial ownership definition for purposes of Rule 14a-11 that netted all hedging arrangements (derivatives, swaps, *etc.*). We believe, however, that it is appropriate at this time to adopt the ownership threshold for

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<sup>9</sup> Concept Release, page 122.

<sup>10</sup> Release Nos. 33-9136; 34-62764; IC-29384; File No. S7-10-09. The full text of the release is available on the SEC's website at: <http://www.sec.gov/rules/final/2010/33-9136.pdf>.

Rule 14a-11 with the provision only relating to short sales as it contributes significantly towards the goal of excluding votes from the ownership calculation securities where the voting and economic interests are separated and does not unduly complicate the rule.”

**TAG.** At minimum, the Commission should be considering expanding what is disclosed in 13D, 13F, and 13G forms, but the focus should be on transparency with regard to total “voting power,” and not the disclosure of investment strategies. In this regard, limiting any additional related disclosures to numbers showing total “voting power” would leave uncertainty about whether resulting differences between shares held and voting power data are the result of shares out on loan, short positions, derivatives, and so on.

Potentially *prohibiting* empty voting, e.g., by allowing (quoting the release) “proxy voting only commensurate with...net long positions,” is another matter. We are particularly cautious about such a sweeping proposal, not least because of its likely impact on increasing volatility around record dates. Nor would a sweeping ban take into account all of the reasons and purposes for which a firm may carry short positions to hedge a long-term position in a security. A total ban would marginalize firms and funds running long/short strategies, and could drive investment managers to get around such a provision by changing the way they hedge their portfolios (e.g., greater reliance on options over shares sold short).

### **CONCLUSION:**

The Commission’s review of the U.S. proxy system carries the potential for a series of major changes that will impact the ability of companies, including investment companies, to manage governance risks. Moreover, reforms resulting from this process will likely define the proxy system for decades to come. As a result, we urge all of our clients to review the concepts being examined by the Commission, and to weigh in with letters to the Commission. Comments are due on or before October 20, 2010 (SEC File Number S7-14-10).

If you need assistance analyzing the implications of specific proposals contained in the Commission’s concept release on the U.S. proxy system, please feel free to contact:

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