

July 27, 2010

SEC Issues Concept Release on Changes to U.S. Proxy System

On July 14, 2010, the SEC issued a concept release seeking public comment on the United States proxy system and whether regulatory or other reforms are needed to enhance the accuracy, transparency and efficiency of the proxy voting process, to facilitate communications between shareholders and issuers and to address decoupling of voting power and economic interest. The concept release is not a formal rule proposal, but could be the basis of regulatory proposals in the future.

The concept release broadly explores the topics discussed below and seeks comments with regard to the issues raised, as well as potential regulatory and other changes.

Over-Voting and Under-Voting: The concept release discusses over-voting and under-voting—which occur when a bank or broker dealer (referred to collectively as “securities intermediaries” in the concept release) submits votes to an inspector of elections or other vote tabulator (frequently the issuer’s transfer agent) in excess of or below, respectively, the number of shares that the securities intermediary is entitled to vote.

The concept release discusses how lending transactions and “fails to deliver” (instances where a securities intermediary fails to deliver securities on the settlement date of a trade to the National Securities Clearing Corporation, the entity that acts as the central counterparty in the clearing and settlement process) can cause potential over-voting and how securities intermediaries will allocate the votes they have received to the shares for which they are entitled to vote. The concept release notes that the choice of which reconciliation method is used by a particular securities intermediary can potentially result in under-voting based on voter participation levels and can be influenced by whether such entity’s clients are primarily retail or institutional investors.

Among the questions posed for comment, the concept release discusses whether additional disclosures should be made by securities intermediaries regarding the over-vote allocation and reconciliation methods they use, whether such disclosure would adequately address concerns related to over-voting or under-voting by beneficial owners and whether a particular type of reconciliation method better protects investors interests than others.

Vote Confirmation: The concept release describes how under the current proxy voting system no participant in the system can independently confirm votes because no individual participant in the voting process possesses all of the information necessary to confirm whether a particular beneficial owner’s votes have been received and accurately recorded. Beneficial owners, such as institutional investors, often want or need to confirm that their votes have been timely received by the vote tabulator and accurately recorded. Similarly, securities intermediaries want to be able to confirm to their customers that their votes have

been timely received and accurately recorded. Issuers also want to be able to confirm that the votes that they receive from securities intermediaries on behalf of beneficial owners properly reflect the votes of beneficial owners. The concept release notes that this lack of transparency in the proxy voting system is particularly important now, when votes on matters presented to shareholders are increasingly meaningful and consequential to all shareholders.

The concept release requests comments as to whether issuers should confirm to registered owners or securities intermediaries that their votes have been received and properly tabulated and whether all participants in the voting chain should be required to allow issuers and vote tabulators access to voting records to permit vote confirmation. The release describes a number of operational and legal complexities with any proposed solution.

Proxy Voting by Institutional Securities Lenders: When an institution lends securities, all incidents of ownership, including voting rights, transfer to the borrower for the duration of the loan. As a result, if the lending institution wishes to vote the loaned securities, it must terminate the loan and recall the loaned securities prior to the record date for such vote. Because securities lenders typically do not learn of a material stockholder vote prior to the distribution of proxy materials (which typically occurs after the record date for such vote), they are often unable to vote the loaned securities.

The concept release notes that New York Stock Exchange-listed issuers are required to provide the NYSE with notice of record and meeting dates at least ten days prior to the record date for the meeting and describe the matters to be voted on at the meeting. The concept release discusses whether such information should be required to be publicly disseminated by the issuer (though securities filings, the posting of such information on a corporate web site or other public means).

The current system also creates situations where mutual fund investors may not know how many shares of a particular issuer owned by the fund are unable to be voted due to securities lending arrangements. Currently SEC Form N-PX requires disclosure as to how the fund's shares were voted, but does not require disclosure as to how many of the fund's shares were voted. The concept release requests comment on whether Form N-PX should be amended to require such a disclosure.

Proxy Distribution Fees: Issuers are required under Rule 14b-2 of the Exchange Act to reimburse securities intermediaries for the "reasonable expenses, both direct and indirect" that such entities incur in connection with the distribution of proxy materials to beneficial owners. Reimbursement rates are set by the stock exchanges pursuant to Section 19(b) of the Exchange Act, and the current rates are based on the number of beneficial owners of the issuer. The concept release discusses reasons why the current fee structure may be in excess of "reasonable expenses", including situations where multiple beneficial owners may only receive one set of proxy materials. In particular, the release examines the fees paid under the Notice and Access model of proxy distribution adopted by the SEC, because the reimbursable fees under this model are not capped by stock exchange rule.

The concept release requests comments as to whether the current proxy distribution fee structure needs to be revised, including determining what might constitute "reasonable

reimbursement” for the Notice and Access model, and whether, in lieu of the current fee structure, a market-based fee structure would increase or decrease costs for issuers.

Issuer Communications with Stockholders: In the current proxy voting system, issuers have difficulty identifying and communicating directly with the beneficial owners of their securities. In light of recent developments in corporate governance, including the recent amendments to NYSE rules to prohibit broker discretionary voting on uncontested director elections and the voluntary adoption of majority voting standards, the possible drop in voting by retail stockholders may cause greater need for issuers to communicate directly with their stockholders.

Under current rules, securities intermediaries are required to provide issuers, upon request, with the names and addresses of beneficial owners who do not object to having the information provided to the issuers, which beneficial owners are referred to as "NOBOs," while those who do not want the information shared with issuers are referred to as objecting beneficial owners are referred to as "OBOs." The concept release notes that greater than a majority of shares of public issuers are held by "OBOs." The concept release requests comments on whether an elimination of the OBO concept (through the execution by securities intermediaries of omnibus proxies in favor of beneficial holders) would aid issuer communication with stockholders, reduce expenses involved in such communications and allow issuers to deliver more tailored proxy materials to stockholders. An alternative approach discussed in the concept release would allow issuers to obtain a list of all beneficial holders, but only as of the record date of a particular stockholder meeting.

Facilitating Retail Investor Participation: Retail investor participation in the proxy voting process has been historically low, and the SEC views such lack of participation as a significant concern. The concept release discusses multiple possible ways to improve retail participation, including improvements in investor education, enhanced information availability on issuer and broker web sites and encouraging shareholder communications with other shareholders (including modifications to Rule 14a-2(b)(6), which provides an exemption for electronic shareholder forums).

In addition, the concept release discusses permitting advance voting instructions, or client-directed voting. An advance voting instruction structure involves brokers or other parties soliciting voting instructions from retail investors on particular topics at the time they enter into their brokerage agreement or periodically thereafter. The retail investor would give broad instructions to the securities intermediary, such as voting with or against board recommendation, and the instructions would be limited to the topics covered thereby, presumably the more typical items voted on at shareholder meetings. The instructions would be applied unless the retail investor changes those instructions. The concept release notes that advance voting instructions raise a variety of questions and concerns, such as requiring investors to make voting decisions in advance of receiving proxy materials.

The concept release also solicits views on whether investor interest in matters to be voted on is affected or influenced by the extent to which shareholders are able to communicate their opinions on the matters to be voted on with other shareholders. The release solicits comment on whether current rules designed to enhance shareholder communications, such as rules

promoting the use of electronic shareholder forums, have been effective and whether further steps to promote communication would increase retail shareholder participation in votes.

Finally, the concept release considers modifications to the current regulations regarding the Notice and Access method of proxy material delivery, which has been blamed for the drop in retail participation. For example, one suggestion was to permit issuers to include a proxy card with the required notice of internet availability of proxy materials. However, the SEC expressed concern that separation of a proxy card from the proxy statement may lead to the uninformed voting that the proxy rules are designed to prevent.

Data Tagging Proxy-Related Materials: Currently, proxy statement and voting information is not required nor permitted to be provided to the SEC in an interactive data format. The concept release requests comments as to whether requiring data tagging of proxy statement and voting information, including executive compensation disclosure, would be beneficial to investors and as to the costs to issuers of providing such information in a tagged format.

Proxy Advisory Firms: The concept release describes the increasing use of proxy advisory firms by institutional investors and discusses potential conflicts of interest that may exist when proxy advisory firms advise issuers with regard to corporate governance practices and stockholder proposals while at the same time advising institutional holders with regard to voting on such proposals. There is a discussion of disclosure of conflicts of interest. In particular, at least one proxy advisory firm provides a generic disclosure that such conflicts may exist and the SEC questions whether such disclosure is adequate.

Some commentators expressed concerns that voting recommendations from proxy advisory firms may be made based on materially inaccurate or incomplete data or analysis, or that proxy advisory firms may base their recommendations on a "one size fits all" governance approach. In addition, some issuers have expressed a desire to be able to review proxy advisory firms' reports before they are distributed in order to ensure the reports are accurate. While the concept release notes that voting advice by proxy firms is generally subject to the anti-fraud provisions of the proxy rules contained in Rule 14a-9, which rules should act to deter rendering voting advice that is misleading, the release discusses whether additional safeguards are appropriate.

The concept release requests comments on a number of possible ways of addressing conflicts of interests of proxy advisors, including enhanced disclosure requirements, requiring these firms to register as investment advisors, providing additional guidance on the fiduciary duties of proxy advisers and other additional regulations, similar to those recently adopted with respect to nationally recognized statistical rating organizations.

With regard to improving the accuracy and transparency of voting recommendations, the concept release proposes for comment additional disclosures by proxy advisory firms regarding the extent of research involved in a particular recommendation and the extent and/or effectiveness of controls and procedures in ensuring the accuracy of issuer data or requiring proxy advisory firms to file their voting recommendations with the SEC as soliciting material to facilitate independent evaluation by market participants of the quality of those recommendations.

Dual Record Dates: The concept release notes recent state law changes that permit issuers to use two record dates with regard to stockholder meetings, one date to determine which stockholders are entitled to receive notice of the meeting and a second to determine which stockholders are entitled to vote at the meeting, and requests comment on whether the use of dual record dates could reduce the likelihood that persons who no longer had an economic interest in the issuer could nevertheless vote. The concept release discusses various models that could be employed using dual record dates, but also notes that there are currently certain legal and logistical matters that prevent issuers from setting such a voting record date and that each proposal involves balancing the desire to encourage voting by persons with an economic interest in the issuer with concerns regarding giving investors adequate time to review proxy materials and issuer disclosure obligations.

Empty Voting: Empty voting occurs in circumstances in which a stockholder's voting rights substantially exceed the stockholder's economic interest in the issuer, such as when the issuer has hedging-based strategies to obtain a negative economic interest in the issuer or when a person who was a stockholder as of the record date sells its shares prior to the meeting date. In both instances, the person would retain the right to vote such shares even though it no longer has an economic interest in such shares. The concept release considers for comment changes to Section 13 of the Exchange Act, or the adoption of a new disclosure system, to elicit further disclosure of empty voting. The concept release also includes proposals on a number of topics including requiring issuer disclosure of the stockholder meeting agenda sufficiently in advance of the record date for the meeting to enable securities lenders to recall loaned securities and regain voting control over such securities, prohibiting empty voting, requiring voters to certify they hold the full economic interest in shares being voted and requiring stockholders to be in a net-long position in order to vote.

The deadline for the submission of comments is October 20, 2010.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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