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SEC's OBO/NOBO System Said Overdue For Change; Apache Proposal Suit Advances

By Yin Wilczek

The framework created by the Securities and Exchange Commission in which public companies primarily communicate with shareholders through broker or banker intermediaries—the so-called "OBO/NOBO" system—is long overdue for change, a white paper commissioned by the Council of Institutional Investors said.
Under the system put in place by the SEC in the mid-1980s, most publicly traded shares are not registered in companies' records in the names of the beneficial owners but rather are held in street name. When they open their accounts, investors who hold shares in street name are classified into one of two categories, either Non-Objecting Beneficial Owners (NOBOs)—who do not object to having their names and addresses supplied to companies—or Objecting Beneficial Owners (OBOs)—who can be contacted directly only by the broker or bank.

The council's February white paper, now available on the organization's website, is an independent study of the OBO/NOBO system performed by Cleary Gottlieb Steen & Hamilton LLP. According to the paper, the system is impeding companies' direct communications with their shareholders. To reach shareholders, companies must either forward solicitation materials through intermediaries for OBOs, or rely on lists provided by intermediaries, in the case of NOBOs. In both situations, companies incur costs for the intermediaries' services. The OBO/NOBO system also is proving an obstacle to communications between shareholders, the paper said.

Governance Changes

The system is particularly outdated in light of recent corporate governance developments that have increased the need for a reliable communications framework for companies and shareholders, the paper said. The changes include:
• amended New York Stock Exchange Rule 452, which since Jan. 1 has barred brokers from voting uninstructed client shares in uncontested director elections;
• the adoption by large companies of majority voting in uncontested director elections;
• recent amendments of the Delaware General Corporation Law and the Model Business Corporation Act to allow bylaw changes to effect proxy access or to reimburse shareholders for proxy costs; and
• the SEC's proposals to allow shareholders access to the company's proxy statement.

However, although change is necessary, the paper advocated taking incremental steps to decrease reliance on or to eliminate altogether the distinction between OBO/NOBO shareholders. If the SEC were to attempt change of the system, it would face strong opposition from entrenched interests, the paper said. "The compelling and competing interests we describe above are likely to make the SEC cautious in seeking to change the communications framework in significant ways, at least in the near term," it said. "That said, some change is all but inevitable given the emerging consensus that the limitations of the current framework are increasingly unworkable in an era of rising investor activism and more meaningful shareholder voting."

SEC Members

SEC Chairman Mary Schapiro and Commissioner Elisse Walter have questioned the efficacy of the OBO/NOBO system . SEC staff currently is performing an in-depth review of the mechanics

through which proxies are voted and the way information is conveyed to shareholders. After the review, the SEC will publish a concept release—slated for the first half of the year—that, among other questions, will ask about the need to allow beneficial owners of a security to object to having their names disclosed to the issuer.

CII deputy director Amy Borrus told BNA Feb. 18 that the white paper serves as a “starting point” for the council's discussion about key issues to be highlighted in the SEC's coming concept release. “A review of the convoluted ‘proxy plumbing’ is long overdue,” she said.

However, Borrus warned, any overhaul must be crafted carefully. “Companies' desire to communicate directly with their shareowners is understandable,” she said. “But any changes must not come at the expense of investors. Shareowner-to-shareowner communications are a critical part of proxy contests, soliciting support for shareowner proposals, and vote-no campaigns.”

Borrus said that CII has no policies on the OBO/NOBO system, and the white paper does not necessarily represent the views of its members.

Apache Lawsuit

Meanwhile, a recent lawsuit is highlighting deficiencies of the OBO/NOBO system. Apache Corp. (APA) has asked the U.S. District Court for the Northern District of Texas to allow it to exclude from its proxy materials a proposal filed by shareholder activist John Chevedden. Attorneys previously told BNA that the lawsuit—Apache Corp. v. Chevedden—could be the first of its kind challenging a shareholder proposal on procedural grounds.

In a brief filed Feb. 15, Apache alleged that Chevedden failed to show proof of current ownership of Apache stock, and that the broker letters he submitted were not from registered or record holders of company shares. “Chevedden has not submitted any letter or other proof from the Depository Trust Company or Cede & Co., which apparently is the actual ‘record’ holder of Chevedden's purported stock,” the brief said.

Describing Chevedden in the filing as the “Goliath” of shareholder proposals, Apache noted that in 2008 alone, Chevedden submitted more than 125 shareholder proposals to more than 85 companies. In addition, Chevedden has been the subject of 953 SEC staff no-action letters, the company noted. In comparison, the next most frequently mentioned shareholder proponent—the AFL-CIO Reserve Funds—received only 207 mentions, it said.

“Chevedden has withdrawn a multitude of other proposals to other companies when he or the purported shareholder naming him as proxy has been faced with a company's request for proof of shareholder status and eligibility under Rule 14a-8(b) [under the 1934 Securities Exchange Act],” the brief said. “There is no record of Chevedden ever explaining his conduct, and no record of Chevedden ever apologizing to any company (or to SEC staff) for causing them to devote time, attention and substantial amounts of money to dealing with his often improper submission of proposals.”

Complicated

However, other observers told BNA that the issue of proving share ownership is not as simple as it seems.

While getting a demand letter from Cede to inspect the books in order to obtain a list of shareowners of record may be common practice in a bona fide proxy contest, it is not common practice when shareholders file resolutions, said James McRitchie a commentator on corporate governance issues and publisher of CorpGov.net. “Nor should it be,” he said. “How many banks or brokers have been caught lying, by writing a letter evidencing ownership by a customer who is

not a beneficial owner? Even if a rare instance of such behavior can be found, the same could occur if there were a requirement to get broker letters from Cede & Co.”

McRitchie added that Cede does not have a list of beneficial owners, and would have to depend on the word of the bank or broker, just as 99.99 percent of companies do in accepting a broker letter. “Let's not put up more procedural barriers to the exercise of our rights,” he said.

Meanwhile, Glyn Holton, the executive director of U.S. Proxy Exchange, told BNA Feb. 18 that it would not have been feasible to have Cede issue a letter showing Chevedden's proof of ownership. U.S. Proxy Exchange Feb. 16 asked the court for permission to file an amicus curiae brief in the case. “This is a complicated issue, which we will explore fully in our amicus brief,” he said.

U.S. Proxy Exchange and McRitchie are collaborating on a petition to the SEC to eliminate street name registration and to implement a certificateless direct registration system. McRitchie said the petition should be ready by the end of February.