LET'S MODERNIZE THE PROXY SYSTEM

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Every proxy service provider is well aware that the shareholder voting and communications system in the United States is an overly complicated and antiquated system that has not kept pace with market innovations or the effective use of technology.

The Shareholder Communications Coalition was formed several years ago to advocate for a more modernized proxy system, and one which is simpler, more efficient, and less expensive for all parties. These advocacy efforts began with a Petition for Rulemaking that was filed with the Securities and Exchange Commission (SEC) in 2004, requesting that the SEC undertake an evaluation of its shareholder communications rules. This Petition also recommended that the SEC consider three regulatory changes:

- eliminate the NOBO/OBO distinction;
- require brokers, banks, and their agents to execute omnibus proxies on behalf of beneficial owners; and
- remove the requirement to mail proxy materials to beneficial owners through brokers and banks.

Since this 2004 Petition was filed, additional problems have been identified in the proxy system. These problems illustrate the integrated nature of many proxy issues, as well as the need to avoid addressing problems and issues in a piecemeal fashion.

One proxy voting problem that has been identified is called **empty voting**. Empty voting occurs when there is a decoupling of the economic and voting interests in corporate shares. This generally can occur through share lending. As an example, consider an investor who can secure a voting interest by borrowing shares shortly before a record date and then returning the same shares shortly after the record date. This practice — called record date recapture — entitles the investor to vote the shares at the shareholder meeting, even though he or she has no economic interest in the company.

Another problem that has emerged in the past several years involves efforts by certain institutional investors to **hide their ownership** of a company's shares through the use of a financial derivative called a cash-settled equity swap. This problem arose last year in a proxy battle between the CSX Corporation and a group of hedge funds.

A third proxy voting problem involves **over-voting**, where a broker casts more votes than it is entitled to cast. Since brokers hold all their shares in fungible bulk, they do not typically match loaned shares to specific customer accounts. The inability to match long and short positions means that brokers are often unable to accurately calculate the number of equity shares their customers are entitled to vote when a corporate record date is established. When shares are lent out by brokers, both long and short investors of the same security may receive an instruction form for proxy voting.

A structural problem in the system is the fact that **proxy administrative services** are largely controlled by one company, Broadridge Financial Solutions. Under current SEC rules, issuers pay for the proxy administrative services provided by Broadridge and its broker-dealer clients. Unfortunately, issuers have no choice in selecting a service provider, exert little or no control over the services that are actually provided, and have no direct ability to negotiate the fee structure. As a result, there is little accountability or economic incentive to change the system.

Another unaddressed problem is the role of **proxy advisory firms**. These firms are a dominant force in corporate elections, yet are not subject to any required disclosures or oversight regarding their ability to control or influence the outcome of a vote.

In 2005, the New York Stock Exchange (NYSE) established a Proxy Working Group, to evaluate many of these proxy voting and shareholder communications issues. The Working Group has released several reports and studies over the past several years and is currently advocating the elimination of broker discretionary voting in the election of directors. This proposed change to NYSE Rule 452 is currently under active consideration by the SEC.

The Proxy Working Group has recommended an evaluation of the entire proxy voting and shareholder communications system. The Working Group also has recommended that a study be conducted to change the current proxy system into a free market model, with multiple service providers and fees established by market forces and not by regulators. Additionally, the Working Group has recommended that the SEC examine the role of proxy advisory firms, to improve transparency and oversight.

Despite these recommendations for a thorough and all-inclusive review of the proxy system, the SEC is moving forward on proxy issues in a piecemeal fashion. It has promulgated new notice and access rules. It is

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considering the Proxy Working Group's amendment to NYSE Rule 452, without improving investor education or permitting issuers to engage in direct communications with their beneficial owners. And it is also considering new proposals for director nominations by large shareholders.

The proxy system is very complex and interrelated. Proxy issues need to be resolved in an integrated manner, so that any reform measures do not cause additional problems or unintended consequences. This can only occur if these issues are evaluated and resolved through a process that considers the impact of each proposed change on the entire system.

A comprehensive review of the proxy system should at least include the following measures:

- issuers should be able to know who their shareholders are and be permitted to engage in direct communications with them;
- the ability of issuers to select a service provider of their own choosing should be permitted for proxy administrative services;
- new regulatory measures should be adopted to address empty voting and the use of financial derivatives to manipulate the shareholder voting process;
- new rules should be established to ensure an accurate vote count in a shareholder election, by requiring pre-mailing reconciliation of beneficial owners and end-to-end vote confirmation; and
- proxy advisory firms should be subject to appropriate disclosures and oversight in a new regulatory regime.

Tackling all of these issues will be an enormous task for proxy stakeholders and federal regulators. But corporate elections should not be held to a lesser standard than political elections in the United States. All interested parties should commit themselves to a proxy system that encourages best practices, open communications, and the latest advances in technology.

[1] The Shareholder Communications Coalition currently comprises the following organizations: the Business Roundtable, the National Association of Corporate Directors, the National Investor Relations Institute, the Securities Transfer Association, and the Society of Corporate Secretaries & Governance Professionals. More information about the Coalition can be obtained on its website at www.shareholdercoalition.com. ■

2011 IS JUST AROUND THE CORNER! *What You Need To Know About The New Cost Basis Rules!*

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Covered Versus Uncovered Transactions

Share lots acquired prior to January, 2011 are not covered under the cost basis legislation but what about transfers of those shares after that date? What if the transfer request is received directly from the shareholder? Will the IRS require that all shares acquired after the effective date carry cost basis? We think not. In fact, the IRS has indicated that certain transactions will be exempt and that the legislation does not contemplate that shareholders would be required to provide this information. But what about shares issued as a result of a stock option exercise? Or shares acquired under a qualified employee stock purchase plan? Because the cost basis of these transactions is dependent on a number of different factors which can be determined only at the time of sale, the STA has recommended to the IRS that these share lots be treated as uncovered and, as such, not reportable.

Processing Challenges

As if overcoming the challenges of exchanging cost basis info with brokers and of average cost and wash sales are not enough, there are plenty of thorny processing requirements that Transfer Agents will have to deal with as well. This is just a small sampling of the issues identified to date:

- Track and calculate cost basis using multiple methodologies: specific share lots, high cost shares, low cost shares, last in/first out and first in/first out (default method), in addition to average cost if the IRS requires it.
- Record the original transaction date (versus posting date) in order to track and report short term versus long term gains and losses.
- Carry forward the original cost on share lots where only partial lots are being transferred or when a lost certificate is being replaced.
- Adjust share positions and/or cost basis of original purchase lots for stock dividends and splits while retaining the ability to produce accurate Record Date positions.

As you can imagine, supporting these processing requirements also means expanding shareholder record layouts to include additional fields such as cost basis, cost basis methodology, acquisition date, indicator if transaction is covered or uncovered, and reason code (if uncovered).

It should come as no surprise that the impact of this initiative is widespread and will involve a considerable amount of effort to implement and to coordinate with other affected parties. Transfer Agents will essentially have to modify their shareholder recordkeeping systems to resemble investment accounting systems in less than 2 years – no easy feat! Stay tuned for more developments. To see the issues list and IRS comment letter, or for more info on this subject, go to the cost basis page of the STA website. ■