The Mechanics of Shareholder Communications:
The SEC’s Concept Release – An Opportunity for Funds

Mutual Fund Directors Forum
February 16, 2011

Edward L. Pittman
Edward.Pittman@Dechert.Com
Proxy Issues are Significant

- Affects Relationship Between Issuers and their Shareholders
- Magnitude of Industry
  - 13,000 Corporate Actions Annually Require Votes*
  - 340 Million Shareholder Packets Mailed in 2009*
- Important to Mutual Funds
  - Ability to Effect Changes
  - Expenses Borne by Fund Shareholders

*Source: Broadridge
Overview

• Background
• Key Terms and Concepts
• How the System Works
• Role of Participants
• Issues Under Consideration
Origin of Current System

- Paperwork Settlement Crisis – 60s and 70s
- Introduction of a Central Depository - DTC
- Recommendations of the SEC Ad Hoc Advisory Committee
- Reforms Adopted by SEC in 1983
  - NOBO – OBO System
  - Defined Time Periods for Proxy Participants
  - Issuers Must Pay “Reasonable Expenses” of Brokers
Overview

• Laws Affecting Proxy Voting

• Forms of Share Ownership
  – Registered Owner ("Legal Owners")
  – Beneficial Owners ("Street Name", "Nominee Name")
    • Objecting Beneficial Owners ("OBOs")
    • Non-Objecting Beneficial Owners ("NOBOs")

• Rationale for Distinction
  – Privacy
  – Competitive Concerns about Customer Accounts
  – Maintain Control of Customer Relationship

• For Retail Investors, Status Often Determined by Default at Account Opening
Overview of Legal Share Ownership (Corporate)

- Public Company
  - Transfer Agent
    - Shareholder
    - Shareholder
    - Shareholder
    - DTC
      - Broker
        - OBO
        - NOBO
      - Bank
        - OBO
        - NOBO
Overview of Legal Share Ownership (Mutual Funds)

Mutual Fund

Transfer Agent

Shareholder

Bank

Shareholder

Broker

Shareholder

Broker

OBO

NOBO

OBO

NOBO

OBO

NOBO
OBOs/NOBOs (corporate)

- Shares Owned by Registered Owners: 10-20%
- Shares Held in Street Name: 80-90% (NOBOs and OBOs)
  - 75% of Beneficial Owners are OBOs (Retail and Institutional)
- Retail v. Institutional
  - Retail Investors (73% NOBOs)
  - Institutional Investors (75% OBOs)
- Broker Account Defaults – No Regulatory Standard
NOBO/OBOs (Corporate - based on number of shareholders)

- 73% Registered Shareholders
- 15% Beneficial Owners
- 27% OBOs
- NOBOs
Overview of the Proxy Communication Process

• Key Players
  – Issuers
  – Shareholders
  – Transfer Agents
  – Brokers and Banks
  – Depository Trust Company (“DTC”)
  – Broadridge
  – Proxy Advisors
  – Vote Tabulator

• Additional Terms
  – Search Card
  – Voting Instruction Form (“VIF”)
  – Omnibus Proxy
Proxy Process Step 1 — (Proxy Materials - Corporate)

1 – Request to DTC for list of Nominees

2 – DTC “promptly” responds to Issuer

3 – Search card sent to Nominees requesting number of Shareholders

4 – Broker/Bank delegates response obligation

5 – Broadridge responds to Issuer

Issuer

Depository Trust Company

Broker/Bank

NOBO

OBO

Broadridge
Proxy Process Step 1 – (Proxy Materials – Mutual Funds)

1 – Request to Broadridge for list of Nominees

2 – Broadridge “promptly” responds to Fund

3 – Search card sent requesting number of Shareholders

4 – Broker/Bank delegates response obligation to Broadridge

5 – Broadridge responds to Fund

1. Request to Broadridge for list of Nominees
2. Broadridge “promptly” responds to Fund
3. Search card sent requesting number of Shareholders
4. Broker/Bank delegates response obligation to Broadridge
5. Broadridge responds to Fund

Issuer

Broker/Bank

Broadridge

NOBO

OBO
Proxy Process Step 2 – (Voting – Corporate)

- **Issuer**: Issuer prints and delivers proxy materials & proxy cards.
- **Depository Trust Company**: Omnibus proxy assigned to Nominees.
- **Brokers and Banks**: Power of attorney and data feed of beneficial owners.
- **Registered Shareholder**: Executed proxies.
- **Retail Beneficial Owners**: Forwards proxy materials & voting instruction form (VIF).
- **Institutional Beneficial Owners**: Executed VIFs.
- **Vote Tabulator**: Forward proxy materials & VIF.
- **Proxy Advisory Firms**: Executed VIFs.
- **Broadridge**: Issuer prints and delivers proxy materials.
- **Broadridge (sometimes, transfer agent)**: Executed proxies on behalf of securities intermediary according to VIF.

*Broadridge is sometimes used as a transfer agent.*
Proxy Process Step 2 – (Voting – Mutual Funds)

Issuer

Delivery of proxy materials & proxy cards

Broadridge
(sometimes, transfer agent)

Brokers and Banks

Power of attorney and data feed of beneficial owners

Retail Beneficial Owners

Registered Shareholder

Forward proxy materials & voting instruction form (VIF)

Executed proxies

Vote Tabulator
(sometimes, transfer agent)

Executed proxies on behalf of securities intermediary according to VIF

Executed VIFs

Delivery of proxy materials
Institutional Investors

• Fiduciary Obligations

• Fund Disclosure of Voting Policies and Record

• The Role of Proxy Advisory Firms
  – Highly Concentrated (ISS/Risk Matrix/MSCI)
  – Many Services
  – Gatekeeper Functions
  – Conflicts of Interest
Role of Brokers

• The NYSE Plays an Important Role in Proxy Mechanics
  – NYSE Regulates Member Brokers
  – Rule 452 – Broker-Discretionary Voting
    • Non-Controversial Proposals
      – Uncontested Director Elections
    • Brokers May Vote Uninstructed Shares on Routine Proposals
      – Auditor Ratification
      – Broker non-votes for quorum purposes

• Methods of Voting – Echo or Mirror Voting
Role of a Single Service Provider

• Issuers Not Allowed to Mail Directly

• Central Intermediary Concept Proposed
  – Standardized Data Delivery Format
  – Economies of Scale
  – Confidentiality of Customer Names

• Independent Election Corporation of America Chosen by NYSE in 1987

• Automated Data Processing (“ADP”) Entered Market in Late 1980s

• Monopoly Created - 99% Market Share by 1997

• Broadridge – Public Company – a Spin-Off From ADP
Proxy Plumbing Step 1 – (Proxy Materials – Mutual Funds)

1 – Request to Broadridge for list of Nominees

2 – Broadridge “promptly” responds to Fund

3 – Search card sent requesting number of Shareholders

4 – Broker/Bank delegates response obligation to Broadridge

5 – Broadridge responds to Fund

Broaderidge

Issuer

Broker/Bank

NOBO

OBO
NYSE as a Reluctant Rate Setter

• Rules 451 and 465 Define “Reasonable Expenses”

• NYSE Proxy Working Group

• Examples of Regulated Fees NYSE Rules
  – $.40 Base Mailing Fee - Per Account
  – $.25 - $.50 Incentive Fee for Suppression - Per Account/Per Issuer/Per Year
  – $.06.5 – NOBO Lists - Per Account
  – $.40 Follow-Up/Reminder - Per Account
  – $.05 - $ 25 - Notice Only Fees – Per Account
  – Out of Pockets – Postage, Envelopes etc.

• Unregulated Fees
Problems with Current System

- Outdated – Designed 40 Years Ago
- Inefficient – Too Costly
- Impedes Issuer Communication with Shareholders
- Leading Proponents of Change
  - Business Roundtable (2004 Proposal)
  - Council of Institutional Investors
  - Shareholder Communications Coalition (Five Major Industry Groups)
Issues Raised in the SEC Concept Release

• Integrity of Voting Process
• Role of Proxy Advisory Firms
• Communications with Shareholders
• Expenses
Improving Shareholder Communication

- Enhance Shareholder Education
- Eliminate the NOBO/OBO Distinction
  - Fees
  - Nominee Accounts
  - NYSE Proxy Working Group Study (Retail Status)
- Address Retail Account Opening Default Status
- Permit Advance Voting Instruction (“Client-Directed Voting”)
Reducing Communication Expenses

• Eliminate NYSE Rate Setting Function

• Absence of Competition
  – Funds/Issuers Cannot Communicate Directly with NOBOs
  – Brokers Do Not Pay Fees - Agnostic
  – Brokers Do Not View as a Revenue Center
  – Brokers Delegate Obligations to Broadridge
  – Funds/Issuers Must Pay Fees - But Do Not Select Service Provider

• Evidence of Cost Savings From Potential Competitors

• Proposal for Central Data Aggregator
Issues for Fund Industry

• Large Retail Investor Base – Not Like Corporate Equities

• Difficulty Obtaining Quorums and Necessary Votes

• More Frequent Communications
  – Annual and Semi-Annual Reports
  – Current Prospectus
Final Thoughts

• Proxy System Has Not Been Revisited for 40 Years
• Many Embedded Interests and Conflicts
• The Mutual Fund Industry is a Big Stakeholder
• This is an Opportunity to Consider Improvements
• Directors Should Inquire About How Changes Would Affect Their Funds
The Mechanics of Shareholder Communications: The SEC’s Concept Release – An Opportunity for Funds

Mutual Fund Directors Forum

Edward L. Pittman
Edward.Pittman@Dechert.Com