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DEVELOPMENTS OF NOTE

SEC Proposes to Amend Rules Relating to Fees Paid for Marketing and Distribution of Mutual Fund Shares

The SEC recently proposed to eliminate Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act"), the rule that currently allows a registered open-end investment company (a "mutual fund" or "fund") to pay certain marketing and distribution expenses from the fund's assets. In its place, the SEC has proposed new Rule 12b-2 and amendments to Rule 6c-10, which would limit the amount of asset-based sales charges an investor would pay to acquire shares of a fund. In addition, various amendments to rules under the 1940 Act and other federal securities laws, if adopted as proposed, would require a mutual fund to provide better disclosure of distribution fees, allow a fund to sell its shares through broker-dealers that establish their own sales charges, and eliminate the need for mutual fund directors to approve and annually reapprove fund distribution financing plans.

SUMMARY OF PROPOSED RULE CHANGES

- **Rescission of Rule 12b-1.** The proposed rule changes would rescind Rule 12b-1. Rule 12b-1 generally permits a mutual fund to use fund assets to pay broker-dealers and others for providing services that are primarily intended to result in the sale of fund shares. Without the rule, Section 12(b) of the 1940 Act would prohibit a mutual fund from acting as a distributor of its own shares, and the fund would have to rely on sales loads and the assets of its investment adviser and principal underwriter to compensate brokers for their selling activities. Among other things, Rule 12b-1 requires that before a fund may pay for distribution expenses using fund assets, the fund must adopt a written plan describing all material aspects of financing of distribution, the plan must be approved initially and reapproved annually by the board as a whole and separately by the independent directors, and in some cases by the fund's shareholders, and the fund

must meet certain fund governance standards. In order to approve or reapprove a 12b-1 plan, the fund's directors generally are required to find that the plan is reasonably likely to benefit the fund and its shareholders.

Rule 12b-1 does not limit the amount of fees that may be permitted by a 12b-1 plan, and it does not prohibit a fund from paying non-distribution related expenses under the plan. NASD Rule 2830 ("Rule 2830"), however, prohibits a FINRA member broker-dealer from selling shares of a fund that pays more than 0.75% of fund assets as "asset-based sales charges," or more than 0.25% of fund assets as "service fees." Rule 2830 also imposes an aggregate cap of 6.25% of a fund's gross sales if the fund has an asset-based sales charge and charges a service fee, and imposes an aggregate cap of 7.25% of a fund's gross sales if the fund does not charge a service fee. The proposing release notes that the caps are intended to limit how much fund underwriters may receive not how much an individual shareholder may pay to acquire fund shares.

- **New Rule 12b-2.** New Rule 12b-2 would continue to permit funds to use fund assets to pay for distribution related activities, but subject to different limitations. Unlike Rule 12b-1, proposed Rule 12b-2 would permit a fund, with respect to any class of shares, to deduct a "marketing and service fee" of up to the Rule 2830 "service fee" annual limit of 0.25%. This marketing and service fee could pay for any distribution-related expense or servicing cost, without limitation on the amount of a sales load the fund could impose. Proposed Rule 12b-2 would not require a written plan, board approval or re-approval, compliance with any fund governance standard, or any special board finding. Shareholder approval, however, would be required to institute or increase any marketing and service fee on any existing class of shares.

In the case of funds that invest in other funds (such as a fund-of-funds and a feeder fund in a master-feeder structure), proposed Rule 12b-2 would prohibit the total marketing and service fees charged by the acquiring and acquired funds, when added together, from exceeding the Rule 2830 service fee limit. Funds underlying insurance company separate accounts would be treated for these purposes as any other acquired fund.

- **Amendments to Rule 6c-10.** Rule 6c-10 under the 1940 Act generally permits a mutual fund to charge a deferred sales load on any class of fund shares. The SEC is proposing to amend Rule 6c-10 to permit a fund to charge a fund-level sales charge, that is, to permit it to deduct from fund assets amounts in excess of the Rule 12b-2 marketing and service fees, and treat the excess amount, which the proposed amended rule refers to as the "ongoing sales charge," as another form of sales load. Under the proposed amendments to Rule 6c-10, the treatment of deferred sales loads generally would remain the same.

The proposed amended rule would limit the amount of all sales charges that an investor would pay in any form, that is, the sum of all front-end, deferred and asset-based sales charges paid by the investor, to the highest sales load rate that the shareholder would have paid if the shareholder had purchased a class offered by the fund that does not have an ongoing sales charge, or, if the fund does not offer such a class, the maximum sales charge rate permitted under Rule 2830 for a fund that deducts an asset-based sales charge and a service fee (currently, 6.25%). At the time the amount of all sales charges paid by an investor reached the limit, all sales charges would have to cease or the investor's shares would have to convert to class that does not apply a sales charge.

For funds that invest in other funds, the acquiring fund and the acquired fund could not both charge an ongoing sales charge of any amount. Funds underlying insurance company separate accounts would be treated for these purposes like any other acquired fund.

The proposed amendments to Rule 6c-10 also would permit a fund to offer a share class as to which, in lieu of any asset-based sales charge established by the fund's underwriter, fund intermediaries could impose charges for sales of fund shares at negotiated rates. In order to offer such a share class, the fund would have to disclose in its prospectus that it has elected to rely on the applicable section of Rule 6c-10 (as proposed to be amended). Once a fund has offered any shares of such a class, the fund could not include or raise any ongoing sales charge with respect to that class, even with shareholder approval.

As with proposed Rule 12b-2, the proposed amendments to Rule 6c-10 would not require a written plan, board or shareholder approval or re-approval, compliance with any fund governance standard, or any special board finding. The proposing releases notes that a fund's board would continue to have a fiduciary duty as provided under Section 36(a) of the 1940 Act and state law with respect to its oversight of the use of fund assets.

- **Amendments to Rule 10b-10.** Rule 10b-10 under the Securities Exchange Act of 1934 (the "1934 Act") generally requires broker-dealers to disclose on customer trade confirmations certain information about the transaction being confirmed, including the price of the security at which the transaction was effected and the commissions and other remuneration paid by customers to broker-dealers and certain third parties. The SEC currently permits broker-dealers to omit from confirmations of mutual fund transactions information relating to sales charges and payments to third parties, provided that the customer receives a fund prospectus that adequately discloses that information. The SEC is proposing amendments to Rule 10b-10 to require disclosure in customer trade confirmations of, among other things, all front-end and deferred sales charges, ongoing sales charges and marketing and service fees, in percentage and dollar terms, the net amount invested in the fund at the time of purchase, and the amount of any applicable breakpoint or similar threshold used to calculate the sale charge. Confirmations of share redemptions would be required to disclose the amount of any deferred sales charge that the customer has incurred or may be expected to incur, expressed in dollars and as a percentage of the fund's net asset value at the time of purchase or redemption, as applicable.
- **Certain Other Conforming Amendments.** Other amendments to existing SEC rules and forms include:
 - (1) Form N-1A, the registration form for mutual funds under the Securities Act of 1933 and the 1940 Act.
 - Item 3 - the prospectus fee table, which currently requires identification of 12b-1 fees, would require identification of any ongoing sales charges and marketing and service fees, both of which would be reflected as expenses that shareholders would pay indirectly;

- Item 19(g)(1) - the current requirement to describe a fund's 12b-1 plan in its Statement of Additional Information ("SAI") would be replaced with a requirement to disclose the principal activities paid for through ongoing sales charges and marketing and service fees;
 - Item 25 - the current requirement to provide information in a fund's SAI concerning the distribution of fund shares would be amended to accommodate the required disclosure for a fund that offers a share class as to which fund intermediaries may impose charges for sales of fund shares at negotiated rates.
- (2) Schedule 14A under the 1934 Act - funds soliciting proxies using Schedule 14A would, among other things, no longer be required to disclose information concerning 12b-1 plans but would be required to disclose information concerning marketing and service fees.
- (3) Rule 11a-3 under the 1940 Act - Rule 11a-3 which permits a sales load to be charged on shares acquired in certain exchanges between funds in the same fund group under certain conditions, would be amended to, among other things, treat ongoing sales charges as a sales load.
- **Expected Transitioning.** Under the SEC's proposal, if adopted, the proposed rule changes would become effective within 60 days of the date that the adopting release is issued, and funds would be expected to comply with the amendments for new shares sold beginning no later than 18 months after the effective date. The SEC also has proposed a five-year grandfathering period for share classes deducting fees pursuant to Rule 12b-1 that issued shares prior to the compliance date. Under the grandfathering provision, by the date five years after the compliance date, a grandfathered share class would have to have converted or exchanged into a class that does not deduct an ongoing sales charge. New sales of a grandfathered share class would not be permitted after the compliance date.

ISSUES ON WHICH THE SEC IS SEEKING PUBLIC COMMENT

The SEC has requested comments on the following issues, among others:

- The appropriate level and uses of marketing and service fees under proposed Rule 12b-2;
- The operational implications of the proposed automatic conversion of shares once the shareholder has paid the maximum amount of sales charges under proposed amended Rule 6c-10;
- Whether there should be a maximum limit on the amount of ongoing sales charges that may be deducted, or should fund boards be assigned the responsibility of establishing that maximum limit and if so, what should be the standards or factors relevant to their determination;
- Whether Rule 6c-10 should permit the Rule 2830 maximum sales charge (*i.e.*, 6.25%) to serve as the default reference for funds that do not offer a class of shares without an ongoing sales charge;

- Whether dividends and other distributions should be invested in a share class without an ongoing sales charge;
- Whether the proposed approach to the role of a fund's board in overseeing asset-based distribution fees is appropriate;
- Whether the information included in mutual fund trade confirmations is useful to investors and if not, how it should be improved;
- The appropriateness of the proposed approaches regarding marketing and sales fees and ongoing sales charges in the context of funds that invest in other funds;
- Whether funds underlying insurance company separate accounts should be treated differently than other types of mutual funds;
- Advantages and disadvantages of externalizing sales charges;
- The placement and accuracy of the proposed disclosure regarding marketing and sales fees and ongoing sales charges; and
- Whether the SEC should require account statements to include disclosure of the actual dollar amount of asset-based distribution fees.

Deadline for Comments. The SEC has stated that comments on the proposed rule changes must be received no later than November 5, 2010.

SEC Issues Concept Release on the U.S. Proxy System

On July 14, 2010, the SEC unanimously approved the issuance of a concept release soliciting public comment on whether it should consider revisions to the proxy voting system to promote greater efficiency and transparency and enhanced accuracy and integrity of shareholder voting. The release focuses on the following three principal topics:

- Whether the SEC should take steps to enhance the accuracy, transparency and efficiency of the voting process;
- Whether SEC rules should be revised to improve shareholder communications and encourage greater shareholder participation; and
- Whether voting power is aligned with economic interest and whether SEC disclosure requirements provide investors with sufficient information about the issue.

After generally describing the current proxy distribution and voting process and the major participants in the process, the release explores specific issues relating to each of the three principal topic areas.

ACCURACY, TRANSPARENCY AND EFFICIENCY OF THE VOTING PROCESS

The release notes that investor and issuer interests may be undermined when perceived defects, or uncertainty about such defects, are believed to impair the accuracy, transparency and cost-efficiency of a proxy vote.

Over-Voting and Under-Voting

First, the SEC raises the concern that vote tabulators may, in some cases, receive votes from a securities intermediary that exceed the number of shares that the securities intermediary is entitled to vote. This could occur, for example, in connection with the way broker-dealers track securities lending transactions or through existing clearance and settlement systems that do not assign particular shares of a security to a particular investor. As a result, a broker-dealer may need to reconcile the actual voting instructions it receives from investors with the numbers of securities that the broker-dealer is permitted to vote with the issuer, which could lead to over-voting or under-voting by beneficial owners. Currently, neither the SEC nor any self-regulatory organization (“SRO”) mandates a reconciliation or the use of a particular reconciliation or allocation methodology, and in practice, there have been several different approaches to reconciliation.

The SEC asks for general comment on whether it would be helpful for investors to have broker-dealers publicly disclose the allocation and reconciliation method used and the likely effect of that method on whether customers’ voting instructions would actually be reflected in a broker-dealer’s proxy sent to the vote tabulator. The SEC also seeks comment on whether it would be beneficial to mandate a particular reconciliation method. In addition, the SEC notes the lack of empirical data on the frequency of over-voting and under-voting and, among other things, has asked for comment on whether it would be beneficial to have additional data regarding both, including their size and impact.

Vote Confirmation

The SEC notes that a number of market participants, including both individual and institutional investors, have raised concerns regarding their inability to confirm whether an investor’s shares have been voted in accordance with the investor’s instructions. The SEC attributes this inability, in part, to the fact that no one participant in the process (*i.e.*, issuers, transfer agents, vote tabulators, securities intermediaries, and third-party service providers) has all of the information required for confirmation, and often certain participants may be unwilling or unable to share their information with others. In addition, there is no legal or regulatory requirement to compel the sharing of any such information.

The SEC believes that both record owners and beneficial owners should be able to confirm that the votes casted have been timely received and accurately recorded. It suggests that issuers, or their transfer agents or vote tabulators, be permitted to access information needed for these confirmations through unique identifying codes, and the automation of such confirmation processes culminating with an e-mail to the beneficial owner. In this regard, the SEC has asked for comment on the confirmation process, including whether participants in the voting process should grant others access to certain records, the best way to preserve the anonymity of investors and whether issuers should confirm to registered owners, beneficial owners, or securities intermediaries that it has received and properly tabulated their votes.

Proxy Voting by Institutional Securities Lenders

The SEC cites certain issues raised by institutional securities lenders regarding whether the timing and information regarding recalled securities loaned is adequate and whether disclosure of the votes they cast might improve the transparency of the voting process.

Advanced Notice of Meeting Agenda. The SEC notes that, when institutional securities lenders loan their securities, they must generally terminate the loan and recall the loaned securities prior to the record date in order to vote those securities, which vote, in some cases, may be required by lenders' voting policies. Often, however, these lenders may not receive information about an upcoming vote until after the record date, which is when issuers typically mail their proxy statements. As a result, securities lenders may learn of votes too late to recall the loans and vote the proxies. The SEC suggests that one possible course of action is to modify rules implemented by certain exchanges that require issuers to provide the exchange with notice of the record meeting dates for shareholder meetings at least ten days prior to the record date to also contain information about the matters to be voted on and to make such advance notice public. It asks for comment on whether such a proposal should be made, whether any other rules should be proposed by the SEC and what the advantages and disadvantages of such advance notice of a meeting are. In addition, the SEC requests data regarding the recall of loaned securities by institutional securities lenders for voting purposes.

Disclosure of Voting by Funds. The SEC notes that the current Form N-PX, which requires disclosure of proxy voting information for each matter relating to a portfolio security held by management investment companies registered under the Investment Company Act of 1940 (each, a "fund"), does not require disclosure of the number of shares for which proxies were voted, nor does it require disclosure with respect to loaned securities. Thus, the fact that a fund that lends out 99% of its portfolio holdings in an issuer and only votes 1% of such shares would not be reflected on Form N-PX; the form would only disclose that the fund voted proxies with respect to the issuer. Accordingly, the SEC asks whether the form should be amended to require disclosure of the actual number of shares voted and the number of portfolio securities not voted because the securities were on loan or for other any other reasons. It also asks for a cost estimate of such disclosure.

Proxy Distribution Fees

The SEC highlights its staff's concerns about the structure and size of fees charged for the distribution of proxy materials to beneficial owners. Pursuant to the Securities Exchange Act of 1934, broker-dealers and banks must distribute materials received from an issuer to their customers who are beneficial owners of the securities. A broker-dealer or bank only needs to satisfy this obligation if the issuer provides assurance that it will reimburse the broker's or dealer's direct and indirect "reasonable expenses" incurred in distributing materials to its customers. Rules implemented by SROs overseeing broker-dealers have interpreted what reasonable expenses are, establishing the maximum rates for various services that SRO members may receive in order to be deemed "reasonable." Securities intermediaries may request reimbursements for amounts that are less than the maximum rate but not for any amounts that exceed such rate.

The SEC notes certain inefficiencies caused by these reimbursements. Specifically, it notes that the maximum rates have not taken into account the "notice and access" model of proxy

delivery, which has, in some cases, resulted in the overcharging of certain accounts. In addition, broker-dealers generally outsource their delivery obligations to proxy service providers, who charge the broker-dealers fees and seek reimbursements from the issuer on behalf of the broker-dealers. The SEC notes that these proxy service providers have often sought from issuers reimbursement for the maximum fees permitted under SRO rules but have charged broker-dealers fees that are less than the maximum amount permitted, raising concerns as to the reasonableness of reimbursements. Further, the SEC notes that, with respect to certain managed accounts in which hundreds or thousands of beneficial owners may delegate their voting decision to a single investment manager, certain fees are assessed for all accounts, even though only one set of proxy materials is transmitted to the investment manager.

The SEC suggests that one way of addressing this problem could be to create a central data aggregator that would collect beneficial owner information from securities intermediaries and provide the information to any agent designated by the issuer. This could create competition among service providers for the distribution of proxy materials by making the beneficial owner information available to all of them. Further, it would place the choice of proxy service provider in the hands of the issuer, who has an incentive to reduce costs, rather than a securities intermediary. In relation to these issues, the SEC seeks comment on several issues, including whether the current fee/rebate structure reflects reasonable expenses, whether there should be an independent third-party audit of the fee structure, whether the current proxy distribution system creates a lack of incentives to reduce issuer costs, what steps would be necessary to enable prices to be based on competitive market forces, and what the potential merits and drawbacks of creating a central data aggregator are.

COMMUNICATIONS AND SHAREHOLDER PARTICIPATION

The release next addresses three topics related to issuer communications and shareholder participation: the ability of issuers to communicate with shareholders, the level of shareholder participation in the proxy voting process, and the ability of investors to obtain and evaluate information pertinent to voting decisions.

Issuer Communications with Shareholders

The SEC notes that the current proxy system, which involves the interposing of securities intermediaries between issuers and beneficial owners to enhance the efficiency of the clearance and settlement system, creates issues regarding the direct communications between issuers and their beneficial owners. While there is a requirement that broker-dealers and banks provide issuers, at their request, a list of names and addresses of beneficial owners who do not object to the provision of such information, approximately 75% of shares held in street name have beneficial owners that do object. Without this information, it is difficult for issuers to directly appeal to their beneficial owners. Issuers have indicated to the SEC staff that they face considerable expense in engaging in such communications through securities intermediaries or their agents, or even obtaining the list of non-objecting beneficial owners. In addition, issuers have expressed a desire for more flexibility to modify the design of current proxy materials and have expressed concerns regarding the potential quality control problems with proxy service providers (*e.g.*, proxy materials that have been delivered late).

The SEC cites several responses to these concerns suggested by prior commentators. One suggestion involves eliminating the ability of objecting beneficial owners to object to the disclosure of their identities and other information to issuers. This would allow issuers to obtain a list of beneficial owners and enable them to communicate directly with such beneficial owners. Others have suggested that issuers be entitled to a list of all beneficial owners as of the record date of a particular meeting, so that objecting beneficial owners would not be able to shield their identity for purposes of a shareholder meeting but could continue to shield their identities at all other times. Another suggestion would be to encourage beneficial owners not to object to providing certain information to issuers, which could be done by requiring disclosure of the consequences of objecting to disclosure of identifying information. As a consideration in evaluating each of these suggestions, the SEC notes the issue of whether beneficial owners have a privacy right with respect to the disclosure of their ownership positions.

In considering regulatory action to address these communication concerns, the SEC seeks comment on whether the ability to object should be eliminated, whether additional disclosure should be required about the choice of whether or not to object, or whether disclosure or non-disclosure of beneficial owner information should be the default approach. The SEC asks for comment on several related topics, including suggestions on what changes should be made to improve investor communication, what the costs and benefits of any such changes are, whether proxy materials are being delivered in a timely manner and whether non-uniformity in their appearance would encourage shareholder participation in voting. In addition, the SEC asks whether there are legitimate privacy interests with respect to disclosure of share ownership information, whether a central beneficial owner data aggregator for use by issuers be established and whether securities intermediaries should be required to provide an omnibus proxy to their underlying beneficial owners and identify them to the issuer.

Means to Facilitate Retail Investor Participation

The SEC next notes the historically low participation rates in the proxy voting process and suggests five potential regulatory responses that could be undertaken to encourage more shareholder participation.

First, the SEC suggests that there could be a significant investor education campaign informing investors about the proxy voting process and the importance of voting. In addition, it suggests that investors might benefit from education on issuer or broker websites and asks whether improvements could be made to the scope, format and content of the communications between brokers and their customers in connection with the opening of accounts. In connection with this, the SEC asks several questions, including whether it should take additional steps to encourage retail investor participation, whether it should require greater use of plain English, and what role the SEC should play in promoting or developing the education campaign.

Second, the SEC suggests that brokers' internet platforms could be enhanced by making proxy materials available directly on their websites as opposed to those of third-party proxy service providers. Regarding this suggestion, the SEC specifically asks whether the issuer's website or a broker's website would be a useful location for investor information, whether issuer or broker websites should be enhanced to provide shareholders with the ability to receive notices of upcoming votes and access proxy materials, and whether the SEC should

encourage the creation of inexpensive or free proxy voting platforms that would provide retail investors with access to proxy research, recommendations and vote execution.

Third, the SEC suggests the potential adoption of rules to facilitate “client-directed voting,” which contemplates that brokers or other parties solicit voting instructions on particular topics in advance of receiving proxy materials from companies. Such instructions would then be applied to votes related to the investors’ securities holdings, unless changed. With each proxy solicitation, investors would receive a proxy card or voting instruction form that would pre-marked in accordance with those instructions that could be overridden by subsequent investor action. In addition to the question of whether advance voting would be a disincentive for retail investors to vote after a detailed review of proxy materials, the SEC notes that there is currently no exemption that would allow securities intermediaries to solicit advance voting instructions from their customers. Also, it notes that such a response would raises questions as to the extent to which an investor’s vote is informed and how frequently investors should be required to re-affirm such instructions.

The SEC asks several questions regarding advanced voting instructions, including among others, whether it should consider allowing securities intermediaries to solicit voting instructions in advance of the distribution of proxy materials pursuant to an exemption, to what extent such instructions made without proxy materials would be less informed, and whether retail investors would be put at a disadvantage to institutional investors that use a proxy advisory firm when providing advance voting instructions. In addition, it asks whether it should allow advance voting instructions to apply to all proxy proposals or just some, whether it should require an investor to reaffirm its voting instructions, and how difficult it would be to obtain advanced voting instructions from existing brokerage customers.

Fourth, the SEC suggests that perhaps investor interest would increase to the extent to which they are able to communicate with other investors about their opinions regarding matters up for a vote. In this regard, they ask about the extent to which investor interest and voting participation are affected by the lack of investor-to-investor communication, whether electronic shareholder forums permitted by rule have been used extensively and whether any other rules or revisions to rules or any additional guidance would facilitate these types communications or improve the extent and quality of investor participation.

Fifth, in response to concerns that it has reduced investor participation, the SEC suggests possible revisions to the “notice and access” model by which an issuer posts proxy materials on a publicly-accessible website and sends notice to shareholders at least 40 days in advance of the shareholder meeting date informing them that the materials are available electronically, or in paper or via e-mail upon request. Although the SEC notes that it is difficult to make any conclusions on the effects of the “notice and access” model based on current data, it suggests that adding a proxy card or voting instruction form with such a notice may encourage greater voter participation. To better understand these issues, the SEC asks whether, it should require companies using a “notice and access” model for distributing proxy materials to send full sets of proxy materials to shareholders who have voted on paper within the past two years, whether the SEC should amend the proxy rules to permit the inclusion of a proxy card or voting instruction form with the notice of internet availability of proxy materials, and whether there are other changes that can be made to the “notice and access” model to improve voting participation.

Data Tagging

The SEC then asks whether, in addition to being presented in the traditional format, proxy-related materials (proxy statements and voting information) should be required or permitted to be data tagged using a computer markup language that can be processed by software for analysis. By doing so, the data becomes “interactive” allowing investors and others to retrieve and search information more easily. In this regard, the SEC asks, among other things, whether a particular format should be used, whether only certain information should be tagged, whether it would be useful for investors to have this information in interactive data format on corporate websites, and what the costs for providing such data are.

RELATIONSHIP BETWEEN VOTING POWER AND ECONOMIC INTEREST

The third principal topic that the SEC requests comment on involves the possible misalignment of voting power with economic interest. The SEC notes that when votes are cast by persons lacking any economic interest in the company, confidence in the proxy system may be undermined. It divides its discussion on this topic into three areas in which concerns have been expressed.

Proxy Advisory Firms

The SEC provides a general description of the current role that proxy advisory firms play in assisting institutional investors exercise their voting rights, including analyzing and making voting recommendations, executing votes in accordance with instructions, providing research and potential risk factors relating to corporate governance and helping to mitigate conflicts of interest. While providing these services, the SEC notes that, in certain cases, proxy advisory firms may also provide consulting services to issuers on corporate governance or executive compensation matters or provide consulting services to issuers seeking to improve their corporate governance that may result in certain conflicts of interest. Also, depending on their activities, proxy advisory firms may be deemed to be soliciting proxies by providing recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy or may be deemed to be an investment adviser because, for compensation, they engage in the business of (i) providing advice to others as to the value of securities, or whether to invest in, purchase or sell securities, or (ii) issuing reports or analyses concerning securities. The release notes that proxy advisory firms generally do not register with the SEC as investment advisers because they do not have sufficient assets under management and are therefore prohibited from doing so.

The release discusses the concerns raised by proxy advisory firms, including with respect to insufficient disclosure and management of conflicts of interest, the lack of adequate accountability for informational accuracy in the development and application of voting standards, and the ability of proxy advisory firms to control or significantly influence shareholder voting without appropriate oversight or an actual economic stake in the issuer. The release then focuses two areas of concern: conflicts of interest and lack of accuracy and transparency in formulating voting recommendations. In particular, the release cites the most commonly cited conflict as arising when the proxy advisory firm provides both proxy voting recommendations to institutional investors and consulting services to corporations. The release also cites concerns that voting recommendations by proxy advisory firms might be made based on materially inaccurate or incomplete data and that once given, proxy

advisory firms are unwilling to reconsider such recommendations. In addition, there is concern that proxy advisory firms base their recommendations on a one-size-fits-all approach that may not be suitable for all issuers.

To address these concerns, the SEC suggests several potential solutions. As to the conflicts of interest, the SEC identifies three possible approaches that could work separately or in tandem. First, it suggests potentially revising, or providing interpretive guidance regarding, its rule providing an exemption from the proxy solicitation rules for a person furnishing proxy voting advice that meets certain conditions, including disclosing any “significant relationship” the proxy advisor has with the issuer, its affiliates or any shareholder proponent of the matter on which advice is given, to require more specific disclosure about such conflicts. Second, it suggests that eliminating certain prohibitions on the registration of such proxy advisor firms as investment advisers with the SEC would enable the SEC to regulate such entities under the Investment Advisers Act of 1940. Third, it suggests imposing additional regulations to proxy advisory firms that are akin to those imposed on credit rating agencies registered as Nationally Recognized Statistical Ratings Organizations that would address conflicts of interest, such as requiring periodic filings describing any conflicts of interest and procedures to manage them.

For the accuracy and transparency concerns, the SEC suggests potentially requiring increased disclosure by the proxy advisory firm regarding: the extent of research involved with a particular recommendation and the extent and/or effectiveness of its controls and procedures in ensuring the accuracy of issuer data; the policies and procedures for interacting with issuers, informing issuers of recommendations, and handling appeals of recommendations; and voting recommendations, at least on a delayed basis, to facilitate independent evaluations by market participants.

The SEC lists several topics for comment regarding proxy advisory firms, including: whether additional regulation of proxy advisory firms is necessary or appropriate for the protection of investors; what policies and procedures, if any, do proxy advisory firms use to ensure that their voting recommendations are independent and are not influenced by fees; whether issuers modify or change their proposals to increase the likelihood of favorable recommendations by a proxy advisory firm; what the competitive structure of the market is for proxy advisory firms and what are the reasons for it; what criteria proxy advisory firms use to formulate their recommendations and corporate governance ratings; and whether proxy advisory firms control or significantly influence shareholder voting without appropriate oversight.

Dual Record Dates

The SEC notes that the same record date has historically been used to determine which shareholders are entitled notice of the meeting (“notice record date”) and which shareholders are entitled to vote (“voting record date”). Recently, however, states have permitted, but not required, entities to use separate record dates for making the two determinations. In certain cases, the voting record date may be as late as the meeting date itself. Despite the provision for dual record dates, however, because of SEC rules requiring that proxy materials be mailed sufficiently in advance of the meeting date to allow five business days for processing by the banks and broker dealers and an additional period to provide ample time for delivery, consideration, return of voting instructions, and transmittal of the vote from the bank or broker-dealer to the tabulator, issuers are limited in how close to the meeting date their voting record date can be. Likewise, under other SEC rules,

issuers must allow for a period of time between the mailing of materials and the meeting date. These restrictions limit how close to the meeting date an issuer can set its voting record date.

The release notes that by having a dual record date, an issuer may set the voting date closer to the meeting date, thereby raising the likelihood that investors who are entitled to vote will still have an economic interest in the issuer at the time of the meeting. Also, a dual record date could allow issuers to provide more time between the notice record date and the voting record date that could assist shareholders in recalling loaned securities. Alternatively, by keeping the notice record date and voting record date together, it would allow more time for shareholders to consider the decisions before them.

On this basis, the SEC is considering whether to facilitate an issuer's use of separate record dates. If it does, it suggests choosing between two models. The first model would require issuers to provide proxy materials or an information statement to those who are investors as of the notice record date. However, this would raise questions as to whether issuers should subsequently be obligated to send the disclosure document to those who were not investors as of the notice record date but who become investors by the voting record date. The second model would require issuers to provide the disclosure document to those investors who are investors as of the voting record date. Under either model, it notes that the number of shares held at the time of submission of the proxy or voting instruction form may differ from the number of shares that are ultimately voted on behalf of the investor. The SEC notes that, in addition to the acceptance of either model, additional disclosure may be required to discuss the effects that trades subsequent to the submission of the proxy or voting instruction form will have on their voting rights.

To assist in deciding what action, if any, to take regarding record dates, the SEC asks specific questions relating to dual record dates, including: whether the SEC should wait to take action to see how popular the election of dual record dates becomes; whether the SEC should respond in a way that facilitates the use of dual record dates; what rules would need to be clarified or revised to allow for dual record dates; whether a separate disclosure document would need to be sent to shareholders who purchase shares after the notice record date but before the voting record date; and which of the two general approaches is more appropriate.

“Empty Voting” and Related “Decoupling Issues”

Finally, the SEC discusses the ability to separate a share's voting rights from its economic stake, which challenges the fundamental notion upon which the securities laws have been based that a “shareholder” possesses both the voting rights and economic interests in a company. It uses the term “empty voting” to refer to circumstances in which a shareholder's voting rights substantially exceed the shareholder's economic interest in a company and describes such circumstances as an “decoupling” of rights and obligations associated with share ownership. The SEC notes that this decoupling may raise several issues, citing an example in which an empty voter with a negative economic interest may prefer that a company's share price fall rather than increase, potentially undermining investor confidence in the public markets. On the other hand, the SEC acknowledges that empty voting may also benefit shareholders when informed investors with long economic positions in the company acquire disproportionate voting power from less informed shareholders, casting more informed votes that are likely to contribute to increased value.

Regardless of the ultimate effect of empty voting, the SEC believes there is a strong argument for more transparency about its use and notes that it would like to further evaluate this trend. It, therefore, seeks information on the ways in which decoupling can occur and its nature, extent, and effects on shareholder voting and the proxy process. In connection with this, the SEC identifies certain techniques in which empty voting can be accomplished through both hedging-based strategies and non-hedging based strategies. Pursuant to hedging-based strategies, the SEC notes that an investor could buy a put option on a security that it holds or credit derivatives to hedge against the poor economic performance of the security. In addition, a shareholder of an entity may hedge against the company by purchasing assets correlated in some fashion to the company's sale price (e.g., an investor that purchases shares of a potential acquirer of the company he or she owns). The SEC also cites instances of empty voting through non-hedging techniques, including the active trading of a company's shares between a voting record date and the actual voting date that may result in voters having voting rights different from their economic interest, the voting of Employee Stock Ownership Plans by trustees on behalf of employees who only have a contingent economic interest in shares, and the borrowing of shares outside the U.S. in the stock lending market in which a borrower can "buy" votes associated with the shares without having any economic interest.

To address the issues raised by empty voting, the SEC, in addition to improved transparency and data gathering, suggests: potentially requiring voters to certify that they held the full economic interest in the shares being voted at the time the proxy is cast, or disclose the extent to which their economic interest was shorted or hedged; require advanced disclosure about the meeting so there is enough time for investors to recall loans to vote those securities; permit only persons who possess pure long positions to vote by proxy; or the prohibition of empty voting, especially in cases in which there is a negative economic interest. In connection with these suggestions, the SEC asks, among other things, for information about the potential for and actual prevalence of decoupling, what mechanisms about decoupling give rise to public policy concerns, under what circumstances should disclosure of a shareholder's net economic interest be required, and whether and to what extent should the SEC propose rule changes to provide more disclosures and transparency about decoupling.

PUBLIC COMMENT

In addition to comments on the topics specifically discussed in the release, the SEC also seeks public comment on any other concerns related to the proxy process that commentators may have. The comment period is open until October 20, 2010.

DOL Issues Interim Final Regulations Regarding Service Provider Fee Disclosure

The Department of Labor (the "DOL") issued an interim final regulation under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Section 408(b)(2) of ERISA provides an exemption from ERISA's prohibited transaction rules for reasonable arrangements with service providers. The DOL originally proposed an amendment to the regulation under Section 408(b)(2) of ERISA in December 2007. The interim final regulation, which includes substantive changes from the regulation as proposed, is effective July 16, 2011, while comments are due by August 30, 2010. The interim final regulation will be discussed in greater detail in a future issue of the *Alert*.

SEC Adopts Amendments to Form ADV Part 2 Including Electronic Filing Requirement

On July 21, 2010, the SEC voted unanimously to adopt amendments (the “Amendments”) to Part 2 of Form ADV, the part of the registration form for registered investment advisers commonly referred to as the “brochure,” which is delivered to adviser clients. The Amendments complete an overhaul of Form ADV that began in 2000 with the adoption of changes to Form ADV Part 1. In general, the Amendments replace Part 2’s existing check-the-box, fill-in-the-blank approach with a narrative brochure that addresses specified topics in plain English. An adviser must also provide “brochure supplements” to clients containing information about the specific personnel who will be providing them with advisory services. Investment advisers will be required to file their brochures electronically with the SEC, which will make them publicly available on its website. The SEC expects most advisers will begin using amended Form ADV Part 2 in the first quarter of 2011. The Amendments will be described in further detail in a subsequent *Alert* after the SEC issues the formal release describing the Amendments.

SEC Requests Comment on Adviser and Broker-Dealer Standards of Care for Retail Customers

The SEC published a request for public comment to assist it in preparing a study examining the legal and regulatory standards of care for broker-dealers, investment advisers and their personnel when providing personalized investment advice and recommendations about securities to retail investors. The study is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The SEC must submit a report on the study to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services no later than January 21, 2011. The Dodd-Frank Act also gives the SEC express authority to address the foregoing standards of care, but does not mandate rulemaking based on the study. Comments must be submitted no later than 30 days after publication of the SEC request for comment in the *Federal Register*.

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