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Making Sense Of SEC's NOBO-OBO Rules

Law360, New York (February 19, 2010) -- The past several months have seen a resurgence in the years-long debate over proxy mechanics.

The debate has focused on the desire of issuers to have more direct channels of communication with their retail shareholders, and a dissatisfaction with the U.S. Securities and Exchange Commission's "NOBO-OBO" rules. The SEC has indicated that it will publish a concept release seeking input on these issues soon.

In response to questions about the somewhat complicated regulatory context for communicating with retail shareholders, we have prepared the below answers in order to better explain the SEC's NOBO-OBO rules and how they operate.

What are the SEC's proxy communications rules?

The SEC's substantive communications rules govern the content of an issuer's proxy communications with its shareholders. They seek to prevent issuers from soliciting proxy votes by use of materially incomplete and/or inaccurate communications.

Because the communications rules focus on communications that influence proxy voting, they only apply to solicitations. As defined in the rules, a "solicitation" is any communication that requests a shareholder to vote in favor of or against a matter, or to abstain from voting on a matter.

Many communications simply do not bear on a current or anticipated proxy vote; accordingly they are not solicitations and their content is not regulated under the proxy rules. For instance, a letter from the CEO discussing the current economic climate and its impact on the company's business would not ordinarily be a solicitation.

However, a letter urging shareholders to support an anticipated company-sponsored "say-on-pay" proposal ordinarily would be a solicitation because it seeks to influence the outcome of an anticipated vote. As is the case with any public statement, issuers should still be mindful of Regulation FD if the communication includes material, nonpublic information.

As addressed below, the SEC's communications rules also include another set of rules, those governing the underlying mechanics of proxy voting, which govern the highways and other routes that issuers can use in distributing communications to their shareholders.

Are solicitations off-limits in issuer-shareholder communications under the proxy rules?

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Not at all. Under existing rules, issuers can communicate freely with all of their shareholders, even on matters that are — or are expected to become — proxy statement proposals, which accordingly are solicitations. That is because an exemption allows issuers to communicate with shareholders on such matters.

In 1999, the SEC amended Rule 14a-12 to permit issuers to communicate with their shareholders orally or in writing about a matter that the company expects to be presented at the next annual meeting. This is the exemption upon which issuers often rely today in communicating with their large institutional holders.

In most cases the company relying on the exemption must file with the SEC any written material that it uses, and include some legends.

For example, an issuer may, if it wishes, communicate during the year with its shareholders on its compensation principles and strategies, in anticipation of a say-on-pay proposal to be presented at its next annual meeting. If a company sent out a letter from the CEO along these lines, it would have to file the letter at the time the letter was distributed.

Even if an issuer has wide latitude in communicating with shareholders, how can the issuer do this if it does not know the identity of many of its retail shareholders?

It is true that issuers do not have direct contact information for many of their shareholders who hold their shares in “street name.” “Street name” holders are those shareholders who hold their shares through a broker or bank custodian. Under this form of ownership, the shares are technically “owned” by the broker, bank or other intermediary, so that only the broker or bank knows the identity of its client, the true beneficial holder.

The other type of shareholder is a “registered” shareholder, who holds shares directly on the books of the issuer or its transfer agent. In the case of registered holders, the issuer either has a list or can obtain one from its transfer agent. However, most issuers should have access to the names and addresses of a large proportion of their retail shareholders, including all registered holders and street name holders who are NOBOs.

The NOBO-OBO rules, adopted by the SEC in the mid-1980s, govern when an issuer may obtain a list of its street name shareholders who have not objected to such disclosure. These shareholders are “non-objecting beneficial owners,” or “NOBOs,” while "OBOs" are shareholders who have objected to the disclosure of their identities and share positions.

A shareholder is a NOBO by default, unless he or she has taken affirmative steps to object.

The number of registered holders and street name holders who are NOBOs will vary from one company to the next, but they typically represent a sizable proportion of a company’s retail shareholders.

According to proxy industry participants, approximately 75 percent of all street name retail shareholders are NOBOs and approximately 20 percent of all shareholders are registered shareholders.

An issuer can communicate efficiently and effectively with the remaining shareholders who are OBOs, but it must do so through an agent chosen by the broker or bank at rates set by the New York Stock Exchange. In some cases, electronic communications can be processed on a same-day basis.

What information can an issuer obtain about a NOBO?

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An issuer may obtain the shareholder's name, address and share position as of the date of the request. However, the issuer does not have access to the shareholder's e-mail address(es), or the particular bank or broker with which the account is held.

E-mail addresses of many holders are included in databases of distribution agents that have collected shareholders' consents to electronic delivery of proxy materials.

How does an issuer obtain a list of NOBOs?

An issuer may request that a NOBO list be generated at any time, and must pay a "reasonable reimbursement" fee set by the New York Stock Exchange. The SEC determined that the list should be available from a single intermediary in order to benefit from "economies of scale" in gathering and storing the data.

At the time that the SEC adopted the NOBO-OBO rules, the magnitude and allocation of start-up and ongoing costs were a matter of controversy. The NYSE convened a committee represented by interested parties, including the Society of Corporate Secretaries, on behalf of issuers. The committee recommended a single intermediary, with fees set by the NYSE.

What are the objectives of the NOBO-OBO rules?

The principal objective of the NOBO-OBO rules was to balance the interests of issuers, brokers and shareholders, both retail and institutional. When the SEC first began to consider such a mechanism in 1981, the reconciliation of interests proved difficult.

Five more years would pass before the rules were implemented on Jan. 1, 1986, and this was only after convening an SEC advisory committee and an NYSE advisory committee, each of which included representatives of interested parties. The principal interests to be balanced included the following:

- Brokers' interest in protecting their proprietary client information — pointing to their ownership of their own databases, and highlighting a concern that the transmission of client information by a broker directly to an issuer would allow the recipient to reverse engineer the broker's client list

- Investors' interest in privacy — pointing to their desire to avoid having their name, address and share ownership information provided to parties other than their banks, brokers and solicitors

- Issuers' desire to choose the mailing agent for communications with street name holders

- Technological feasibility and operational efficiency

- The allocation of related costs, including start-up costs, as well as ongoing costs such as software development, database maintenance and data storage

As noted above, providing investors with the opportunity to "opt out" of NOBO status addressed privacy concerns. The use of an intermediary addressed brokers' concerns because it permitted the transmission of a client's name, address and share position without any ability to associate the shareholder with a particular broker.

The intermediary structure also addressed efficiency, as the SEC stated in 1985 that "economies of scale will be realized by permitting [brokers and banks] to delegate this function to an intermediary which will maximize cost savings while minimizing burdens on brokers."

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The fees for obtaining a NOBO list would be regulated by the NYSE. Banks and brokers would be required to promptly forward communications to OBOs on behalf of issuers.

Is elimination of OBO status a possibility?

Shareholders are unlikely to accept the elimination of OBO status without replacing it with another mechanism that in effect provides a similar election. The forces competing with the issuers' desire for the information have only strengthened.

Since the mid-1980s, when the current system was implemented, institutional investors have only become more vocal about their desire to remain anonymous. Likewise, the general societal focus on privacy and data protection has only intensified.

The forces driving investors' desire for privacy are the same ones that resulted in the adoption of the "do not call" list earlier in the decade, and that are driving current legislative proposals aimed at beefing up data protection laws.

Any new or modified system for disclosure of beneficial holders almost certainly will have to include an opt-out mechanism, just as the current system allows for OBO status.

Given the need for an opt-out mechanism under any scenario, any new or modified system or approach seemingly would result in the disclosure of a greater proportion of retail shareholders.

Indeed, in 2006 the NYSE sponsored an Investor Attitudes Study. Among retail investors surveyed, 79 percent stated that they would choose, if asked, to allow their identities to be disclosed to issuers. This matches almost exactly the current actual percentage of retail NOBOs under the current system.

If a new opt-out mechanism was more costly or burdensome than it is today, it is more likely to result in fewer OBOs.

What are the potential consequences of eliminating OBO status (i.e., the ability of shareholders to opt out of disclosing names and other information to issuers)?

If NOBO status were eliminated in its entirety, issuers would have access to a list of their shareholders at any given time, just as today they can obtain a list of registered holders from their transfer agent. Issuers would then be able to choose their own distribution agent for all shareholders, just as they could, in theory, do today with respect to NOBOs.

In that case, however, it seems unlikely that elimination of OBO status would reduce the cost of soliciting street name shareholders, as costs would continue to include:

- the cost of generating the street name shareholder list, including technology and personnel to gather the shareholder information from numerous brokers and banks, and the organization and reporting of the collected data (including any start-up costs if the task is undertaken by one or more new entities); and

- actual communication costs, including printing, postage and any solicitor costs.

Is it really burdensome to include OBOs in a communication if an issuer wants to communicate with all shareholders at the same time?

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The debate over direct vs. indirect communications boils down to who chooses the intermediary used to make the distribution. If the issuer has direct contact information for a shareholder — as in the case of a NOBO — it can hire its own distribution agent for informal, interim communications.

If it does not have direct contact information — as in the case of an OBO — it must use an intermediary that is chosen by the broker. So, either way, the issuer would normally be using an intermediary.

In the long run, and maybe even in the medium term, the continuing development of electronic communications will render moot the current controversy over OBOs.

With electronic communications, it matters little that street name shares may be held by one or more layers of intermediaries because electronic communications simply "fly over" such complexity. Electronic communications also cut down on some of the big expenses of shareholder communications—namely, printing and postage costs.

One obstacle to electronic communications is the absence of complete databases containing e-mail addresses.

Because of their role in making proxy distributions, brokers' intermediaries have generally collected e-mail addresses along with consents to electronic delivery of proxy materials — which permits them to send a good proportion of a distribution electronically — as well as databases reflecting when a single distribution may be made for the benefit of numerous holders (e.g., when it is permissible to send one set of materials to a single household).

Is it permissible to distribute a communication only to NOBOs and registered shareholders?

There is nothing in the proxy rules that forbids communications with some, but not all, of an issuer's shareholders. Many issuers routinely communicate with only a handful of institutional holders.

However, years ago, after adopting its NOBO-OBO rules, the SEC made statements encouraging (but not requiring) issuers to communicate with all of their shareholders rather than just one or more segments.

While issuers should endeavor to communicate with all shareholders in an equal manner, the SEC's statements on the subject almost certainly have less force today, given the alternative means for shareholders to access information that were not available back then — e.g., the issuer's company Web site.

In all events, for communications that are not compelled by SEC rules and are not otherwise material, it is hard to argue with an issuer's decision to contact only those shareholders who have evidenced a desire to be contacted directly by the issuer — the NOBOs.

Why can't the SEC just get rid of the system that allows shares to be held in street name?

Street name ownership facilitates the efficient and accurate clearance and settlement of securities transactions.

Following the "paper crisis" of the 1960s, Congress enacted legislation, and the SEC adopted rules and policies, designed to encourage street name ownership.

As brokerage firms in the 1960s faced increasing volumes in securities transactions, their back offices were unable to keep up with the processing requirements in a world of paper stock certificates.

Street name ownership facilitates clearance and settlement because there is no paper that has to be transferred back and forth, and shares are fungible.

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While the system has been criticized as complicated, it is actually extremely modern and efficient, permitting the aggregate netting of multiple transactions among brokerage firms at the end of the day, rather than on a trade-by-trade basis.

Because street name ownership is necessary to the efficient operation of the securities markets, its elimination is not on the table as a practical matter.

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