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Gifts and Entertainment Policies: A Guide for Reevaluating the Policies of Investment Advisers

by Kurt J. Decko

Until recently, the receipt of gifts and entertainment by employees of investment advisers garnered little attention from regulators and the media. With news reports revealing bachelor parties and the like financed by brokers, investment advisers are reevaluating existing gifts and entertainment policies and procedures (or adopting new policies and procedures) in heightened recognition of the need, to minimize not only any potential conflicts

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Proxies on the Internet: A Harbinger for Investment Company Prospectuses and Reports?

Michael Berenson and Christopher D. Menconi

On December 8, 2005, the Securities and Exchange Commission (SEC) proposed¹ proxy rule amendments (Proxy Proposals) that would markedly change the proxy solicitation process. Specifically, the proposal would allow issuers, such as investment companies, and other parties soliciting shareholders' proxies to use the Internet as the primary means for delivery of proxy materials without satisfying one of the more burdensome conditions imposed by the SEC for electronic delivery—obtaining the investor's informed prior consent. Nevertheless, essential investor protections would be maintained. This is the latest in a series of actions taken by the SEC that recognize the tremendous growth in the public's access to, and facility with, the Internet, as well as the benefits the investing public gains from using the Internet to receive and review information sent in accordance with the federal securities laws.

Unfortunately, investment companies, most of which continuously offer their shares to the public through prospectuses, have been explicitly precluded from adopting some of the SEC's revised provisions allowing greater use of the Internet as a means of information delivery. More importantly, it does not appear that there has been a comprehensive SEC review addressing whether the growth of the Internet and the passage of the Electronic Signatures in Global and National Commerce Act (E-Sign)² in 2000 has affected the continued vitality of SEC positions regarding investment company use of the Internet and other electronic communications as set forth in SEC releases beginning in 1995.

This article discusses the Proxy Proposals,

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including the key decisions they embody regarding Internet use, and reviews other recent SEC actions allowing greater reliance on the Internet for investor communications. There is a discussion of certain elements of the SEC's 1995³ and 2000⁴ releases on use of the Internet, particularly as they apply to investment companies, and a discussion of the important areas in which the current limitations on investment company use of the Internet are costly to investors, deny them access to information in their preferred medium, and are no longer necessary to protect investors.

Proposed Proxy Rule Amendments

Currently, the proxy process is extremely paper-intensive. Issuers are required to send shareholders a proxy card and proxy statements, and these proxy materials must be accompanied by or preceded by the issuer's annual report.⁵ Issuers also can deliver additional soliciting materials.

An extra layer of paper is added when shares are not held in the name of the beneficial owner, but rather through an intermediary, such as a broker or bank. In these instances, the issuer sends proxy materials to the intermediary which in turn forwards them to the beneficial owner, along with a request for instructions on how the shares should be voted. The intermediary aggregates the instructions received from beneficial owners and, as the registered owner, votes the shares accordingly.

Organizing Principle Underlying Proxy Proposal

Distilled to its essence, the Proxy Proposals accept the “access equals delivery” model as an acceptable method for electronic delivery of documents. The SEC’s 2000 Interpretive Release described the “access equals delivery” model as one under which “investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished *solely* by an issuer posting a document on the issuer’s or a third-party’s Web site.” In doing so, the SEC recognized that 75 percent of Americans have Internet access in their homes and this percentage is increasing. By 2003, 84.4 percent of US households with family income of over \$50,000 had Internet access in their homes.⁶



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Key Elements of the Proposal

Shares Held by Beneficial Owners

If shares are held by their beneficial owners, issuers would send their shareholders a Notice of Internet Availability of Proxy Materials (Notice) at least 30 days in advance of the meeting date.⁷ To ensure that the Notice is not overlooked, it can be accompanied only by a proxy card, return envelope and, if applicable, a meeting notice required by state law. The Notice would include a boldface legend stating:

“Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on [insert meeting date].

- **This communication presents only an overview of the more complete proxy materials that are available to you on the Internet. We encourage you to access and review all of the important information contained in the proxy materials before voting.**
- **The [proxy statement] [information statement] [annual report to shareholders] [proxy card] are available at [Insert Web site address].**
- **If you want to receive a paper or e-mail copy of these documents, you must request one. There is no charge to you for requesting a copy. Please make your request for a copy as instructed below on or before [Insert a date that is two weeks or more before the meeting date] to facilitate timely delivery. If you hold your shares through a broker, bank, or other intermediary, you may request delivery of a copy of the proxy materials through that intermediary, but it likely will take longer to receive your materials through an intermediary than directly from the company.”**

The Notice also would include:

- The date, time, and location of the meeting or, if corporate action is to be taken by written consent, the earliest date on which the corporate action may be effected;
- A clear and impartial identification of each separate matter intended to be acted on and the issuer’s recommendations regarding those matters, but no supporting statements;
- A list of the materials being made available at the specified Web site;
- A toll-free telephone number; and

- An email address where the shareholder can request a copy of the proxy materials.

Issuers would be required to post the proxy materials on or before shareholders receive the Notice.⁸

Shares Held by Intermediaries

Rules 14a-13, 14b-1 and 14b-2 under the Securities Exchange Act of 1934 (Exchange Act), collectively referred to as the “shareholder communications rules,” impose obligations on issuers and intermediaries to ensure that beneficial owners are given an opportunity to cast informed votes. Rules 14b-1 and 14b-2 would be amended to mesh with the proposed “notice and access” option. One key element is that the issuer decides whether the “notice and access” model will be used, and intermediaries must honor the issuer’s choice.

From the beneficial owner’s perspective, the process will involve the same steps as if the beneficial owner were the record owner. There will, however, be additional timing considerations and action choices because there is an intermediary between the issuer and the beneficial owner. Among other steps:

- The issuer would have to provide copies of its Notice five days prior to the issuer’s deadline for sending the Notice to record holders;
- The intermediary would decide whether to include voting instructions with the Notice or post them on its own Web site; if the latter, then the intermediary would have to post the issuer’s proxy statement and other proxy-related material on its own Web site; and
- The intermediary would be required to respond to any record holder’s request for written or emailed versions of any proxy materials.

Solicitations by Persons Other Than the Issuer

Management of some corporations may regard the “notice and access” model as a 21st century Trojan horse. While it will reduce the proxy solicitation costs that are borne indirectly by all shareholders, it also will reduce the costs of proxy contests against corporate management. These costs, of course, are borne by those waging the proxy contests and can be a significant deterrent.⁹

Like an issuer, other soliciting persons can furnish a Notice and post their proxy statement

on a Web site. Similarly, they can choose between including the proxy card with the Notice or posting it with the proxy statement. However, unlike an issuer, other solicitors can choose to provide proxy materials only through a Web site.

In addition, other solicitors need not furnish a Notice to any shareholders. Rather, a solicitor could post the proxy materials and proxy card on a public Web site and announce the solicitation through a press release or other communication permitted by Rule 14a-12 under the Exchange Act.

Key Principles of the 1995 Release As Compared to the Proxy Proposals

In the 1995 release, the SEC set forth a three-part test for ensuring effective electronic delivery consisting of (1) notice; (2) access; and (3) evidence of delivery. The SEC also required that the recipient have the right to receive the information in paper.

The Proxy Proposals reflect the notice, access and right to paper concepts, but very significantly, do not include an evidence of delivery requirement. The 1995 Release gave five examples of how evidence of delivery could be established:

1. Obtaining evidence that an investor actually received the information, for example, by electronic mail return-receipt;
2. Disseminating information through certain facsimile methods;
3. An investor accessing a document containing a hyperlink to a required document;
4. Using forms or other materials available only by accessing the information; and
5. Obtaining an informed consent from an investor to receive the information through a particular medium.

Not including an evidence of delivery requirement in the Proxy Proposals is a natural evolution in the SEC’s approach to the use of electronic media. In the 2000 Release, the SEC simplified the process of obtaining the informed consent necessary to establish evidence of delivery by clarifying that issuers and market intermediaries, for example, broker-dealers, can obtain the consent telephonically, as well as in writing or electronically, as long as a record of the telephonic consent is retained.

Similarly, the Proxy Proposals reflect further acceptance of the use of negative consent procedures in meeting securities law obligations. Under

a negative consent procedure, an investor is advised how an issuer intends to meet an obligation and the investor is assumed to have consented, unless there is an objection. This approach is permitted by the SEC's householding rules, for example, Rule 14a-3(e) under the Exchange Act with respect to proxies, and Rule 154 under the Securities Act of 1933 and Rule 30e-1(f)(2) under the Investment Company Act of 1940 with respect to prospectuses and investment company periodic reports respectively. These rules permit the delivery of one copy of a proxy, prospectus or periodic report to more than one shareholder residing at the same address if there has been notice of the intent to do so and the shareholder(s) has not objected. Under the Proxy Proposals, the issuer will be able to meet its proxy delivery obligations by advising the shareholder that the proxy materials are available on a Web site, unless the shareholder in essence objects by asking that the proxy materials be delivered in paper or by email.

Additional SEC Approvals of Web Site Postings

The past several years have seen a number of instances in which SEC rules and rule proposals have identified a Web site posting as one of several acceptable means of delivering information, or allowed a delivery requirement to be met by a Web site posting only. These instances include recently adopted Securities Act Rule 172; investment company disclosures concerning proxy voting policies, and sales load breakpoints as well as point-of-sale disclosures.

Rule 172 relieves an issuer of the obligation to send a final prospectus as long as the issuer files the final prospectus with the SEC. Investors will then have access to the prospectus through the SEC's EDGAR system or can request one from the issuer.

Although the SEC did not permit investment companies to rely on Rule 172, it has recognized in several rulemaking initiatives that investment company shareholders can benefit from electronic delivery of information. For example, the recent amendments to Form N-1A, the combined Securities Act and Investment Company Act registration form for investment companies, require the mutual fund to disclose whether information about breakpoints in sales loads is available on the mutual fund's Web site and, if not, to explain the reasons why. The SEC noted in the adopting release its intention "to encourage mutual

funds to provide accessible Web site disclosure regarding the availability of breakpoint discounts" and that "[t]he increased availability of information through the Internet has helped to promote transparency, liquidity, and efficiency by making information available to investors quickly and in a cost-effective manner."¹⁰

Similarly, when the SEC recently adopted amendments to Form N-1A to require disclosure of portfolio manager compensation and information about the members of portfolio management teams, the SEC also implemented a separate disclosure requirement: That registrants disclose whether the statement of additional information and shareholder reports are available on a Web site and if not, to explain the reasons why they are not available in that manner.¹¹ These amendments can reasonably be read as an indication to registrants that the availability of information on a Web site, while not required, is strongly encouraged.

The SEC has also permitted funds to disclose their proxy voting records on their Web sites rather than requiring delivery of paper copies. The SEC stressed the importance of this information to investors when it stated that:

We believe that the time has come to increase the transparency of proxy voting by mutual funds. This increased transparency will enable fund shareholders to monitor their funds' involvement in governance activities of portfolio companies, which may have a dramatic impact on shareholder value.

Apparently, whatever concerns the SEC had about electronic delivery were no longer an issue because the SEC permitted funds to disseminate this important information *solely* through electronic means.¹²

In addition to the rule and registration form amendments discussed previously, a recent SEC rule proposal further illustrates the SEC's increased recognition of electronic-based communications as a means of conveying information to investors. On February 28, 2005, the SEC reopened the comment period on proposed Exchange Act Rules 15c2-2 and 15c2-3 that would require broker-dealers to provide their customers with information regarding the costs and conflicts of interest regarding the distribution of certain products, such as mutual fund shares, 529 college savings plans, and variable insurance products (Point of Sale Proposal) and revise the existing requirements relating to confirmation of securities

transactions.¹³ The Point of Sale Proposal contemplates the increased use of Internet disclosures to disseminate supplemental information to investors about revenue sharing and other compensation arrangements. For example, supplementary point of sale disclosure on broker-dealer Web sites could serve as a primary means of providing some information to customers, who, the proposing release suggested, could become overloaded if all the required information was presented in a paper statement.¹⁴

Investment Companies and the Internet Background

The Investment Company Act requires investment companies each year to deliver large amounts of information to shareholders, most of which is currently provided in paper. Open-end management companies, typically referred to as mutual funds, must provide a prospectus to shareholders as part of the offering process. Thereafter, a shareholder will receive, at a minimum, a new prospectus annually as well as annual and semi-annual reports. Closed-end management companies, which typically offer a fixed number of shares in an underwritten offering, also provide prospectuses as part of the initial offering process as well as annual and semi-annual reports.¹⁵

Insurance companies offering variable annuity contracts and variable life insurance policies are particularly conspicuous consumers of paper because these offerings almost always involve a two-tier structure. The top tier is an insurance company separate account, which is a unit investment trust investment company. The bottom tier consists of the mutual fund portfolios whose shares are held by discrete sub-accounts of the separate account. Owners of the insurance products choose to which mutual fund portfolios their premium payments are allocated. Owners receive initial and annually updated prospectuses for the insurance product. They also are entitled to the prospectuses and annual and semi-annual reports for the bottom tier mutual funds. Because many insurance products offer 50 or more investment options from multiple mutual fund complexes, a contract owner annually receives a large quantity of paper. In 2004, 35,000 contract owners of one insurance company each received approximately 1,050 prospectus pages and 1,850 pages of annual and semi-annual reports, a total of over 100,000,000 pages in one year for one company.

Current Guidelines for Investment Company Use of the Internet

Issuers, including investment companies, and others can rely on the guidelines in the SEC's 1995 Release to satisfy their information delivery obligations through electronic means. The most significant barrier to investment companies using the Internet on a widespread basis has been the "evidence of delivery" element. In the context of annual prospectus updates and annual and semi-annual reports, the least difficult means of satisfying this element is obtaining the shareholder's consent to receive these materials electronically. However, as noted in the Proxy Proposals Release,¹⁶ it is possible that:

a significant portion of the difficulties that issuers have encountered in implementing [the SEC's] existing guidance to date has stemmed from shareholders' inattention to requests for consent to electronic delivery rather than an unwillingness to receive documents electronically.

Attractive Opportunities for Adoption of Access Equals Delivery Model for Investment Companies

As long as investors can obtain required information on paper or by email, it appears that the access equals delivery model could be adopted for all investment company information. There are certain delivery obligations which are particularly appropriate for this less paper-intensive approach. For example, notwithstanding certain recent modifications, investment company annual and semi-annual reports contain listings of portfolio holdings, financial statements and other information that is probably of little interest or value to most shareholders. Although the portfolio listing can be limited to the 50 largest issuers, a question remains whether that information is worthwhile to shareholders, particularly in the case of an index fund in which the shareholder's investment is based on a decision to allocate a portion of his or her assets to a particular country, industry, asset-class, or other category covered by an index, rather than to the particular issuers that comprise the index. It also is likely that there are relatively few shareholders of non-index investment companies who have the investment sophistication to want access to the individual holdings and other more detailed information, but are unable to access the information electroni-

cally and unwilling to wait until the information is delivered by mail.

Annual prospectus updates are another compelling opportunity to adopt the “access equals delivery” model. Existing fund shareholders already have access to ongoing information from the fund through periodic reports, proxies, and prospectus supplements. In addition, it is industry practice to send existing fund shareholders an updated prospectus each year, even if they have not purchased additional shares. A comparison of the result of adopting the “access equals delivery” approach for prospectus updates to the existing method may be helpful. Currently, a shareholder receives an updated prospectus and, for purposes of discussion, puts it in an easily retrievable location. When the shareholder next considers whether to make any adjustments to that investment, the prospectus is available for immediate review. Under the access equals delivery model, the shareholder could review the notice that was sent in lieu of the updated prospectus and, when he or she wants information, either access the prospectus on a Web site, through a home or work computer or in one of the many locations, such as public libraries, where computers are available, or request a copy by mail, incurring a time delay. However, this time delay in some respects can be considered the shareholder’s responsibility because the shareholder had the option to immediately request a printed copy when he or she received the notice that an updated prospectus was available. This approach might be taken if the shareholder knew, as it is likely most people would, that when and if he or she wanted to review the updated prospectus, he would want it in printed form, not electronically. In the end, if the “access equals delivery” model were adopted for prospectus updates and periodic reports, mutual funds and their shareholders would benefit from significant decreases in printing and mailing costs balanced against a slight delay for a limited category of shareholders who ultimately decide they want to receive information by mail.

Recommendations

SEC Chairman Cox and his two immediate predecessors, William Donaldson and Harvey Pitt, have all recognized that technology can be a means to provide information to investors in a more usable format and on a more timely and cost-effective basis. While the SEC’s Division of Investment Management has undertaken a comprehensive review of the investment company disclosure regime, it does not seem necessary to

defer action on whether investment companies can make increased use of the Internet to satisfy delivery obligations until the Division of Investment Management and ultimately the SEC itself makes decisions on what changes should be made in the investment company disclosure regime.

The SEC is poised to embrace the “access equals delivery” for proxy solicitations and, in the case of prospectuses for operating companies, has already done so in Rule 172. Pending a comprehensive review of the SEC’s guidance on investment company use of electronic delivery, the SEC might wish to be open to requests for no-action assurance or other interpretive guidance from investment company complexes related to electronic delivery. The experience of individual investment company complexes might prove useful in setting guidelines for the industry as a whole. Even if the SEC determined not to issue guidance to investment company complexes on an individual basis, the specific proposals that were presented would certainly be helpful because there is a broad range of ways the Internet could be used by the mutual fund industry and these proposals would indicate the direction of the mutual fund industry. The SEC would then be able to consider whether the industry’s ideas are consistent with the SEC’s role in protecting the interests of mutual fund investors.

Conclusion

The Proxy Proposals’ adoption of the “access equals delivery” model reflects a significant advance in the SEC’s views on how the Internet can be used to communicate important information to investors. Investment company shareholders and the investment company industry would benefit if the Proxy Proposals were the first step towards using the many attributes of the Internet to provide easier access to required information about investment companies on a less-costly basis.

NOTES

1. Release No. 34-52926 (Dec. 8, 2005) (Proxy Proposal Release).
2. Pub. L. No. 106-229 (June 30, 2000).
3. Release No. 33-7233 (Oct. 6, 1995) (1995 Interpretive Release).
4. Release No. 33-7856 (Apr. 28, 2000) (2000 Interpretive Release).
5. This requirement does not apply to investment companies

that send reports to shareholders at least semi-annually pursuant to Section 30(e) of the Investment Company Act of 1940 and the rules thereunder.

6. US Census Bureau, Computer and Internet Use in the United States: 2003.

7. The Notice could be sent electronically if permitted under existing SEC guidance.

8. If an issuer is already relying on the “householding” rules in Rule 14a-3(e) under the Exchange Act to send one proxy statement to an address with multiple shareholders, the issuer could send one Notice to the same address.

9. See, e.g., Phyllis Plitch, “SEC’s Online Plan to Cut Costs May Rally Dissident Investors,” *The Wall St. J.*, December 27, 2005, at C3.

10. Final Rule: Disclosure of Breakpoint Discounts by Mutual Funds, Sec. Act Rel. No. 33-8427 (June 7, 2004).

11. Final Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Sec. Act Rel. No. 33-8458 (Aug. 27, 2004).

12. Disclosure of Proxy Voting Policies and Proxy Voting Record, by Registered Management Investment Companies, Investment Co. Act. Rel. No. 25922 (Jan. 31, 2005). As pro-

posed, funds would have been required to send the proxy voting record upon request. By permitting electronic delivery, the rule as adopted addressed concerns that funds with large numbers of holdings would have been required to produce lengthy proxy voting spreadsheets and to send them to investors who request them.

13. Proposed Rule: Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Sec. Act Rel. No. 33-8544 (Feb. 28, 2005).

14. *Id.* at 55.

15. Typically, closed-end funds have been exchange-traded and are required to have annual shareholder meetings and solicit proxies. In contrast, a mutual fund generally holds meetings and solicits proxies only when required to elect new members of its Board of Directors, or to take significant actions such as approving a new investment advisory agreement or changing a fundamental investment policy. Assuming the Proxy Proposals are adopted substantially as proposed, investment companies will have a means to avoid the costs associated of what is now a paper-intensive proxy process.

16. Proxy Proposal Release, note 27 and accompanying text.