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## **The Hanging Chads of Corporate Voting**

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### **Intro**

Never has voting been more important in corporate law.

With the activism of institutional investors and hedge funds in corporate governance and corporate control, there are more and more closely fought contests. For example, the controversial merger between Compaq and HP was approved by “about 45 million votes (out of 1.63 billion shares voted), a percentage margin of 51.4 to 48.6.”<sup>2</sup> In the battle over the AXA/MONY merger, [INSERT]. Heinz proxy fight [insert]. [Other examples of close contests?]

Director elections have likewise become much more important. In control contests, Delaware law, by upholding the poison pill, has channeled the decision into the annual meeting. The prevailing mode of hostile acquisition has become a bid coupled with a proxy contest so as to replace the directors and remove the poison pill. Director elections have also become an important arena for the expression of shareholder discontent. Starting with the “just vote no” campaigns, shareholder activists have now extended the strategy towards pushing firms to adopt a “majority of the votes cast” standard for director election in place of the current plurality standard. Delaware has recently amended its corporate law to permit a shareholder adopted bylaw, unamendable by the board, to require the “majority of the votes cast” standard.

Shareholders also vote on executive compensation, an area that has increasingly become a focus for shareholder activism.

Finally, shareholder proposals at the annual meeting, both mandatory and precatory, have been a favorite device for galvanizing and expressing shareholder discontent since the 1980s. It is now a fixture of the landscape and an important part of the governance structure.

But is the existing voting system adequate to the task? Can it meet the demands that are placed on it? Do we have reasonable grounds for placing confidence in the reported outcome of close corporate elections?

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<sup>1</sup> Thanks to . . . . And participants in workshops at Georgetown, . . . . Particular thanks to Chuck Mooney for numerous conversations about clearing and settlement and UCC Art. 8.

<sup>2</sup> Balotti at 7-23.

The 2000 Presidential election in Florida revealed that the technology of punch card ballots was not sufficient to determine the outcome of a close political election. The degree of precision, we discovered to our chagrin, was less than the X% margin of victory. We learned that the voting system could not answer the question “who won?” and then we had to improvise a procedure to break the statistical tie. What are the hanging chads of corporate voting? And do we have an adequate procedural for breaking statistical ties?

In Part I, we provide a bit of background on when shareholders vote, which shareholders have a right to vote, how votes are counted and the basic Delaware law on resolving close contests. In part II, we provide a description of how shares are actually held, transferred and voted in the US system in which approximately 80% of the shares are held by nominees. In part III, we analyze the various pathologies that infect the shareholder voting system. These pathologies arise from three separate, but overlapping sources: the multiple tiers of custody (“pathologies of complexity”); uncertainties as to who owns a particular share (“pathologies of ownership”); and the gaming of an exceedingly complex system. In part III, we also review the current legal treatment of these problems.

Pathologies of Complexity include: situations in which the beneficial owners do not receive proxy materials in time; situations in which beneficial owners who receive materials in time do in fact vote but the votes are not counted; and finally the problem of providing confirmation that votes have been received and counted and the related difficulties ex post of establishing a proxy audit trail. Each of these pathologies – which arise directly from the complexity of the modern system of nominee ownership – stand in the way of the vote tally reflecting the actual sentiment of the shareholders and the ability of the system to determine, in a close contest, who prevailed.

The complexity of the system also creates uncertainties over who owns particular shares. This uncertainty results in two types of pathologies: over-voting by custodians and their customers; and under-voting by institutional investors because their shares have been inadvertently lent out.

Finally, the complexity of the system permits and may encourage participants to game it. In this connection, we briefly discuss empty voting.

Then, in part IV, we consider a variety of directions for reform, ranging from increased judicial scrutiny to a fundamental redesign of the system. While some of the proposals – principally the Georgeson/BRT proposal and the “Spanish” solution – hold significant promise to improve the situation, none solves all the problems. This is because, at the end of the day, the problems are intrinsic to a system in which shares are widely held and in which thousands of votes are taken every year. The inescapable complexity, combined with the already well studied issues of shareholders’ rational apathy and free rider problems, counsels against single minded reliance on shareholder voting. There is little sense in putting matters to a shareholder vote if we do not trust in the outcome.

We close with a brief conclusion.

## I. Corporate Election Law: A Brief Introduction

In this section, we briefly review the legal structure of corporate voting, as a preliminary to describing the existing voting system. We leave the gory details of the legal structure to later when we discuss specific duties and examine a variety of voting pathologies.

### a. When do shareholders vote?

Shareholders vote in a variety of circumstances, some set by Delaware law, some by Federal Securities Law, some by tax law and some by stock exchange rules.

Under Delaware law, shareholders generally elect directors.<sup>3</sup> The statutory default rule for director elections is a plurality of the votes cast, although Delaware has recently amended its corporate law to permit shareholders to adopt a bylaw requiring a “majority of the votes cast”.<sup>4</sup>

Shareholder approval is also required in some mergers. Under §251, mergers must be approved by a majority of the outstanding stock of the constituent corporations.<sup>5</sup> Under NYSE rules, shareholder approval is required if a merger involves the issuance of stock that increases the number of outstanding shares (or voting power) by 20% or more.<sup>6</sup> Less commonly, a sale of all or substantially all the assets requires shareholder approval.<sup>7</sup>

Amendments to the certificate of incorporation likewise require approval of a majority of the outstanding stock.<sup>8</sup> Charter amendments are required to implement or remove an effective staggered board and to increase or decrease the number of authorized shares. Both can be important in control contests.

Section 109 of the Del GCL permits shareholders to adopt bylaws.<sup>9</sup> In addition, even when a proposal is not a proper subject for shareholder action, shareholders may adopt “precatory” resolutions at a properly called meeting.

Shareholders also vote on executive compensation. Under IRC 162(m), for an incentive compensation plan to qualify for optimal tax treatment, it must be approved by the

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<sup>3</sup> §§211(b), 216.

<sup>4</sup> DGCL §216 (“A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors”), combined with §141(b) which permits director resignations to be made irrevocable and effective upon the happening of a future event (such as failure to be elected by a majority vote)(“A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable.”).

<sup>5</sup> §251(c).

<sup>6</sup> NYSE Listed Company Manual 312.03(c).

<sup>7</sup> §271.

<sup>8</sup> §242.

<sup>9</sup> 109.

shareholders. Similarly, and without regard to tax treatment, the NYSE Listing Requirement require that equity compensation plans be approved by the shareholders of listed companies.<sup>10</sup> Finally, Delaware case law, while not requiring shareholder approval of self dealing transactions or executive compensation, provides a variety of inducements for it.

Finally, under federal securities law, shareholder must ratify the appointment of the auditor.

### **b. Who gets to vote?**

The requirement of a shareholder vote, however, does not itself determine which shareholders get to vote. With annual turnover of shares in a public company on the order of 99%, the shareholder base is constantly in flux. It is thus necessary to define a date as of which a list of shareholders qualified to vote is determined.

Under DGCL §213, a “record date” is fixed in advance of any vote. Under §213(a), the record date “shall not be more than sixty nor less than ten days before the date of [the] meeting.” The legal owners of shares as of the record date are entitled to notice of, and to vote at a shareholder meeting. The corporation is obligated to prepare, in advance of a vote, a complete list of shareholders entitled to vote at the meeting.<sup>11</sup>

Section 213 puts record rather than beneficial ownership at the center of the system. Firms are entitled to rely on its stock list – the list of registered owners – in determining who is entitled to vote and need not look beyond the registered owners, even when shares are held in nominee name.<sup>12</sup> They may authorize another person to vote in their stead by means of a proxy.<sup>13</sup> But, in the absence of such a transfer, the legal owner of the shares, even when the person holds the stock in a fiduciary capacity, is entitled to vote the shares held.<sup>14</sup>

Delaware has steadfastly refused to modify its reliance on record ownership. It has done this not because it is unaware of custodial ownership structures, but because of several concerns. First, there is a statutory and judicial concern for definiteness which is maximized by a system of reliance on the stock list. A variety of provision in Delaware law explicitly refer to record ownership including §262(a) (Appraisal rights). Similarly, §219 provides that “(c) The stock ledger shall be the only evidence as to who are the stockholders entitled by this section to examine the list required by this section or to vote in person or by proxy at any meeting of stockholders.”

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<sup>10</sup> NYSE Listed Company Manual 303A.08, 312.03(a).

<sup>11</sup> 219

<sup>12</sup> Berlin v. Emerald Partners, 552 A.2d 482 (Del. 1988); Schott v. Climax Molybdenum Co., 38 154 !.2d 221 (Del. Ch. 1959).

<sup>13</sup> 212c.

<sup>14</sup> 217(a).

Second, Delaware views custodial arrangements as matters between shareholders and their agents and as not involving the firm. To the extent that things go wrong, Delaware views that as a problem for the shareholder, not for the company.

Thus, going back at least to *Salt Dome Oil Corp. v. Schenck*,<sup>15</sup> the court held that:

The merging corporations are entitled to know who the objecting stockholders are so that the amount of money to be paid to them may be provided. The stockholders in general are entitled to know the dissentients and the extent of the dissent. *Stephenson v. Commonwealth & Southern Corporation*, 18 Del.Ch. 91, 156 A. 215. The corporation ought not to be involved in possible misunderstandings or clashes of opinion between the nonregistered and registered holder of shares. It may rightfully look to the corporate books as the sole evidence of membership. On the other hand, the non-registered holder of a stock certificate is deprived of no essential right. He has it in his power to [\*\*24] record the transfer of his shares and thereby become a member of the corporation in the full legal sense. If, for any reason, he chooses to allow his shares to be registered on the corporate books in the name of another, it is not a denial of his right of actual ownership to require him to establish his rights and pursue his remedy through the nominee of his own selection. Any disadvantage is the result of his own non-action. [\*\*\*447] To hold that one who does not possess the essential rights incident to stock ownership is, nevertheless, a stockholder as against the corporation, and, as such entitled to interject himself in matters of internal management, is to disregard essential verities and must lead to unnecessary confusion.

This focus has continued. Thus, in *Enstar v. Senouf*,<sup>16</sup> the Delaware Supreme reiterated this bright line view:

In making that choice, the burden must be upon the stockholder to obtain the advantages of record ownership. See *Lewis v. Corroon & Reynolds Corp.*, Del. Ch., 30 Del. Ch. 200, 57 A.2d 632, 634 (1948); *Nickles v. United Nuclear Corp.*, Del. Ch., 41 Del. Ch. 234, 192 A.2d 628 (1963). The legal and practical effects of having one's stock registered in street name cannot be visited upon the issuer. The attendant risks are those of the stockholder, and where appropriate, the broker.

There are numerous other Delaware cases, arising in both the merger and appraisal contexts, in which the courts maintain this focus.<sup>17</sup>

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<sup>15</sup> 41 A.2d 583 (Del. 1945)

<sup>16</sup> 535 A.2d 1351 (Del. 1987)

<sup>17</sup> See, e.g., *American Hardware Corp. v. Savage Arms Corp.*, 136 A.2d 690 (Del. 1957) (“ Under the General Corporation [\*\*11] Law, no one but a registered stockholder is, as a matter of right, entitled to vote, with certain exceptions not pertinent here. If an owner of stock chooses to register his shares in the name of a nominee, he takes the risks attendant upon such an arrangement, including the risk that he may not receive notice of corporate proceedings, or be able to obtain a proxy from his nominee. The corporation, except in special cases, is entitled to recognize the exclusive right of the registered owner to vote. It has been held in this State that an unregistered stockholder may not dissent from a merger and

### c. Counting the Votes

Once votes are cast, what is supposed to happen is clear in its broad outlines if a bit blurry in its details. Del 251(c) provides that “If a majority of the outstanding stock of the corporation entitled to vote thereon shall be voted for the adoption of the agreement, that fact shall be certified on the agreement by the secretary or assistant secretary of the corporation.” Similarly, unless the certificate or a bylaw provides for majority election of directors, “directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors.”<sup>18</sup>

It is complicated slightly, but only slightly, by proxy voting. Again, the statute anticipates proxy voting: “Each stockholder entitled to vote at a meeting of stockholders . . . may authorize another person or persons to act for such stockholder by proxy.”<sup>19</sup> Where more than one valid proxy is given for a share, the later proxy revokes the earlier proxy.

Finally, the validity of proxies and the tally of votes is the responsibility of the inspector of elections, appointed by the corporation.<sup>20</sup> In contested votes, the inspectors, while appointed by management, are independent.<sup>21</sup>

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demand appraisal of his stock. . . . The corporation has ordinarily discharged its obligation under Delaware law when it mails notice to the record owner.); *Berlin v. Emerald Partners*, 552 A.2d 482 (Del. 1988)(“Shares of publicly traded corporations are often held in the name of brokers or fiduciaries (commonly called “street name”) for the account of the beneficial owners. The brokers or fiduciaries are the stockholders of record. . . .Delaware law expressly recognizes the right of the corporation to rely upon record ownership, not beneficial ownership, in determining who is entitled to notice of and to vote at the meetings of stockholders. *See*, 8 *Del. C.* § 213(a) (Supp. 1988); *Enstar Corp. v. Senouf*, Del.Supr., 535 A.2d 1351, 1356 (1987). “In dealing with its stockholders a Delaware corporation need not look beyond the registered owners.” *Williams v. Sterling Oil of Oklahoma, Inc.*, Del. Ch. 267 A.2d 630, 634 (1970), *rev'd on other grounds*, Del. Supr., 273 A.2d 264 (1971). Therefore, from the perspective of the Delaware corporation, a broker [\*\*36] who is the stockholder of record, has the legal authority to vote in person or by proxy on all matters.”); *Giant Portland Cement*, 21 A.2d 697 (Del Ch 1941)(“The record owner may, therefore, be the mere nominal owner, or, technically a trustee for the holder of the certificate ( *In re Canal Const. Co.*, 21 Del. Ch. 155, 182 A. 545; *Thompson v. Blaisdell*, 93 N.J.L. 31, 107 A. 405; 12 *Fletcher*, § 5498, *supra*), but legally he is still a stockholder in the corporation, and so far as the corporation is concerned, like the usual trustee (2 *Machen Modern Law Corp.*, § 1223; *In re Barker*, 6 *Wend. (N.Y.)* 509; *Morawetz Priv. Corp.*, § 373), ordinarily has the right to vote the stock standing in his name.”).

<sup>18</sup> Del GCL 216(iii). §216 has now been amended (effective August 1, 2006) to prohibit a board from amending or repealing a stockholder adopted bylaw that sets a specific voting percentage (such as a majority).

<sup>19</sup> 212(b).

<sup>20</sup> 231

<sup>21</sup> Balotti at 10-5.

#### d. Resolving Close Contests under Current Delaware Law

Not surprisingly, Delaware has encountered numerous close contests. In keeping with its desire to promote certainty and speed over accuracy and perfection, it has adopted a straightforward and somewhat rigid approach.<sup>22</sup>

In contested votes, an independent inspector of elections is appointed by the company.<sup>23</sup> The inspector's role is "ministerial", not "judicial."<sup>24</sup> That is, the inspector is expected to examine the proxies, determine if they meet the formal criteria, and report the tally, but is not to resolve any disputed issues. Those are to be recorded and, if the outcome is challenged, resolved by the court. The report of the inspector is presumed to be correct.<sup>25</sup>

Under §231(d), the inspector of elections is limited in the materials he may use in determining the validity of proxies: "In determining the validity and counting of proxies and ballots, the inspectors shall be limited to an examination of the proxies, any envelopes submitted with those proxies, any information provided in accordance with §211(e) [electronic transmission] or §212(c)(2) [electronic transmission] of this title, or any information provided pursuant to §211(a)(2)(B)(i) or (iii) of this title [remote communication at meetings], ballots and the regular books and records of the corporation."<sup>26</sup> This part of §231(d) largely codifies longstanding Delaware practice.<sup>27</sup>

Up until 1990, Delaware followed a highly formalistic approach. Under the doctrine of *Williams v. Sterling*,<sup>28</sup> the inspector could not look to any extrinsic evidence at all, even evidence of an obvious clerical error (a proxy clerk accidentally submitted two proxies for the same shares at the same time, one for management, one against management), and even when the votes were outcome determinative. Under the *Williams* rule, the inspectors of elections "must reject all identical but conflicting proxies when the conflict cannot be resolved from the face of the proxies themselves or from the regular books and records of the corporation."<sup>29</sup>

In 1990, in the wake of *Concord Financial v. Tri-State*,<sup>30</sup> a Delaware Chancery Court decision that reaffirmed the *Williams* refusal to consider extrinsic evidence, and which held that the inspector erred in considering extrinsic evidence to resolve an overvote,<sup>31</sup> the Delaware legislature adopted §231 which, following on the language quoted above, provides an exception to the inadmissibility of extrinsic evidence:

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<sup>22</sup> DGCL §225 provides the statutory basis for judicial review of contests.

<sup>23</sup> Balotti et al, Meetings, §10.1 at 10-5 to 10-6.

<sup>24</sup> Berlin v. Emerald Partners, 552 A.2d 482, 491 (Del. 1989).

<sup>25</sup> Id. at 491.

<sup>26</sup> §211(e) permits electronic voting; §212(c)(2) permits electronic transmission of proxies; §211(a)(2)(b)(i) permits participation by remote communication. These provisions were added in 2000.

<sup>27</sup> Official Synopsis, 67 Del. Laws Ch. 376, §9 (1990), cited in Seidman at n. 14.

<sup>28</sup> 273 A.2d 264 (Del. 1971).

<sup>29</sup> Williams 273 A.2d at 265.

<sup>30</sup> 567 A.2d 1 (Del. Ch. 1989).

<sup>31</sup> Id. at 16-17.

*except that the inspectors may consider other reliable information for the limited purpose of reconciling proxies and ballots submitted by or on behalf of banks, brokers, their nominees or similar persons which represent more votes than the holder of a proxy is authorized by the record owner to cast or more votes than the stockholder holds of record. If the inspectors consider other reliable information for the limited purpose permitted herein, the inspectors at the time they make their certification pursuant to subsection (b)(5) of this section shall specify the precise information considered by them including the person or persons from whom they obtained the information, when the information was obtained, the means by which the information was obtained and the basis for the inspectors' belief that such information is accurate and reliable. (emphasis added).*

The legislature's recognition of the realities of custodial ownership and the likelihood of clerical and other errors led it to grant inspectors greater latitude in resolving overvotes. But the latitude is constrained. In *Seidman v. G.A. Financial*,<sup>32</sup> the court invalidated proxies for 233,376 shares because of an overvote of 824 shares, when the inspector of elections could not obtain reliable information from the proxy clerk to resolve the overvote.

#### **e. Voting by Registered Owners: the Delaware Paradigm**

The Delaware corporate governance system – the paradigm embedded in the statute and the cases – is quite straightforward and is designed to provide certainty (transparency and verifiability), within its formal limits. The corporation sends out proxy cards, a proxy statement and the annual report to its registered owners. The registered owners execute the proxy to indicate how they wish to vote their shares (never mind how they decide that). The proxies are then returned to a tabulator who, after checking the formal validity of proxies (and not, for example, whether they reflect the voting instructions of beneficial owners), and comparing the proxies to the share register, reports the outcome to the board of directors. Figure 1 outlines the process.

[Figure 1]

The only problem with this paradigm is that it is totally unreal: it willfully ignores how shares are actually held and voted.

## **II. Custodial Ownership: How shares are held, transferred and voted in the publicly held corporation**

The implicit model of corporate voting that emerges from the Delaware statute assumes, as in a typical close corporation, that shareholders will hold shares, and will vote these shares by proxy or at the meeting. This, of course, is not what happens in publicly held corporation in which around 80% of the shares are held by nominees.

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<sup>32</sup> 837 A.2d 21 (Del. Ch. 2003).

### **a. Shares held in “street name”**

During 2005, the NYSE reported average daily volume of approximately 2 trillion shares, in approximately 3 million separate trades, with a dollar volume of around \$72 billion. With volume of this magnitude, the “old fashioned” system of shareholders holding share certificates which are registered with the issuer and transferred by the transfer agent upon delivery of the certificate after a sale is obviously unworkable for most shareholders.

Some shareholders hold directly and there are some advantages to direct registration. Record shareholders receive their corporate communications directly from the issuer, and return their proxies directly to the issuer. From the perspective of the issuer, there are advantages as well. The issuer knows who its shareholders are, and can communicate with them directly.

During the late 1960s, the “paper crunch” of certificated shares caused the system to crash. In response, the US adopted a policy of “immobilization” of share certificates through a depository system.<sup>33</sup> Indeed, it would not be an exaggeration to say that, since the 1975 enactment of Section 17A, it has been the policy of the United States Federal Government to encourage custodial ownership to facilitate clearing and settlement and thereby reduce systematic risk.<sup>34</sup> Without custodial ownership as the normal mode of holding securities, implementing a system to settle securities within five business days (T+5) much less today’s norm of T+3 or, the current goals of T+1 or T+0 would simply be impossible.<sup>35</sup>

The revolution that began in the 1970s has achieved its goal. Most shares (60-80%) of publicly held corporations are held in “street name” through custodians such as banks and brokerage firms with the shares themselves held by a depository, the most prominent of which is DTC.<sup>36</sup> Because there are differences that will be important between bank and brokerage custodians, we’ll discuss them separately. Figure 2 provides an overview.

[Figure 2]

### **i. Bank Custodians**

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<sup>33</sup> As described in the prefatory note to UCC Article 8, “Transfer of securities in the traditional certificate-based system was a complicated, labor-intensive process. Each time securities were traded, the physical certificates had to be delivered from the seller to the buyer, and in the case of registered securities the certificates had to be surrendered to the issuer or its transfer agent for registration of transfer. As is well known, the mechanical problems of processing the paperwork for securities transfers reached crisis proportions in the late 1960s, leading to calls for the elimination of the physical certificate and development of modern electronic systems for recording ownership of securities and transfers of ownership.” UCC Article 8, prefatory note.

<sup>34</sup> Concept Release, Securities Transaction Settlement, SEC Release Nos. 33-8398; 34-49405; IC-26384; 17 CFR PART 240; RIN 3235-AJ19 (March 11, 2004), 2004 SEC LEXIS 581

<sup>35</sup> Id.

<sup>36</sup> UCC Art. 8 prefatory note.

Bank custodians (the leading firms are JP Morgan, Bank of NY, State Street, and Northern Trust) hold most shares [find numbers]. Shares owned by mutual funds, pension funds, insurance companies, endowments and trusts are all typically held by a bank custodian who, in turn, has an account at DTC in which the actual shares are held. The DTC account will hold all the bank's shares in a fungible bulk, without any subdivision into separate accounts of the custodian's customers.

The bank custodian's records will indicate how many shares are held in which accounts, who has voting authority and who has trading authority. Often an institutional investor will allocate money to various asset managers some with only trading authority, others with both trading and voting authority. The allocation of voting and trading authority is a matter of contract between the institution, the asset manager and the custodian.

Because custodial services is a specialized and highly competitive function, many small banks which take custody of assets will deposit those assets with another, larger, specialized bank custodian. This "piggy-backing" can involve three or four tiers. These "respondent" banks will keep track of their own customer accounts, with the larger bank simply recording on its records how many shares it is holding for the respondent bank.

Bank custodians provide a variety of services to their customers including asset safekeeping and trade processing and settlement. When, for example, a customer or its asset manager sells shares, the custodian bank will process and clear the trade. When the trade clears, DTC will shift shares by book entry from the selling custodian bank's account to the acquiring custodian's account.

Custodian banks, or their agent (typically ADP Shareholder Services, the dominant provider of proxy services), will also provide proxy services (more on this below).

Finally, and very importantly and lucratively, custodian banks may also provide securities lending services. With their enormous holdings, the custodian banks are well positioned to offer this service. When a custodian bank "lends" out shares, a notation is typically<sup>37</sup> made in the account of the customer whose shares have been lent. If this is done, then the loan will be transparent to customers when they check on line or receive monthly statements.<sup>38</sup> The allocation of the fees generated by securities lending between the custodian and the customer is a matter of negotiation. Some large institutions put their securities lending business separately out to bid. Large institutions make large amounts from securities lending. According to a 2001 estimate, beneficial owners earn about \$5 billion a year in fees from securities lending.<sup>39</sup> CalPERS alone made \$129.4 million on its securities lending business for the year ending March 31, 2006.<sup>40</sup>

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<sup>37</sup> But, we are told, not always.

<sup>38</sup> As will be discussed below, a securities loan is not really a loan but is a sale coupled with an obligation to return fungible shares.

<sup>39</sup> Euromoney Institutional Investor, Mark Faulkner, Lending message fails to get through (December 1, 2001).

<sup>40</sup> <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2006/june/approves-investment-contracts.xml>

## ii. Broker Custodians

Brokers also act as custodians for their customers. Like bank custodians, brokers will have accounts at DTC where their shares and their customers' shares are held in fungible bulk. Brokers are responsible for keeping track of their customer accounts and, when customers buy or sell, the broker's DTC account will be updated.

Among broker customers, one can distinguish between the large customers such as hedge funds and smaller retail customers. The hedge funds, and other very large customers, will receive "prime brokerage" services, which provide a variety of services, including share borrowing, and financing of trades.

Individual customers may hold their shares in margin accounts which allow them to borrow against the shares and to receive a variety of services. As a matter of contract, the shares held in a margin account are available to be lent out by the broker, with the broker retaining the proceeds from the lending.<sup>41</sup>

When brokers lend shares of margin account customers, they do not typically identify or attribute the shares lent to specific accounts.

### **b. Who owns the share held in street name?: An introduction to UCC Article 8**

The vast volume of securities trading has led to a transformation of the structure and content of property law as it applies to securities. Beginning around 1973, there has been a concerted effort to change property law so as to minimize the number and impact of failed trades. As a result, as we describe in this section, there is a substantial divergence between corporate law's concepts of legal and beneficial ownership and property law's structure of ownership.

Article 8 establishes a property rights regime for securities that is designed for modern, indirect shareholding. See figure 3. Under this system, in the typical case of custodial ownership, the beneficial owner of the share is considered to be the holder of a "securities entitlement" in a "financial asset" which is ultimately held by a depository.<sup>42</sup> This needs to be unpacked a bit. The UCC defines an "entitlement holder" as "a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary. If a person acquires a security entitlement by virtue of Section 8-501(b)(2) or (3), that person is the entitlement holder."<sup>43</sup> "Financial assets" include shares. A customer of a broker dealer (a securities intermediary) thus becomes an entitlement holder when the broker makes a book entry indicating that the customer has bought shares. One important effect of this structure is that a brokerage customer can

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<sup>41</sup> Cite.

<sup>42</sup> UCC 8-501(b)(1).

<sup>43</sup> UCC 8-102(7).

become an entitlement holder even if the broker has not, in fact, acquired the shares credited to the customer's account.<sup>44</sup>

Article 8 then defines the nature of the "property interests" created and the priority of claims on financial assets held by securities intermediaries. Section 8-503(a) provides that securities that a firm holds for its customers are not general assets of the firm subject to the claims of firm creditors: "To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511." But, at the same time, Section 8-503 makes clear that the interests of the customers is not an interest in any particular item of property, but rather is a common interest held by all the entitlement holders: "An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset." Finally, in order to prevent the shortfall of an intermediary's securities holdings from leading to the failure of securities trades – the minimization of such failures being the paramount goal of Article 8 – section 8-503(c) – (e) sharply limits the methods by which an entitlement holder may enforce its rights.<sup>45</sup>

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<sup>44</sup> UCC 8-501(c).

<sup>45</sup> UCC 8-503(c), (d), and (e) provides that:

(c) An entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against the securities intermediary only by exercise of the entitlement holder's rights under Sections 8-505 through 8-508.

(d) An entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against a purchaser of the financial asset or interest therein only if:

- (1) insolvency proceedings have been initiated by or against the securities intermediary;
- (2) the securities intermediary does not have sufficient interests in the financial asset to satisfy the security entitlements of all of its entitlement holders to that financial asset;
- (3) the securities intermediary violated its obligations under Section 8-504 by transferring the financial asset or interest therein to the purchaser; and
- (4) the purchaser is not protected under subsection (e).

The trustee or other liquidator, acting on behalf of all entitlement holders having security entitlements with respect to a particular financial asset, may recover the financial asset, or interest therein, from the purchaser. If the trustee or other liquidator elects not to pursue that right, an entitlement holder whose security entitlement remains unsatisfied has the right to recover its interest in the financial asset from the purchaser.

(e) An action based on the entitlement holder's property interest with respect to a particular financial asset under subsection (a), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504.

Under this system, then, the customer – the “securities entitlement holder” under Article 8 but the “beneficial owner” or just “shareholder” for corporate and securities law purposes – has a superior claim in the securities against general creditors of the securities intermediary, but a far inferior claim vis a vis purchasers of that security from that intermediary, including creditors of the intermediary who have obtained security interests.<sup>46</sup> While the intermediary, by statute,<sup>47</sup> has an obligation to pass on payments and other distributions, and to exercise rights with respect to the financial asset if directed to by the entitlement holder, Article 8 makes crystal clear that an entitlement holder’s claim to a security is just that – a claim – that is on equal footing with all other customers of the same intermediary regardless when the shares were purchased. As the official comment to 8-503 states, “Subsection (b) makes clear that the property interest described in subsection (a) is an interest held in common by all entitlement holders who have entitlements to a particular security or other financial asset. Temporal factors are irrelevant. One entitlement holder cannot claim that its rights to the assets held by the intermediary are superior to the rights of another entitlement holder by virtue of having acquired those rights before, or after, the other entitlement holder. Nor does it matter whether the intermediary had sufficient assets to satisfy all entitlement holders’ claims at one point, but no longer does. Rather, all entitlement holders have a pro rata interest in whatever positions in that financial asset the intermediary holds.”

Notice how fundamentally different this system is from the understanding of property rights implicit in, and underlying, corporate and securities law. Corporate law views the shareholder as the owner of a thing – a share – that carries with it various rights. When shares are held in nominee name, the custodian of the share, who becomes the legal owner, is expected to act for the beneficial owner. As we’ll discuss below, this misalignment between the traditional property rights model implicit in corporate and securities law with the revised property concepts are Article 8, driven by the reality of custodial ownership, comes to the fore in the problem of overvoting.

### **c. How Nominee Shares are Voted**

When most shares are held in street name, the voting process becomes far more complicated. Imagine that the annual meeting is coming up.

#### **i. Step One: Finding the Beneficial Owners**

In the first step, the issuer sends an inquiry to depositories such as DTC in which it asks for a list of participant custodians who hold shares of the issuer in its account, as in Figure 4. Depositories are obligated to identify promptly participants and to indicate the number of shares owned by each as of the date of the inquiry.<sup>48</sup> If there is a discrepancy between the number of shares held by DTC as indicated by the corporation’s share

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<sup>46</sup> UCC 8-511.

<sup>47</sup> 8-505, 8-506

<sup>48</sup> SEA Rule 17Ad-8(a) (and can charge for doing so: SEA Rule 17Ad-8(b))

register and the number as it appears on DTC's records, such discrepancies are not typically reconciled at this stage.

After receiving information from DTC, the issuer will send a "search card" to all bank and broker nominee holders in which it asks for the number of proxies and other materials needed, as indicated in Figure 5a.<sup>49</sup> Upon receipt of the search card, banks and brokers must provide the information requested, as indicated in Figure 6. Most custodians delegate the task of processing proxies and other corporate communications to ADP. When this is done, ADP will provide the information to the issuer.

Custodians operate on a tight time schedule. Brokers must respond to search card inquiries within seven business days of receipt. Banks, because of layering, have a bit more complexity than brokers. Banks must identify all respondent banks within one business day of receipt of the search card.<sup>50</sup> They then have seven business days to indicate the approximate number of beneficial owners holding the issuer's shares (not counting the respondent banks' shares). In determining the number of beneficial owners, the banks must include all those with the power to vote or to direct the voting of shares.<sup>51</sup> See Figure 5b.

Under the NOBO/OBO system, the custodians do not provide the identity of the account holders, unless the account holders have affirmatively opted to be "non-objecting beneficial owners." Because the regulatory default setting is non-disclosure, in the normal situation, the issuers will not be given the identify of the shareholders, only the number of accounts and number of shares in those accounts. ADP, as an agent of the custodians, has access to this information and thus plays the critical role of distributing the proxy materials, etc., to the beneficial owners.

Once the issuer receives the initial response from banks identifying respondent banks, it must send search cards to the respondent banks, and the process is then repeated for subsequent layers.

[INSERT Figure 5a and 5b]

## **ii. Step 2: distributing the material, soliciting the vote**

Once the issuer has identified its beneficial owners, it must provide each record holder and respondent bank with sufficient copies of the proxy card, proxy statement, and annual report. The issuer is also required to pay the costs of the banks and brokers for distributing them.<sup>52</sup> NYSE and NASD have rules setting the charges that ADP, acting on

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<sup>49</sup> required under SEA Rule 14a-13

<sup>50</sup> 14b-1(a)(3).

<sup>51</sup> 14b-(2)(a)(2).

<sup>52</sup> Rule 14a-13(a)(5).

behalf of NYSE member firms, may charge listed firms.<sup>53</sup> Banks, with no similar organization to set rates, typically follow the NYSE rates.<sup>54</sup>

The issuer will send a proxy packet (proxy cards, annual report and proxy statement) directly to the identified respondent banks, or their designee (again, typically ADP). Upon receipt of the proxy materials and annual reports, brokers, banks and respondent banks (or their agent, again ADP) have five business days to forward them to beneficial owners. Banks must forward either an executed proxy card or a request for voting instructions with the materials.<sup>55</sup> Brokers must also send beneficial owners either executed proxies or requests for voting instructions.<sup>56</sup> See Figure 6.

[INSERT Figure 6]

### iii. Step 3: Voting

At the beginning of the process, DTC executes an omnibus proxy in favor of its participant firms. In the case of bank custodians, the custodian will execute an omnibus proxy in favor of the respondent banks who, in turn, will execute omnibus proxies in favor of their (second tier) respondents, and so forth.<sup>57</sup> Custodian banks and brokers will typically not execute proxies in favor of their customers but, instead, will (through ADP) solicit voting instructions.

Once the proxy materials and requests for voting instructions are distributed, the emphasis now shifts to receiving voting instructions. ADP is the key player at this stage. When everything works perfectly, ADP receives the instructions from those with voting authority, verifies receipt, verifies that those voting have authority to do so, executes the proxy on behalf of its custodian (bank or broker) principal, and then forwards the proxies to the “tabulator.” See Figure 7. The tabulator, who is hired by the issuer and charged with the task of checking the validity of proxies received and then tabulating the votes, then checks to make sure that the number of nominee shares voted equals the number of shares that DTC indicates are held in nominee name and forwards the results to the board. [CHECK THIS].

**[MOVE UP]:** Frequent tabulators include [name the main companies]. It is a task often taken on by the issuer’s transfer agent [is this true?]. More recently, ADP has been expanding into this function.

[INSERT Figure 7]

## III. Pathologies of Shareholder Voting: What Can and Does Go Wrong

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<sup>53</sup> NYSE rule 465; NASD?

<sup>54</sup> Rule 14b-2(g)

<sup>55</sup> 14b-2(c).

<sup>56</sup> This too derives from NYSE rules. Cite.

<sup>57</sup> 14b-2(b)(i).

A comparison of Figures 1 and 7 shows the source of the problems that we discuss below. The complexity of the custodial ownership system, combined with the pressure of numerous shareholder votes, creates a system that is far more complex and fragile than that anticipated by the Delaware legal structure. Every year, during proxy season (March to May), \_\_\_ public companies hold their annual meetings. During this period, \_\_\_ sets of proxy materials are sent out, \_\_\_ voting instructions received, etc. It is an accident waiting to happen.

An aggravating factor is that, from the perspective of both issuers and custodians, the voting process is a necessary chore, not a profit center. The issuers must solicit proxies because they need a quorum to act. The custodians must, under federal law, assist in the identification of beneficial owners, distribution of materials and collection of proxies. They typically delegate that task to ADP which is in the happy position of being hired by the custodians but presenting its bill to the issuers.

This system produces three types of pathologies. First, there are problems caused by the sheer complexity of the system. Second, there are problems caused by misalignment of the property concepts implicit in the voting system and the property rules that, in fact, govern shares held by nominees. Third, there are the pathologies that arise from the incentives to game a system as complex as this one.

#### **a. Pathologies of Complexity**

We start with problems that flow from the complexity of the system and cause significant problems, even though they exhibit little *conceptual* complexity.

##### **i. Pathology 1: Materials don't arrive**

The corporate voting system operates on a tight time schedule. As noted earlier, the record date, under Delaware law, cannot be more than 60 days before the meeting. For shares held in nominee name, the following steps must occur before the materials are mailed out: the issuer sends an inquiry to DTC which must respond; the issuer then sends out search cards to the custodians, who must respond; then, and only then, can the issuer send out the materials to be distributed. Given this complexity, there will be numerous cases in which the proxy materials and the request for voting instructions simply do not make it to the beneficial owner in time for the beneficial owner to vote.

[See if we can find some estimate of percentage of beneficial shareholders who get the material too late to vote. Check in the various Congressional hearings and reports]

Does it matter? Perhaps. First, some shareholders who wish to vote and have a right to vote cannot because the materials do not arrive in time. Second, it can make it more difficult for issuers to meet their quorum requirements which, as a default rule, are set at 50%, but can be modified by charter to no less than 33.3%. Third, it makes it more

difficult for other contestants (activists or those running proxy fights) to reach the corporate electorate.

Does this sort of non-voting skew the results in any predictable way? “Non-votes” resulting from the non-delivery of proxy materials are, for legal purposes, treated identically with non-votes because of apathy or carelessness. Under NYSE rule 452, brokers may use their discretion to vote shares on routine and uncontested matters as to which the broker does not receive instructions ten days in advance of the meeting: “a member organization . . . may give or authorize the giving of a proxy to voted such stock, provided the person in the member organization giving or authorizing the giving of the proxy has no knowledge of any contest as to the action to be taken at the meeting and provided such action is adequately disclosed to stockholders and does not include authorization for a merger, consolidation or any other matter which may affect substantially the rights or privileges of such stock.” Under Rule 452.11(2), contests are defined to be matters which are “the subject of a counter-solicitation, or is part of a proposal made by a stockholder which is being opposed by management (i.e., a contest);”

Bank custodians are not covered by this rule (as they are not members of the NYSE), and their ability or duty with regard to uninstructed shares is not covered by federal law. Under Delaware law, banks, as the record owner, have the power to vote uninstructed shares, unless there is an agreement to the contrary. Typically, this will be one of the issues covered in the agreement between the custodial bank and its customer. Most bank customers do not authorize the bank to vote uninstructed shares.

With respect to routine votes, non-delivery of materials arguably helps management because the brokers can be counted to cast their votes in favor of management.

With respect to non-routine votes, the non-delivery of materials (and thus the non-vote by beneficial owners) has a less clear impact. In recent years, it has become clear that even uncontested elections of directors can in fact be controversial, and thus should not be viewed as “uncontested matters.” Consider, for example, a institutional shareholder’s “just vote no” campaign in an uncontested election of directors: the number of votes withheld is the key indicator of shareholders’ dissatisfaction with the incumbent management. In June 2006, a NYSE Working Group recommended that the rule be modified to make clear that uncontested directorial elections should no longer be deemed routine. [Effective 2008]

It is plausible to assume that the beneficial owners who do not receive the materials tend to be the least sophisticated shareholders. If true, then the non-voting (either because of apathy or non-delivery) will tend to magnify the influence of the more sophisticated shareholders. This is why the question whether uncontested elections or executive compensation should be deemed “non-routine” matters under Rule 452 and thus not subject to broker non-votes is controversial. Indeed, when a “majority vote” provision is added for director elections, the rule change will mean that “just vote no” campaigns will gain in effectiveness.

Unlike the NYSE, Delaware ignores the problem of non-votes (arising from either non-delivery of materials or non-voting because of apathy), and views this as an assumed risk of custodial holding.<sup>58</sup> Where non-votes could, in theory, pose a problem for the firm – either with regard to satisfying a quorum requirement or electing directors or approving corporate actions – the Delaware rule that permits the record owner to vote its shares provides clarity even if it is at the expense of reflecting actual shareholder sentiment.

## **ii. Pathology 2: Votes that are not counted**

Consider the following situation: the beneficial owner receives the proxy materials in time from ADP, complies with ADP's instructions on when voting instructions are due (e.g., 11:59 pm on the day before the meeting), sends in the voting instructions which ADP acknowledges receipt of. ADP then executes a proxy embodying these instructions, sends in the proxy to the vote tabulator only to be told that the vote tabulator had already stopped tabulating votes (e.g., at 4 pm on the day before the meeting) in order to be able to prepare its report for the inspector of elections in a timely manner. As a result, the beneficial owner's votes are not counted.

We are told that this is a real problem. It happens that institutional investors with large holdings will send in their voting instructions to ADP in a timely manner only to read the next day that the proposal or whatever passed or was defeated by a margin that clearly did not reflect their votes. Upon inquiry, the institutional investor is told that while they got their instructions to ADP in time, the tabulator had already finished tabulating by the time it received the instructions.

This “non-voting” matters because, in many contemporary circumstances (e.g., shareholder proposals, director elections, approval of executive compensation plans), the magnitude of a no-vote and the margin of victory are important indicators of shareholder dissatisfaction.

The law governing the appointment and role of inspectors is surprisingly sparse. DGCL §231 requires that inspectors be appointed in advance of all meetings of publicly held corporations, and gives them the responsibility for ascertaining the number of shares outstanding, determining the shares represented at the meeting and the validity of proxies counting votes and ballots, and certifying their determination of the number of shares represented and the count. Section 231 further provides that “the date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote at a meeting shall be announced at the meeting. No ballot, proxies or votes, nor any revocations thereof or changes thereto, shall be accepted by the inspector after the closing of the polls unless the Court of Chancery upon application by a stockholder shall determine otherwise.”

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<sup>58</sup> Citation

Typically, the polls are opened officially during the meeting to receive proxies and ballots (from those shareholders present).<sup>59</sup> The official closing of the polls is more complicated. Often, the meeting will be adjourned to a later date for the announcement of the results, which allows the counting of the votes and resolutions of problems..<sup>60</sup> In a “simple, uncontested meeting”, the results of any vote may be tabulated and announced without adjournment.<sup>61</sup> The question, as with broker non-votes, is what counts as a simple uncontested meeting. In an uncontested election of directors, the inspectors may view it as an uncontested meeting and, in order to permit announcement of results without an adjournment, will stop counting the votes sometime the day before in order to be able to prepare a report in a timely manner. It seems that it is in these circumstances that a shareholder late vote against the management slate of directors may end up uncounted.<sup>62</sup>

### **iii. Pathology 3: The Nightmare of Verification**

The most important pathology of complexity is the system’s inability to provide vote verification and an end-to-end audit trail. A voting system is only as good as its post-election system of verification. If the vote tally cannot withstand scrutiny, it will not be believed. The complex system of holdings, combined with the circuitous system of distributing materials, soliciting proxies and collecting voting instructions, creates a nightmare of verification.

The first complexity arises because shareholders may hold shares both directly and in street name, and some shareholders, such as banks and brokers, may hold shares directly, in street name for their own accounts, and in street name for customer accounts. ADP, which acts on behalf of the broker and bank custodians, seeks voting instructions and, as they come in, “tabulates the votes received and sends a ‘multiple proxy’ to the tabulator.”<sup>63</sup> The first multiple proxy is typically issued 15 days prior to the meeting with daily updates from the 9<sup>th</sup> day.<sup>64</sup> Banks and brokers will “frequently use ‘partials,’ i.e., proxies voting less than all of the shares they are entitled to vote.”<sup>65</sup> These partial are cumulative which means that great care is required to prevent the custodian from voting more shares than it is entitled to. With respect to nominee shares, the custodians are voting on behalf of their customers who may have differing views. The proxies will thus be split between “for” and “against” and “abstain.”

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<sup>59</sup> Balotti et al, Meetings of Stockholders at §8.12

<sup>60</sup> Id.

<sup>61</sup> Id.

<sup>62</sup> The situation is more complicated with respect to selectively holding the polls open longer for specific matters where the board has not succeeded in gathering sufficient support. In *SWIB v. Peerless Systems*, C.A. No. 17637 (Del Ch Dec. 4, 2000), the Chancery Court considered such a situation under a Blasius analysis.

<sup>63</sup> Balotti at 10-12-13.

<sup>64</sup> Id.

<sup>65</sup> Id.

With this complexity, problems are common. The leading treatise on shareholder meetings, recounts the following (illustrative but hardly exhaustive) problems:

- “Because of the multiple mailings by each side and the increased pressure placed on the brokers by proxy solicitors, there are some banks and brokers who overvote their position. Some bank [and] brokers will vote all their shares for both sides; others will change their vote without revoking previously voted shares are varying amounts.”<sup>66</sup>
- “Bank proxies sometimes present problems in a contest. . . . Unfortunately, banks sometimes combine accounts at will in voting proxies. The best the inspectors can do is match proxies by account numbers and vote the latest dated proxy for each account. However, banks frequently return proxies for large numbers of shares which do not bear an account number. Upon investigation, the inspectors are told that these proxies are a combination of accounts which the banks can or cannot identify at this time.”<sup>67</sup>
- “[When there is piggybacking],<sup>68</sup> all of the shares of the small bank are given one account number by the large bank, even though there are a number of beneficial owners represented by the small bank. The result is that inspectors receive bank proxies with the same account number bearing varying numbers of shares.”<sup>69</sup>

Over and above these problems, there is a particular piece of the process which is opaque, as will be discussed in more detail below. When a broker or bank over-vote occurs, it is the responsibility of the custodian to adjust the number of votes cast to the number of shares it holds of record and are reflected in the omnibus proxy and its direct holdings. Sometimes the custodian simply does not do so, as in the recent case in which Deutsche Bank was fined \$1 million by the NYSE.<sup>70</sup> In other cases, the custodian, alerted to an overvote, goes into the ADP system, to which it has access, and “fixes” the problem. As will be discussed in more detail, how it fixes the problem is entirely opaque and subject to different practices. This is of particular concern as it can be outcome determinative in a close contest.

### **b. Pathologies of Ownership: Confusions as to Who “Really” Owns the Shares**

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<sup>66</sup> Balotti at 10-16,17. In these cases, the inspector contacts the proxy clerk to resolve the overvote, as permitted by 231. “Some firms cooperate with the inspectors when they overvote; others refuse to change their vote, maintaining that they hold the number of shares they voted. . . . Any broker or bank proxies that cannot be resolved by telephone are not counted, but reported as unresolved.” *Id.* at 10-16.

<sup>67</sup> *Id.* at 10-16.

<sup>68</sup> Discussed above at \_\_.

<sup>69</sup> *Id.*

<sup>70</sup> In the matter of Deutsche Bank Securities Inc., NYSE, Review of Exchange Hearing Panel Decision 05-45, February 2, 2006, available at: <http://www.nyse.com/pdfs/05-045.pdf>. This was part of a more general concern with overvoting by the NYSE. See NYSE Information Memo No. 04-58 (Nov. 5, 2004) (“Several recent special examinations of member organizations’ proxy departments have discovered significant areas of concern involving an apparent systemic over-voting of proxies and a general lack of effective supervision.”)

The second set of pathologies arise because of a misalignment of the property concepts implicit in the voting system and the property rules that, in fact, govern shares held by nominee. As discussed earlier, while corporate and securities law think of the beneficial owner as the true owner of the shares, the relevant property rules – established by UCC Article 8 – are fundamentally different. Under Article 8, the beneficial owner is nothing more than a “security entitlement holder.” As we show in this section, when this framework is combined with modern custodial practices, there can be surprising results with unclear legal guidance.

#### **i. Pathology 4: Securities Lending surprise**

We will start with a simple case first. Suppose that an institutional investor wishes to vote its shares only to discover that they have been “lent out”? This happens. There is a well known anecdote of a prominent institutional investor who had campaigned vigorously for a shareholder proposal only to discover after the record date had passed that it had no shares to vote because it had “lent” them out. Indeed, if the institutional investor is the proponent of a shareholder proposal but all the shares have been “lent out”, under 14a-8, the proposal will have to be withdrawn because the rules require that the proponent hold shares through the meeting.

But what do we mean? How is it that you do not remain the beneficial owner even after you have lent your shares? To understand this pathology, we need to discuss a bit of detail. There is an active market for the borrowing and lending of securities. Securities lending serves a variety of purposes, including importantly short selling. When an investor believes that shares are over-valued and will soon decline in price, it can profit by selling the shares now (at the high price) and then covering the position later at a low price once the price has declined. Because “naked” short selling is illegal,<sup>71</sup> the investor must “borrow” shares in order to sell them now at the high price. Later, he will buy the same class and quantity of shares, hopefully at a lower price, and restore them to the securities lender.

As this example demonstrates, the terms “lending” and “borrowing” are not accurate. Instead, in a securities “loan”, the “lender” in fact is transferring full legal right in the shares to the “borrower” in exchange for a promise to transfer equivalent (but different) shares in the future, a commitment to make the lender whole on any dividends paid during the loan period plus a fee and collateral. This means that when a shareholder “lends” its shares out before the record date, the shareholder is not a shareholder as of the record date and is not entitled to vote, whether or not “returned” shares are received prior to the meeting.

As noted earlier, securities lending is a highly profitable business. Firms are estimated to make around \$5 billion per year from securities lending, with CalPERS alone making about \$130 million per year from its operations. Typically, large institutional investors will either have the custodian bank handle the securities lending or will put the business

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<sup>71</sup> Reg. SHO.

out to bid to a third party specialist. This means that it may well be the case that the personnel in the institutional investor with responsibility for voting the shares may not even be aware that the shares are out “on loan.” Hence the embarrassment of discovering that the institutional investor does not have any shares to vote for its own proposal.

There is nothing mysterious or illegal here. Institutional investors have access to records of their securities lending operations and can, if they choose, decline to lend out their shares, or recall them in advance of meetings at which they intend to raise issues or campaign for proposals. But, while the institutions may bring the problems on themselves, the problems potentially have systemic effects. Much recent reform has rested on the assumption that institutional investors are potentially more engaged shareholders than individual investors. If the temptation of securities lending diverts them from a corporate role, it may undermine the greater monitoring that institutions might provide. Indeed, it may be yet another explanation for the relatively disappointing performance of institutional investors in corporate governance.

The problem that the institutions find themselves in is a consequence of the standard rules of corporate law combined with the practice of securities lending. Under Delaware law, only record owners or those who receive proxies from record owners are permitted to vote. If an investor transfers its shares prior to the record date – either as part of a “securities loan” or for any other purpose – it is no longer entitled to vote, unless it retained the voting rights by receiving a valid proxy from the transferee. Because, in “securities loans”, the right to vote the share follows the share, the lender is not entitled to vote those shares.

Avoiding this problem is non-trivial. The illustration used above is easily handled: when an institution has a shareholder proposal in the proxy materials, it certainly can ask its securities lending operation not to lend its shares of that particular company during the relevant period. But, while that addresses the embarrassment of withdrawing a proposal because you have lent out your shares, it does not address the deeper problem of institutions who cannot vote their shares responsibly on a contested matter (either an election or a shareholder proposal or an executive compensation plan or something else) because their shares have been lent out.

There is no easy solution that allows the institutions to maintain the flow of lending revenue without compromising their ability to play an active role as shareholders. Could the institution simply recall all its shares and freeze new loans around all record dates of portfolio firms? They could, but doing so would destroy their securities lending program and sacrifice hundreds of millions of dollars of revenue and, at least potentially, constrict the lending market.

Here’s why. Most securities lending programs combine the shares of a large number of customers. Recalls of lent shares or freezes on lending complicate the securities lender’s job in a way that does not increase the lender’s profits. Because of this, if a participant in a securities lending program regularly or always recalls/freezes shares in advance of the record date, the securities lender will simply give preference to the many participants

who do not impose any limitations, and will not lend the institution's shares out unless no other shares are available. The effect of such a policy is thus effectively to opt out of securities lending, a very expensive decision.

Could the securities lender solve the problem itself by retaining the vote by securing a proxy from the borrower? No. Because borrowed shares are unrestricted shares and are typically sold through public markets to anonymous buyers, it is impracticable to retain the voting rights by requiring the anonymous buyer to execute a proxy.

Finally, a solution is further complicated by the gap between fixing the record date and announcing the date of the meeting. Under Del GCL 213, the board of directors must fix the record date between 60 and 10 days before the meeting and not before the date of the board resolution. Under New York Stock Exchange rules, the issuer must announce the record date ten days in advance.<sup>72</sup> So suppose that the board fixes the record date for February 1. Later, on March 1, it announces – consistent with the bylaws which typically allow the board to fix the date of the annual meeting – that the annual meeting will be April 1. Even if the proxy voting people at the institution immediately put a freeze on lending the shares of the issuer and recall all shares lent out, it will be too late: any shares that were lent out as of February 1 will not be able to be voted.

These problems, of course, can be lessened to the extent that proponents of shareholder proposals publicize their intention to make a proposal well in advance of the meeting. In proxy contests, however, the challengers may not want to provide that warning.

## **ii. Pathology 5: Over-Voting when there is Short-Selling**

The “securities lending surprise” arises on the bank-custodial side where the customers maintain control over their shares but may choose to lend them out for some extra money. This can cause mischief, as we just saw, but the mischief is ultimately of the institutional investor's own making. On the custodial broker side, the potential mischief is more troubling and less easily resolved because of differences in the contractual arrangements governing custody.<sup>73</sup>

A key issue in running a corporate election is ensuring that shareholders do not try to vote more shares than they own. With respect to shareholders who hold shares in their own name and appear on the stock list, the inspector of election will simply compare the number of votes cast with the number of shares, and, if more votes are cast than are held, will normally invalidate the proxy, unless it can be reconciled pursuant to §231.<sup>74</sup> With custodial owners, the same thing can happen because of clerical errors. A nice

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<sup>72</sup> NYSE Listed Company Manual ¶204.21.

<sup>73</sup> Randall Thomas & Catherine Dixon, *Aranow and Einhorn on Proxy Contests for Corporate Control* (3d edition, 2001) at §15.05[C], Balotti et al., §10.7, and Hu and Black (2006a and 2006b) discuss issues of over-voting.

<sup>74</sup> *Seidman v. GA Financial*, 837 A.2d 21 (Del. Ch. 2003).

illustration appears in *Seidman v. GA Financial*.<sup>75</sup> Bank of New York (BONY), after receiving an omnibus proxy from DTC for 859,647 shares, representing its record position, then issued two further, omnibus proxies to banks for which it held shares for 625,771 and 1,500 shares. BONY then voted 233,200 shares directly. The problem, of course, is that this adds up to 824 shares *more* than its record ownership. When the inspector of election called the proxy clerk at BONY, no clarification was provided. Here, because the overvote could not be reconciled, the court disqualified the two proxies submitted by BONY for a total of 233,200 shares.

While clerical errors can cause overvotes, short selling aggravates the situation. In the standard margin account agreement between brokers and customers, the broker has the right to “lend” out the shares in the account, and to keep the fees for doing so, without notifying the customer.<sup>76</sup> This is true whether or not the margin account holder has borrowed from the broker.<sup>77</sup> It is also standard practice for the broker not to identify from which accounts “lent” shares have been taken.

These standard practices can and do cause significant problems. Consider Figures 8 and 9. Suppose, for example, that Morgan Stanley has 1,000,000 shares of X in its DTC account, while Smith Barney has 500,000 shares in its account. A hedge fund customer “borrows” 100,000 shares from Morgan Stanley and, to go short, sells them to a customer of Smith Barney. Once that sale is completed, the DTC records will show that Smith Barney has 600,000 shares while Morgan Stanley now has 900,000 shares.

[Figure 8 here]

Now the possibility of an over-vote is clear, as illustrated in Figures 10 and 11: DTC’s omnibus proxy will transfer the right to vote 900,000 shares to Morgan Stanley, and will inform ADP of this. Morgan Stanley, by contrast, will give ADP a list of all its customers’ holdings in Delaware Inc. (for a total of 1 million shares). ADP will then send out proxy materials according to the brokers’ customer lists, with the result that it will send out more proxy materials (including proxy cards representing more shares) than are in fact entitled to vote. In this example, although Morgan Stanley and Smith Barney collectively hold only 1.5 million shares, their customers will receive proxy cards representing 1.6 million shares.

What should happen if ADP receives voting instructions for 1 million shares from the Morgan Stanley customers? It clearly should only cast votes for 900,000 million shares

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<sup>75</sup> 837 A.2d 21 (Del. Ch. 2003).

<sup>76</sup> Cite.

<sup>77</sup> The broker’s ability to “lend” out shares in a margin account (with or without notification to the account holder) creates a variety of other complications that we cannot address at length here. First, because the securities “borrower” makes payments to the “lender” in lieu of dividends, and because the tax treatment of dividends is different from the tax treatment of “payments in lieu of dividends”, there are tax consequences. Second, because a securities “loan” is in fact a sale, it should trigger capital gains tax. Third, for the same reason, it should affect standing to bring a derivative suit (which has a contemporaneous and continuous ownership requirement) as well as standing to seek appraisal.

yet, if all vote, it can receive instructions for 1 million. Who is entitled to vote if instructions are submitted for all 1 million shares in the customer accounts?

Under NYSE rules, it is clearly Morgan Stanley's responsibility to reconcile this "over-vote" but how should it do so? The problem typically does not arise because of systematic undervoting of shares. So long as ADP does not receive voting instructions for more than 900,000 shares from Morgan Stanley customers, there is no inconsistency between the voting instructions and the omnibus proxy from DTC. But the problem is still present in under-voting: when there are unallocated securities loans, some of the customers giving voting instructions may not, or should not, be entitled to vote.

The New York Stock Exchange is aware of, and worried about, this problem. As it stated in a recent information memo: "Several recent special examinations of member organizations' proxy departments have discovered significant areas of concern involving an apparent systemic over-voting of proxies and a general lack of effective supervision."<sup>78</sup>

Current practice is that the tabulator notifies the broker [or does ADP notify the broker?] when there is a discrepancy between the number of shares voted and the number of shares that DTC indicates are held for the broker. At that point, it is the responsibility of the broker to reconcile the two.

Sometimes the broker simply refuses to do so. This is what Deutsche Bank Securities did from 1998 to 2003, according to the NYSE, and for which it was fined \$1 million for failure to supervise.<sup>79</sup> The *Deutsche Bank* case gives some indication of the dimensions of the problem. According to the NYSE report summarizing the NYSE's Division of Member Firm Regulation's (MFR's) examination:<sup>80</sup>

26. For 2003, the MFR Examination identified 12 instances, out of 15 tested, in which Respondent over-voted, that is, Respondent submitted more proxy votes than it was entitled to cast, in connection with proxy matters. For example, in March 2003, Respondent cast a total of 8,537,151 shares in a proxy matter involving "XYZ." (record date March 4, 2003). As of the record date, according to the information maintained at DTC, Respondent in fact was eligible to vote only 4,232,867 shares. Thus, the over-vote in this matter was 4,304,284 shares. The over-votes submitted by Respondent in the other 11 proxy matters in 2003 ranged from 16,710 shares to 2,152,721 shares.

27. Enforcement's investigation disclosed that, in 2002, Respondent over-voted in 11 instances out of 12 tested. For example, in March 2002, Respondent cast a total of 11,168,338 shares in a proxy matter involving "XYZ" (record date March 5, 2002). As of the record date, according to the information maintained at DTC,

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<sup>78</sup> NYSE Information Memo No. 04-58 Re: Regulation of Proxy Activities and Over-Voting (November 5, 2004)

<sup>79</sup> In the Matter of Deutsche Bank Securities Inc., NYSE Request for Review of Exchange Hearing Panel Decision 05-45 (February 2, 2006).

<sup>80</sup> Id.

Respondent in fact was eligible to vote only 6,679,676 shares. Thus, the over-vote was 4,488,662 shares. The over-votes submitted by Respondent in the other 10 proxy matters in 2002 ranged from 31 shares to 1,876,283 shares.

28. Respondent's failure to reconcile the stock record in connection with proxy voting instructions was a central cause of the over-votes set forth above. In these uncontested matters, Respondent voted shares up to its unreconciled unadjusted long position, which was generally greater than its DTC position.

*Deutsche Bank* is a case in which the broker failed to reconcile the over-vote. When there is no reconciliation, there is no standard industry practice in what the tabulator should do. As the NYSE pointed out, "Tabulators may respond to over-votes with a variety of vote-counting procedures, including counting votes on a first in-first voted or last in-first voted basis, or disregarding altogether a vote submitted by a broker dealer."<sup>81</sup>

But how *should* the broker reconcile the overvote? There is simply no answer under current law and practice. Because the shares are held in fungible bulk, there is no way, even in theory, to trace whose shares were lent to the short seller and subsequently sold to the Smith Barney customer. The potential problem has been noted for a long time. A 1991 House report recommended that the SEC promulgate a rule to handle this situation, and, specifically, a rule that prohibits brokers and dealers "from soliciting proxy voting instructions from or giving proxies at the direction of beneficial owners for more shares than the net amount owned beneficially by each beneficial owner, as shown on the books and records of the broker or dealer, after subtracting the short security positions of each beneficial owner."<sup>82</sup> If followed, this would solve the problem up front, but still does not provide any principle for determining which of the customers is entitled to vote. Moreover, as far as we can tell, this recommendation was never adopted.

A more complete solution would be to require that brokers allocate the securities loan to a specific account at the time that it is made. While the brokers would obviously prefer not to do so (because customers may ask for a portion of the fees from lending), they may be forced to do so because of the changed tax treatment of dividends. Qualifying dividends are now tax free. When securities are loaned, part of the standard agreement between the "lender" and the "borrower" is that the borrower will make the lender whole for any dividends or other distributions paid during the term of the loan. The legislative history makes clear, however, that "Payments in lieu of dividends are not eligible for the lower rates."<sup>83</sup> Thus, the IRS has indicated that brokers must distinguish between the two.<sup>84</sup> [HAVE THEY BEEN DOING SO?]<sup>85</sup>

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<sup>81</sup> Id. at para 11.

<sup>82</sup> "Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation," Part I, Report of the Committee on Government Operations, U.S. House of Representatives, Dec. 6, 1991, at 33.

<sup>83</sup> H.R. REP. NO. 108-94, 108th Cong., 1st Sess. 31 n.36 (2003).

<sup>84</sup> Internal Revenue Bulletin: 2003-40 (October 6, 2003), Notice 2003-67 (The Jobs and Growth Tax Relief Reconciliation Act of 2003—Information Reporting for Payments in Lieu of Dividends).

There are several collateral effects that would flow from attribution of securities lending to specific accounts. First, because a loan is a sale, it would trigger tax on any capital gains. Second, it would break the holding period which is important for tax treatment (short term versus long term capital gains), derivate suit standing (with its requirement of contemporaneous and continuous ownership), and the right to appraisal (with its parallel requirement).

Another approach would be to follow the UCC Article 8 structure. As discussed earlier, the securities intermediary has an obligation to “exercise rights with respect to a financial asset if directed to do so by an entitlement holder”.<sup>86</sup> This includes soliciting and fulfilling voting instructions. In addition, under UCC Article 8-503(b), when the broker does not have enough shares to cover all of the securities entitlements, “An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.” Together, these rules provide a basis for requiring the same pro rata allocation of votes among the voting customers when an over-vote occurs.<sup>87</sup> Under a pro rata rule, the solution in the example above (figure 10) would be to reduce each margin holder’s votes by 10%.

This leaves open the question of how the court should handle proxies involving overvotes. In *Seidman*, the court excluded the omnibus proxies issued to piggy backed custodian banks from the overvote, but did disqualified the proxies submitted by BONY. Although in that case, it did not affect the outcome, it could have. An unresolved overvote by BONY of 824 shares resulted in the disqualification of 233,276 shares.

### **c. Pathology 6: Gaming the System and “Empty Voting”**

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<sup>85</sup> Given the tax treatment, and the broker’s flexibility in attributing the loan, one would predict that the brokers will first attribute loans to non-taxable accounts.

<sup>86</sup> UCC 8-506.

<sup>87</sup> A counter argument is that UCC Article 8 is designed solely to govern custodial arrangements and to minimize failed securities transactions and should not be viewed as a source for more general obligations between brokers and customers. As the drafter of revised Article 8 argued, “Indeed, one of the main reasons to insist upon a fairly sharp division between the custodial function governed by Revised Article 8 and the other functions of securities professionals not treated by Article 8 is to assure that the rules and approaches appropriate to the ministerial role of a securities custodian will not be misinterpreted as bearing upon the obligations that securities firms incur by performing nonministerial functions.” James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 *UCLA L. Rev.* 1431, 1497 (1996). On the other hand, the property rules established by Article 8 inevitably impact other areas of the law that depend on the allocation of property rights. See, e.g., UCC 2-401 where the property allocation established under Article 8 governs.

In a system as complex as this one, opportunities abound to game the system. In this subsection, we examine the high profile example of “empty voting.”

As if the problems intrinsic to the corporate voting structure and system are not bad enough, of late a wonderfully esoteric and theoretically interesting pathology has emerged which goes by the name of “encumbered shares”<sup>88</sup> or “empty voting.”<sup>89</sup> We address it briefly here because it illustrates a particular sort of gaming of a complex system. We do not address it in detail for two reasons. First, it has already been the subject of substantial scholarly attention and we do not have much to add to the existing treatment.<sup>90</sup> Second, there is little evidence that it has real world significance.

The most famous example arose in the proposed Mylan King merger. In July 2004, Mylan Laboratories entered into a merger agreement with King Pharmaceutical, according to which, subject to shareholder approval, Mylan would acquire King for Mylan shares. Perry, a hedge fund, was a large shareholder in King (approximately 7 million shares) and supported the merger. While the deal was seen as favorable to King, the market reaction to the merger for Mylan was negative and some large shareholders of Mylan, including Carl Icahn, threatened to vote against it. As a result, approval of the merger by Mylan shareholders was in doubt.<sup>91</sup>

Perry then acquired 9.9% of Mylan’s shares. At the same time, Perry apparently entered into “equity swaps” with Bear Stearns and Goldman Sachs which fully hedged its economic exposure to Mylan’s share price. As a result, Perry acquired shares -- and votes -- in Mylan, which, because it had no economic stake in Mylan, it could vote purely on the basis of his interest as a King shareholder – and thus in favor of the merger. Indeed, this was presumably Perry’s purpose. See Figure 12.

[Figure 12 here]

The divergence between the interests of Perry and those of other Mylan shareholders is evident. If the merger is good for King but bad for Mylan, as many Mylan shareholders apparently felt, Perry would still vote its sizeable position in Mylan in favor of the merger and could help push it through. As it happened, King had to restate its earnings, which caused Mylan management to terminate the merger agreement. The success, and legal validity, of Perry’s strategy thus was not tested.<sup>92</sup>

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<sup>88</sup> Martin and Parnoy.

<sup>89</sup> Hu and Black.

<sup>90</sup> The issues relating to empty voting are extensively discussed in Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775, and Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms*, (April 2006), U. of Texas Law, Law and Econ Research Paper No. 70, available at SSRN: <http://ssrn.com/abstract=887183>.

<sup>91</sup> Robert Steyer, *New Player Joins Mylan-King Fray*, *The Street.com*, Nov. 29, 2004.

<sup>92</sup> Other, more traditional conflicts of interest in voting were also present. Icahn had a stake of about 10% in Mylan, both in terms of economic exposure and in terms of voting rights. But Icahn also had a shorted 5.3 million shares of King stock. *Icahn Wins as Mylan-King deal Dies*, *Forbes.com Newsletter*, Mar. 4, 2005. Icahn could thus have an economic interest to oppose the merger, even if the merger were in the

Once one notices it, voting with conflicting interests is a pervasive condition. Because of the volume of trading, millions of shares change hands between the record date and the meeting date. In trades through public markets, it is impossible for the purchaser to secure a proxy from the seller. This leaves the votes with the record date shareholder who has no economic interest in the shares. Some institutional shareholders have a policy of not voting such shares.<sup>93</sup> But there is no legal prohibition on the voting of such shares. As will be discussed below, a simple solution to this problem would be available if we redesigned the architecture of securities holding.

#### **IV. Implications and Avenues of Reform**

The corporate voting system is a mess. The existing systems are not capable of reliably determining the outcomes of close contest. Moreover, the technical inadequacies of the system can be exploited. In this section, we examine some of the implications of these conclusions.

##### **a. Overall Bias or Skew?**

While the system is clearly a mess, to what extent does it bias or skew the outcome of shareholder votes? If the errors are evenly distributed, then, from an ex ante perspective, some might argue that the mess does not matter.

There are a number of reasons to be concerned. First, there is an overarching concern for the legitimacy of the corporate voting system. While one might well argue that, ex ante, the inadequacies of the Florida punch card ballot system in the 2000 presidential election were evenly distributed between Bush and Gore, and that the infirmities had an equal chance of tilting the election towards one or the other, that is hardly an adequate response to the challenge posed by that election. Whatever the overall distribution of errors, the participants in a specific election have a very large stake in the accuracy of the outcome of that election. Whatever the bias, shareholders who cannot vote because the materials do not arrive – or shareholders who do vote but whose votes are not counted – have grounds for complaint. The inability of the current system to provide vote confirmation and an audit trail is an embarrassment that can not be papered over forever by Delaware’s “not my problem” establishment of legal presumptions.

Second, it is not obvious that infirmities do not bias outcomes, although the bias they introduce is likely to vary as between shareholders and managers and among shareholders

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interest of Mylan, as long as the market thought that the merger would be significantly more beneficial to King. In that event, Icahn would gain more from a defeat of the merger through his short position in King than he lost on account of his long position in Mylan. Suppose Icahn shorted the King shares at \$30 per share, that the shares would go up to \$40 per share if the merger is completed but down to \$20 per share if the merger fails. Icahn would then profit from defeating the merger if his profits from shorting are greater than the increase in the value of his Mylan stake from approving the merger.

<sup>93</sup> Remarks of Eric Roiters, Fidelity, at Columbia conference.

in particular situations. Because of the system of “broker non-votes”, non-voting by beneficial owners has historically benefited incumbent boards. On the other hand, with the change to majority voting, and the change in broker non-voting under NYSE rules, non-voting will now benefit shareholders pursuing a “just vote no” strategy. To the extent that issuers control tabulators, the closing of the corporate polls can be (and, we’re told, has been ) used strategically to minimize negative votes.

The effects of confusion over ownership are harder to discern. The non-voting by institutions because they have lent out their shares may reduce turnout if the purchasers of loaned shares are less likely to vote them than the lender.

Finally, the effects of gaming a system as complex and inadequate as the current one should not be underestimated. The possibility that a shareholder might affect the outcome of a close contest by engaging in empty voting stand as a warning of the possibilities for mischief in a system that does not take vote verification or an audit trail seriously. With the amounts potentially at stake, one should be wary of complacency.

[[[Other biases:

Between intense and passive voters. Given the friction, voters with a big stake will try harder to get their votes counted than less interested voters. To the extent that HFs have skewed incentives, these skewed incentives will be replicated in the vote outcomes. Thus, if HFs feed short term bias and long term shareholders are less intense about their voting, then the costs of the voting system will amplify the impact of HFs and short termism.

This is accentuated by the place of short trading. Institutional investors, because they have a real dollar stake in securities lending, will vote LESS. ]]

## **b. Incremental Improvements**

There are a variety of incremental changes to the system that should be considered.

### **i. Adjusting the relation between the record date and the meeting announcement**

The non-delivery of materials is aggravated by the relatively compressed time frame between the record date and the meeting. The “securities lending surprise” pathology derives from the practice of setting the record date before the meeting and its agenda are announced. Can these problems be reduced by changing the record date or by tinkering with the relationship between the record date and the announcement of the meeting?

Here we confront some of the intrinsic difficulties of the system. First, the farther the record date is from the meeting, the larger the problem of unintentional empty voting. With the high volume of share trading that prevails, the longer the time between the

record date and the meeting, the more shares will have been sold and the larger the percentage of shareholders who will be record date holders without any economic interest.

Consider another possibility. Suppose, in order to allow share lenders to recall their shares in advance of meetings in which they would like to vote, that Delaware law were changed to require the board to announce the record date ten days in advance and to publish a preliminary agenda at the same time? This would allow investors to decide whether to freeze/recall shares. But it would also allow others to buy shares in order to influence the outcome of the meeting. As one informed observer commented, “Can you imagine the volume of trading in advance of the record date?”

To some extent shareholder activists can protect themselves by announcing well in advance of a meeting that they intend to pursue some issues. This, in theory, provides an opportunity for fellow shareholders to recall their shares. While this is done, and reduces the problem, it too is subject to gaming: in most companies, the board is given the power by bylaw to set the annual meeting date and record date. While the meeting is usually around the same time every year, it need not be.

## **ii. Encouraging Improvements through Judicial Eyebrows**

Delaware law plays a critical role here. As described above, Delaware seeks to maximize certainty by adopting presumptions and ignoring the complexity of indirect ownership. The result is a system without vote verification or an audit trail. If Delaware were to shift its presumptions slightly, and instead require that the proponent of a transaction (e.g., a party claiming that a merger has been approved) has the burden of establishing that the requisite margin was achieved, the system would be transformed.

As discussed earlier, one of the reasons that the system is inadequate is that no one has either a financial or legal incentive to make it better. The custodians have legal obligations to play their part, but make no money from it and thus have no incentive to improve the system. Issuers, similarly, may be rationally indifferent given the rarity of close contests. ADP has a seemingly unassailable monopoly position and, likewise, makes no money from investing in innovating the underlying systems (as opposed to the systems related to its piece of the puzzle). How might relevant players be given an incentive to invest?

As noted above, Delaware has largely taken a hands off approach. To preserve certainty (even if not accuracy), it has long taken the view that the record holder has the right to vote and any inaccuracies are the risks that shareholders who chose to hold their shares in street name assume. Similarly, Delaware jurisprudence grants a presumption of validity to the report of the inspector, thereby placing the burden not on the party propounding the validity of an election or a merger, but on the party challenging it.

There is a variety of reasons why Delaware’s hands off attitude towards shareholder voting is short sighted. [see discussion above]. But, in this case, small adjustments to its

generally hands off approach could yield large improvements in the voting system. If, for example, in HP/Compaq, the Delaware Chancery Court had simply taken a close and skeptical look at outcome, and cast a skeptical eye (if due) on the quality of the evidentiary record supporting that outcome, that “raised eyebrow” would send a strong signal and would galvanize attention. If participants thought that there was a chance that a vote would be rejected because of an inadequate audit trail, greater care would be taken at earlier stages.

### **c. Renovating the Structure: The Business Roundtable/Georgeson Proposal**

The Business Roundtable together with Georgeson, a leading proxy solicitation firm, have proposed a significant reform to the system.<sup>94</sup> In essence, they propose returning primary voting responsibility to the beneficial owners on the model of direct registration. Under the BRT/Georgeson proposal:

- On the record date, DTC would issue omnibus proxies to its members who would then pass proxies down the chain, eventually arriving at the beneficial owners.
- At the same time, brokers, banks or their agents would generate lists of beneficial owners as of the record date identifying holders and indicating the number of shares held.
- These lists would be integrated and verified into a list of shareholders as of the record date who are entitled to receive proxy materials, make voting decisions and sign proxies.
- This list would be available to the issuer and to any dissidents running a solicitation or counter-solicitation.
- Proxy materials would be distributed directly to the beneficial owners.
- Beneficial owners would return proxies directly to the tabulators.

There are several important features of this structure. First, it takes DTC, broker and bank custodians out of the voting process. As a result, it also eliminates “broker non-votes.”

Second, the reform requires the elimination of the existing NOBO/OBO structure. Shareholders who wished to remain anonymous would have to establish nominee accounts with banks or brokers.

On the other hand, the proposal – by approximating the structure of voting by registered owners – would increase transparency, improve the ability to provide vote confirmation and an audit trail. See Figure 13.

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<sup>94</sup> See John C. Wilcox May 3, 2004 letter to the SEC re: Rule No. 4-493; John C. Wilcox, Shareholder Nominations of Corporate Directors: Unintended Consequences and the Case for Reform of the U.S. Proxy System, in Shareholder Access to the Corporate Ballot (Lucian Bebchuk, Ed.) Ch. 10 (Harvard U. Press 2005?).

[Figure 13 about here]

What are the difficulties in the way of such a reform? First, one key effect is to remove ADP from its position as the key, monopolistic actor at the center of the spider web. Under the current system, ADP is hired by the custodians but is able to bill the issuers, with some price regulation by the NYSE. By all accounts, this is a very profitable business for ADP and one would thus predict that ADP would oppose any substantial reform.

Second, the reform also requires that custodians cooperate in the creation of a single list of shareholders entitled to vote as of the record date. On the broker side, this would require brokers to identify which shares have been lent out. Under the current system, the standard margin account agreements permit brokers to lend out shares and to keep the fees generated. Typically, brokers do not identify which account's shares have been lent out. Under the BRT/Georgeson proposal, they would have to do so, which could lead margin account holders to demand a share of the fees generated, or to resist granting the brokers the right to lend out the shares. On the other hand, as noted above, tax considerations may force this identification in any event.

Third, the elimination of the NOBO/OBO system will expose beneficial owners to more direct lobbying by issuers. While holders who wish to retain their anonymity may create nominee accounts to disguise their ownership, they may feel that taking that affirmative step will subject them to more criticism than under the existing NOBO/OBO system.

In 2004, the Business Roundtable petitioned the SEC to engage in rule making to adopt this approach.<sup>95</sup> The Securities Industry Association, the broker-dealers' trade association, opposed the BRT petition, and argued against a fundamental change in a system that is working well.<sup>96</sup>

Rather than petitioning the SEC to consider re-engineering the entire process of shareholder communications, the SIA believes that it makes far more sense for issuers to work with each of the participants in the system to address the specific concerns that they have. We have an excellent system in place, one that is the result of years of development and investment, and one that successfully balances a complex set of interrelated requirements.<sup>97</sup>

But, even if the reform is adopted, it does not promise a solution to all the problems. For example, it leaves untouched the difficulties caused by the current record date system, described earlier. Moreover, while it promises to improve the audit trail,

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<sup>95</sup> The Business Roundtable April 12, 2004 proposal is at <http://www.sec.gov/rules/petitions/petn4-493.htm>. See also Georgeson's April 12, 2004 letter in support, <http://www.sec.gov/rules/proposed/s71903/gshareholder041204.pdf>

<sup>96</sup> The Securities Industry Association's June 24, 2004 letter in opposition, [http://www.sia.com/2004\\_comment\\_letters/pdf/30454888.pdf](http://www.sia.com/2004_comment_letters/pdf/30454888.pdf).

<sup>97</sup> Id. at p. 2.

there will be problems in the creation of a single shareholder list. In addition, it is still vulnerable to the misalignment between the conceptual structure of UCC Art. 8 and corporate and securities law. By pushing the proxies up to the beneficial owner level, it does not completely solve the problems of over-voting.

#### **d. Redesigning the Architecture: Voting in a Direct Registration Clearing and Settlement System**

As the earlier discussion shows, the problems with the corporate voting system derive from the complexity of our system of custodial ownership, a system adopted to deal with the “paper crunch” and to prevent systemic risk from widespread failure of clearing and settlement. In responding to these problems in the US, we chose the route of “immobilization” of securities through the depository system: by having DTC keep securities certificates in its vaults, we controlled the risk of non-delivery of certificates and failed trades. More subtly, because the certificates still existed, we did not need to get accustomed to the concept of securities that are not evidenced by certificates.

In retrospect, if one were designing a system from the ground up, one would not adopt this structure. The necessity of immobilizing securities certificates yielded the cumbersome system of custody, clearance and settlement that, as we’ve seen, complicates voting as well. The BRT/Georgeson proposal, taking this fundamental architecture of ownership as given, offers an incremental change to the voting architecture that promises some improvements. But actually fixing the voting system requires that we adopt an alternative architecture better suited to providing voting transparency.

#### **i. The Spanish Model**

If we revisit the original choice made in the 1970s, we should consider what structures would be possible if, instead of “immobilization,” we had chosen “dematerialization” of securities. Interestingly, the Spanish system of share holding took that route and thus offers an interesting alternative. For listed shares, Spain has a pure book-entry system with share dematerialization mandatory for publicly traded firms.<sup>98</sup> This makes possible the creation of a share registry that can show all current holders and quickly reflect changes in securities positions.

Dematerialization has clear advantages. The Spanish system works as follows. The key player is IBERCLEAR, the Spanish equivalent to DTC:

IBERCLEAR is the Spanish Central Securities Depository which is in charge of both the Register of Securities, held in book-entry form, and the Clearing & Settlement of all trades from the Spanish Stock Exchanges, the Public Debt

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<sup>98</sup> Para. 1.7.15 European Commission, Financial Markets Infrastructure: EU Clearing and Settlement, Legal Certainty Group, Questionnaire, Horizontal Answers, available at: [http://ec.europa.eu/internal\\_market/financial-markets/docs/certainty/background/comparative\\_survey\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/certainty/background/comparative_survey_en.pdf)

Market, the AIAF Fixed Income Market, and Latibex - the Latin American stock exchange denominated in Euros.<sup>99</sup>

Under Spanish law, in order to issue securities that will be validly issued and tradeable, the issuer, usually acting through an agent which is a participant firm in IBERCLEAR, must inform IBERCLEAR that the steps for listing a security have been completed, and provide relevant details.<sup>100</sup> At this point, the securities are “deemed to be duly recorded in the accounts held by IBERCLEAR as CSD [Central Securities Depository] and its participant entities.”<sup>101</sup>

Once this “recording” has occurred, the investors have full property rights in the shares. The act of recording creates a direct legal relationship between the issuer and the investor.

For a book entry system like Spain’s, the question arises whether to have a one-tier or two-tier registry. In the Spanish system, the registry is structured as a two tier system:

“The name of the account holder appears: (i) in the tier corresponding to IBERCLEAR (accounts opened and maintained by IBERCLEAR) for securities owned by its participants; (ii) exclusively in the “detailed registries” or securities accounts opened and maintained by participants in IBERCLEAR. In this latter case the name of the owner is not required to be recorded in the central registry held by IBERCLEAR.”<sup>102</sup>

The introduction of a second tier complicates the voting process but would not, it seems, be an intrinsic part of the system. Indeed, one suspects that the reason for the system of subregistries is to maintain the link between the participant firms and their customers. Were IBERCLEAR to control the sole and complete registry – which, as a data processing matter, would be straightforward and advantageous – customers could go to any broker to sell their securities.

Transfer of securities follows is by book entry, without any requirement of “delivery” of share certificates (which, in this system, do not exist). Under Article 9 of the Spanish Securities Markets Act,

“Transfer of book-entry securities takes place by means of account transfer. The inscription of the transfer in favour of the acquirer will produce the same legal effects than the delivery of the physical securities.”<sup>103</sup>

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<sup>99</sup> <http://www.iberclear.com/Iberclear/home/home.htm>

<sup>100</sup> Para. 2.7.2

<sup>101</sup> 2.7.2

<sup>102</sup> Para.5.7

<sup>103</sup> 2.7.2

This same principle applies to the creation of security interests in the shares: Such interests can be recorded in the securities account and, when they are, are valid and binding against third parties.<sup>104</sup>

In practical terms, when an order to transfer is received by a seller, and the ownership of the seller and payments by the buyer are verified, the transfer occurs and the share registry is immediately adjusted.<sup>105</sup>

In the SCLV platform managed by IBERCLEAR (which is a “Model-2” settlement platform, i.e., gross for securities and net for cash), no debits or credits of securities are made in the accounts of the participants until a provisional debit and the corresponding credit is made in the cash accounts opened at Banco de España for the net balance of the cash leg of the settlement process for a given settlement date. Once the Banco de España confirms that such provisional debits and credits have been made, the securities accounts in IBERCLEAR are credited and debited, and all of the debits and credits are irrevocable.<sup>106</sup>

It is worth noting that, unlike in the US system, there is no netting of securities but only of cash.<sup>107</sup> In this system, transfers are irrevocable.<sup>108</sup> The buyer takes the shares subject to any recorded interests.<sup>109</sup>

There are numerous virtues to such a system. First, because the investors have clear property rights in the shares, problems of the bankruptcy of the intermediary disappear. Second, because transfers are final only after checking on the ownership of the seller and the available cash of the buyer, failed transfers should not occur. Third, shortfalls, in principle, should not occur either.

The system also simplifies the exercise of rights to receive cash distributions.<sup>110</sup> With respect to dividends and other distributions, on the record date, IBERCLEAR issues a certification of the balance of securities that each holder has and gives this information to the issuer or, if designated by the issuer, its payment agent. The issuer then must pay

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<sup>104</sup> Id. Also 7.7, 11.7 (“According to article 10 of the Securities markets law, “The creation of limited rights in rem or liens of any other kind on securities represented by book-entry shall be recorded on the corresponding account. (...). The creation of the lien is valid vis-à-vis third parties from the time the corresponding entry is recorded. And article 9 of the same Law foresees: “A third party purchasing for consideration securities represented by book entry from a person who was legitimately entitled to transfer such securities according to the book entry records shall not be subject to any claim (reivindicatio) unless said third party acted in bad faith or with gross negligence at the time of purchase”. ”)

<sup>105</sup> 17.7, 19.7, 20.7, 21.7 and 55.7

<sup>106</sup> 55.7

<sup>107</sup> While the US system (according to which the shares sold by Morgan Stanley customers to JP Morgan customers are netted at the end of each day against the shares sold by JP Morgan customers to Morgan Stanley customers) had some advantages prior to the evolution of modern information processing, the costs of not being able to trace particular transfers can be significant.

<sup>108</sup> 21.7

<sup>109</sup> 11.7

<sup>110</sup> 34.7

each participant an amount equal to the dividend per share and the number of shares evidenced in the IBERCLEAR certification.<sup>111</sup>

Finally, it simplifies voting. To start with, when there is a corporate action, IBERCLEAR gives the issuer a certification stating how the securities are distributed among the participants in the system.<sup>112</sup> Then, for voting, the issuer sends an “attendance card” to the domicile of the investor. Since 2003, issuers have been obliged to provide for “distance voting” through mail or electronic means.<sup>113</sup>

For voting, there are clear virtues to the system. Consider Figures 14 and 15. With a book-entry system, either using a two-tier or a one-tier registry, creation of a common comprehensive registry is straightforward. Once this real-time registry exists, creating a record-date shareholder list is also straightforward. The processor, an agent of the issuer, would send out proxy materials according to the record-date shareholder list, collect proxies, tabulate the results and report them to the board of directors.

The system easily solves some of the most difficult problems identified above. The share registry, combined with IBERCLEAR’s obligation to assure that no more than 100% of issued securities are recorded in the system,<sup>114</sup> solves the over-voting problem on an ongoing basis. The existence of an up-to-date, comprehensive shares registry also cuts through the complexity in the distribution of materials, solicitation of voting instructions, collection of proxies, and the verification and audit of votes. Finally, because the share registry is continuously updated, it would be relatively simple – if the substantive corporate law demanded it – to enforce a system in which only shares that were held on the record date and then continuously held between the record date and the meeting date could be voted.<sup>115</sup> Indeed, the structure of the Spanish system, with its genuine share registry, could be developed far beyond what has been done in Spain to make voting even more efficient.

Note how securities “lending” occurs in this system. Because, as noted earlier, securities “lending” is really a transfer of a security subject to an obligation to retransfer an equivalent security later, the securities “loan” itself would be recorded on the registry as a transfer (with the “return” similarly recorded). Thus, the system forces an attribution of “lent” shares to specific accounts, with notice to the account holder, while also ensuring that no more than 100% of the shares appear.

What are the downsides of this book-entry system? First, as with the BRT/Georgeson proposal, it is inconsistent with the existing NOBO/OBO system. In the Spanish system, if investors wish to remain anonymous, they must hold their shares through a nominee.

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<sup>111</sup> 34.7.1

<sup>112</sup> 36.7

<sup>113</sup> 34.7.1

<sup>114</sup> 36.7

<sup>115</sup> It thus could solve one version of empty voting (record date capture), but not other versions (e.g., hedging while retaining ownership).

Such holding is permitted under the Spanish system but not regulated.<sup>116</sup> [OTHER DOWNSIDES?]

## ii. The Obstacles to Reform

There are few legal obstacles to switching to a Spanish style system. UCC Article 8 already permits uncertificated securities and provides a legal structure for transfer. Uncertificated bonds are already very common. Under most (ALL?) states' corporate laws, corporations may issue uncertificated equity securities. Delaware, for example, provides that:

The shares of a corporation shall be represented by certificates, provided that the board of directors of the corporation may provide by resolution or resolutions that some or all of any or all classes or series of its stock shall be uncertificated shares. Any such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation.<sup>117</sup>

Suppose, then, that the SEC or Congress were to decree that all registered issuers must switch to a system of uncertificated securities with book-entry ownership. The board of directors of a Delaware listed company would then pass a resolution providing that all classes and all series of its stock shall be uncertificated shares. At that point, DTC would surrender all its certificates to the corporation, instantly converting around 80% of shares to book-entry. While other shareholders could not be forced to surrender their certificates, it would matter little: those shareholders are already registered owners and listed on the company's share registry. As a result, the company can already, and could continue to, communicate with them directly. Moreover, when these stubborn or lost shareholders eventually sold or transferred their securities (through probate or otherwise), the securities would likely be surrendered at that time, either directly or through DTC. Over time, the number of outstanding share certificates would quickly dwindle. All new securities would be issued in uncertificated form.

The principal obstacles are political. As discussed earlier, ADP, with its monopoly under the current system, has an incentive to oppose a reform, such as this, that would displace it from the center of the spider web.

Brokers, unless the system is set up to protect their customer relationships, are also likely to oppose a change. Under the current system, it is not trivial for a customer to change brokers. By contrast, a pure book-entry system like Spain's holds the potential of loosening the ties between brokers and customers: if IBERCLEAR ran the full shareholder registry, a customer could sell shares through any broker or bank. In the Spanish system, this seems to have been handled by allowing the intermediaries to hold sub-registries with their customer information while IBERCLEAR holds the overall

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<sup>116</sup> 35.7

<sup>117</sup> Del. GCL §158.

registry (without customer information). As a data processing matter, it is an arbitrary and pointless distinction, but politically it may be necessary.

Brokers may further oppose a change because it would eliminate their ability to lend out margin securities without telling the account holder.

#### **e. Implications for Shareholders' Role**

The existing system of shareholder voting is crude, imprecise and fragile. Suppose that Gil Sparks is right, that in a contest that is closer than 55% to 45%, there is no verifiable answer to the question "who won?" So what?

One response, as we've discussed earlier, is to improve the technology so that it would function more reliably and accurately. But perfection of any voting system is impossible. What one should strive for is a system that is adequate for the tasks given it, and that requires that we think seriously about the role of shareholder voting.

Delaware's rather striking indifference to voting problems, as surveyed earlier, is quite suggestive in this regard. As we've seen, numerous Delaware decisions place certainty and timeliness of outcome above accurate reflection of shareholder views. In this context, the opinions focus on the *corporation's* need for certainty and right to rely upon the stock register. As the Delaware Supreme Court held in *Salt Dome*:

With respect to matters intracorporate affecting the internal [\*589] economy of the corporation, or involving a change in the relationship which the members bear to the corporation, there must be order and certainty, and a sure source of information, so that the corporation may know who its members are and with whom it must treat, and that the members may know, in a proper case, who their associates are. Especially is this true in a merger proceeding which is essentially an intracorporate affair. The merging corporations are entitled to know who the objecting stockholders are so that the amount of money to be paid to them may be provided. The stockholders in general are entitled to know the dissentients and the extent of the dissent. *Stephenson v. Commonwealth & Southern Corporation*, 18 *Del.Ch.* 91, 156 A. 215. The corporation ought not to be involved in possible misunderstandings or clashes of opinion between the nonregistered and registered holder of shares. It may rightfully look to the corporate books as the sole evidence of membership.<sup>118</sup>

Corporate voting is a means to an end, not an end in itself.

This takes us back to the fundamental question of the role of voting in corporate law. As noted earlier, shareholders vote on very few things. Mainly, under Delaware law, shareholders vote for directors and have a veto over fundamental changes to the

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<sup>118</sup> *Salt Dome*, 41 A.2d at 588-89.

corporation (mergers) or to its constitutional documents (amendments to the certificate of incorporation).

This sharply limited role for shareholder voting is consistent with the board centered model of corporate governance that Delaware exemplifies. In such a system, one could be rather complacent about voting problems in mergers and charter amendments, regardless of the direction of distortion. If the board recommends a merger, and through some voting failure, the merger is approved even though a proper count would have led to a rejection, a believer in board centered corporate governance could argue that the result is acceptable. After all, the board did in fact recommend the merger. Similarly, when a merger is rejected even though an accurate count would have resulted in approval, a complacent advocate of board centered governance could be comfortable with this result too: in the extreme case in which the board is so out of step with the shareholders that it tries to push a deal over determined opposition of more than 45% of the shareholders, it is no tragedy that the deal fails, even if in fact more than 50% of the votes were cast in favor. Put differently, the veto role of shareholder voting in mergers or charter amendments may not really *require* accuracy.

But what about director elections? Here, complacency is harder to sustain. From a director centered view, one might perhaps remain complacent because normally the board nominates directors and, in most cases, the inaccuracies do not affect who is elected, although they may well affect the margin of victory. On the other hand, one should be disturbed because director elections are the sole governance check on boards of directors (as opposed to market checks). To the extent that the election of directors plays a central ideological and monitoring role within corporate governance, a system that fails to provide transparency and verifiability may undermine its own legitimacy.

Indeed, a healthy skepticism of the limits of the corporate voting system seems to have three implications for the current place of shareholder voting in the Delaware takeover jurisprudence. First, as Gilson & Schwartz pointed out, much of Delaware's approach to takeovers post-Moran has had the effect, and arguably the purpose, of channeling of disputes over control from market contests (tender offers) to election contests (proxy fights over the advisability of pulling the poison pill). The infirmities of the voting system provide support for Gilson & Schwartz's skepticism.<sup>119</sup>

Second, the current fad for "majority election of directors" puts greater stress on the system. The traditional Delaware default rule that only requires that directors receive a *plurality* of the votes cast, rather than a majority, minimizes the occasions in which a director contest ends indecisively.<sup>120</sup> By changing to a majority rule by shareholder adopted bylaw, as is now permitted,<sup>121</sup> the potential for uncertain outcomes increases.

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<sup>119</sup> Hu and Black (2006) likewise make this point.

<sup>120</sup> DGCL §216.

<sup>121</sup> Id. ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors." Effective August 1, 2006).

Finally, given the problems with the existing system, and the difficulties in improving it, one should be skeptical of calls to expand the opportunities for shareholder voting in corporate governance. More shareholder power in corporate elections will generate more close outcomes and will impose even more stress on an already overstressed system.

## **Conclusion**

To be written.

**Figure 1. Voting by Registered Owners**

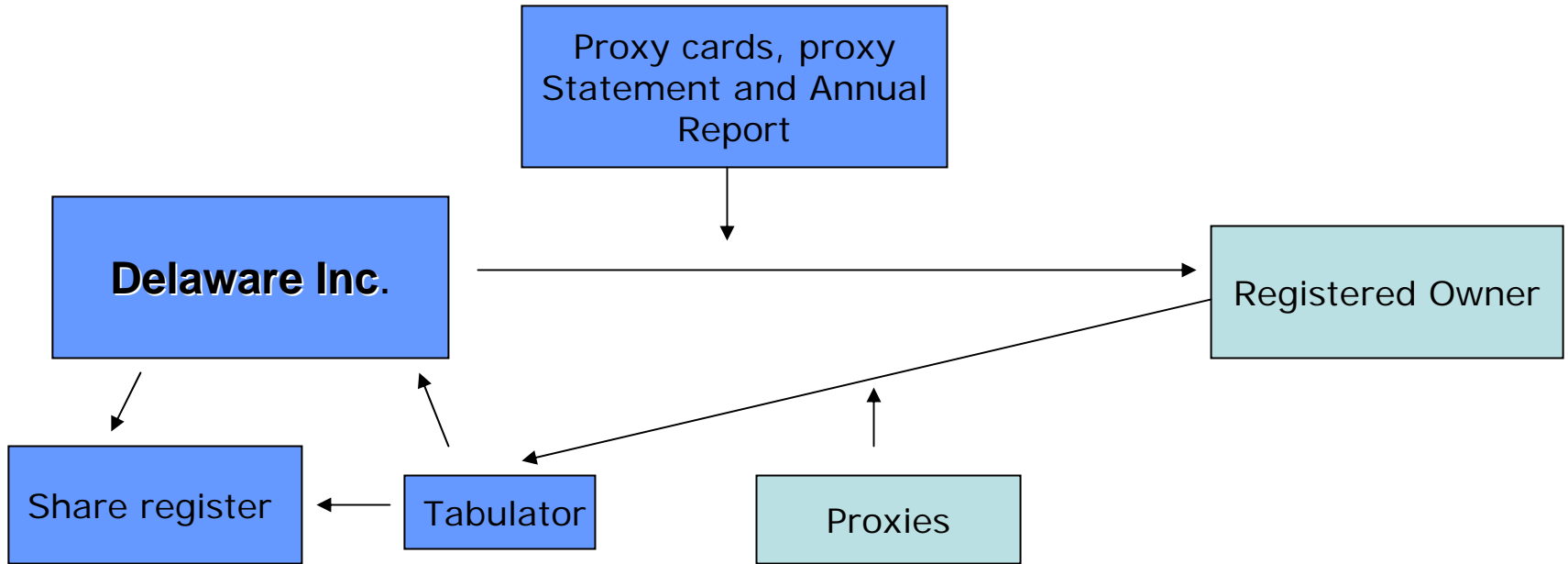


Figure 2. How Nominee Shares are Held.

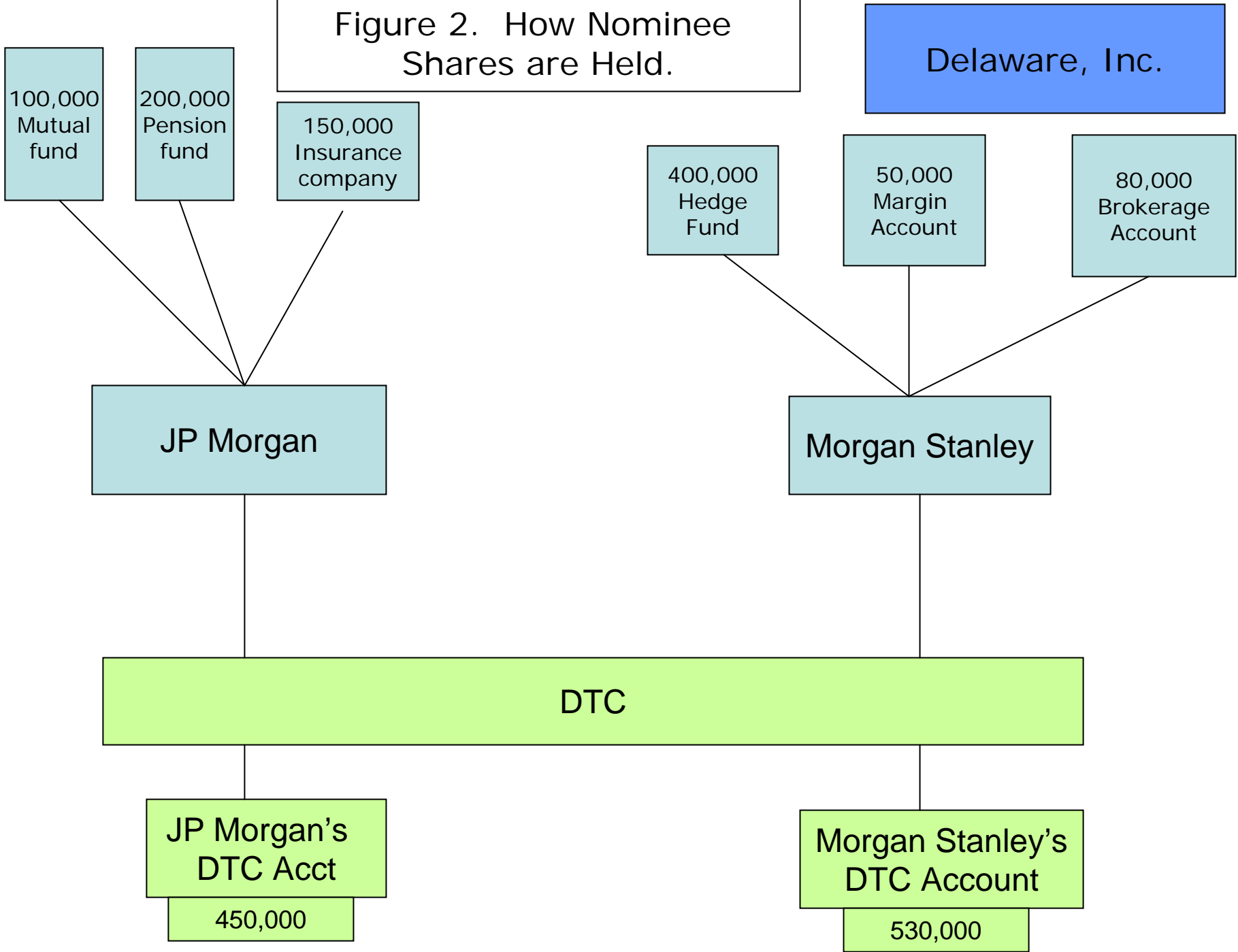
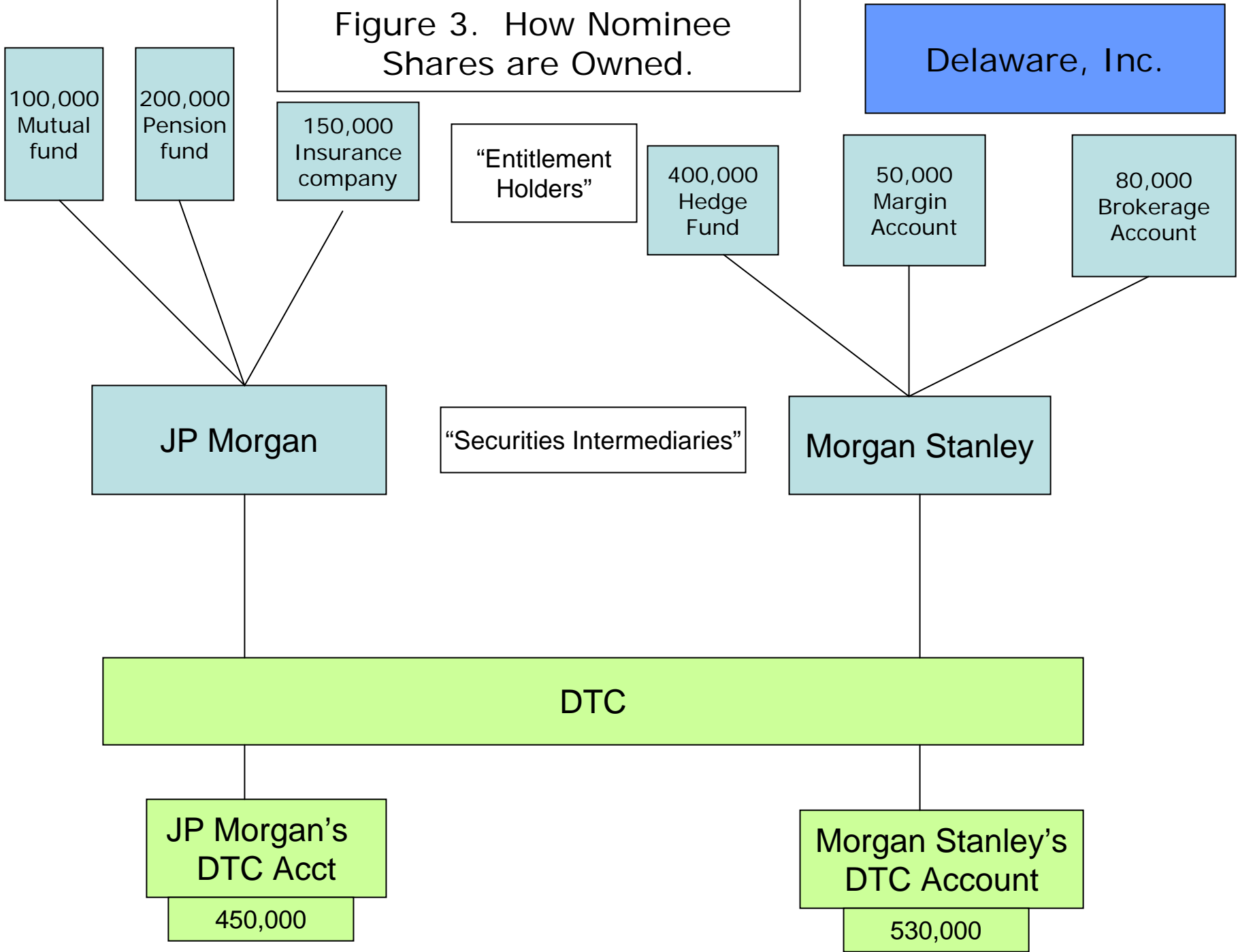
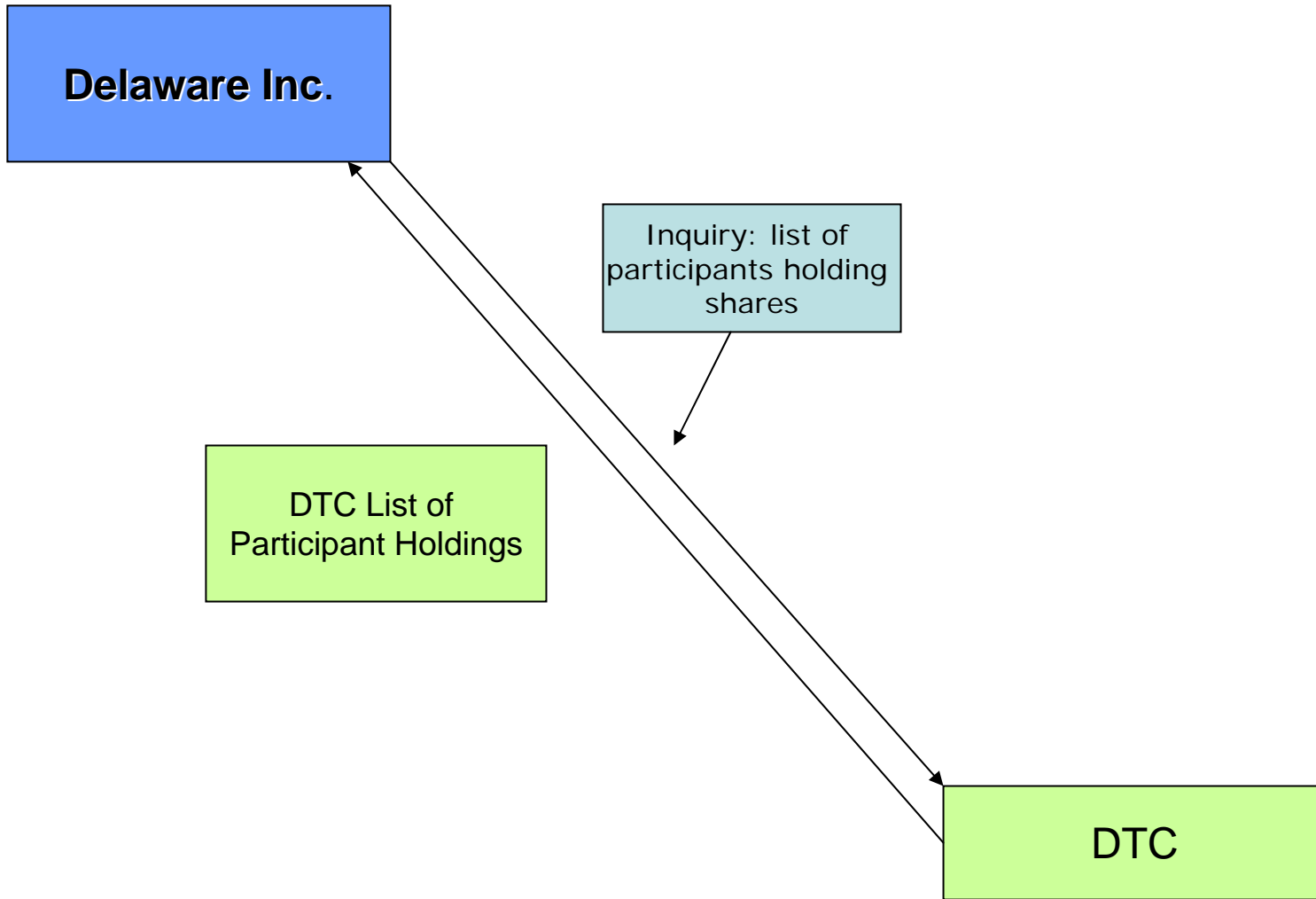
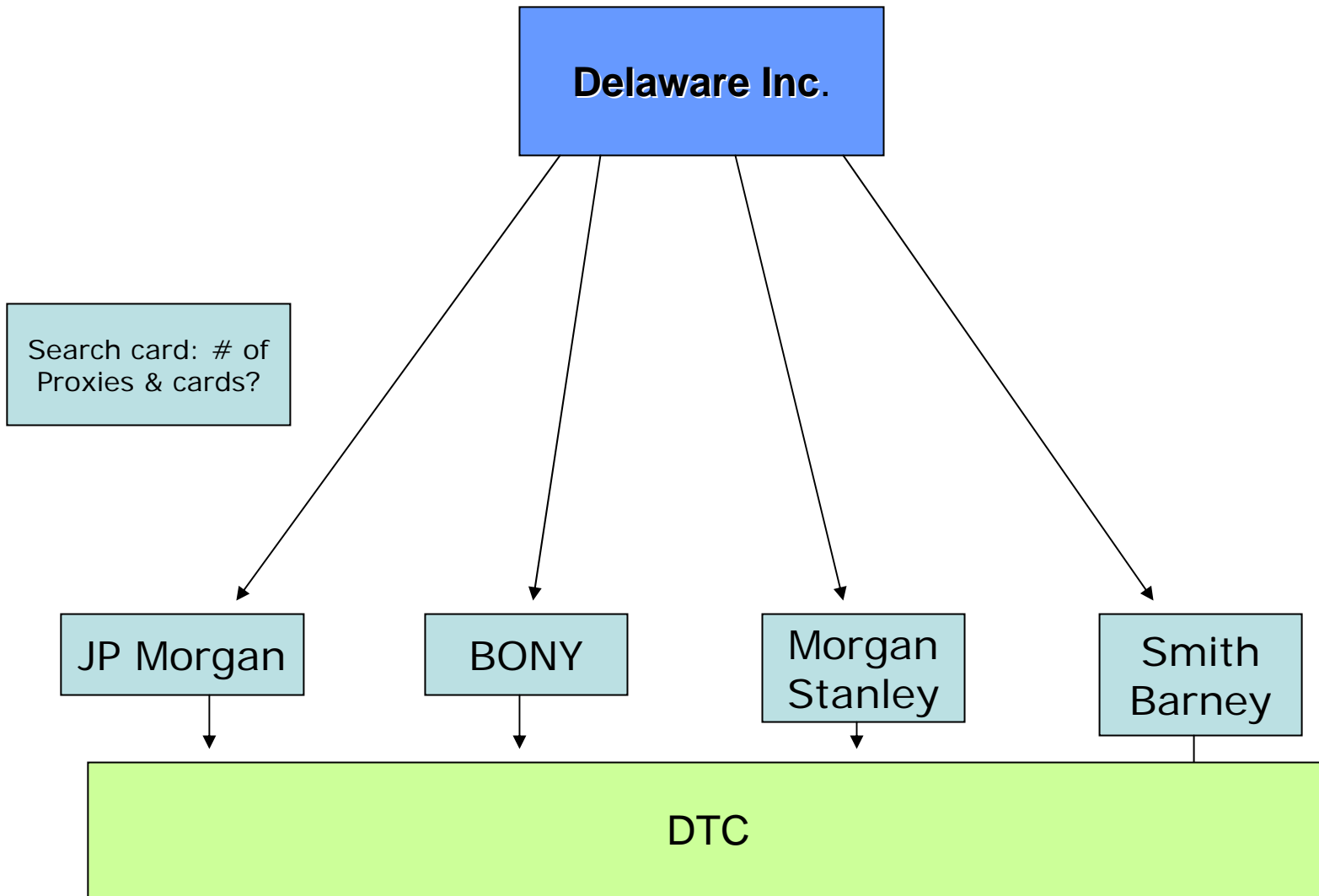


Figure 3. How Nominee Shares are Owned.

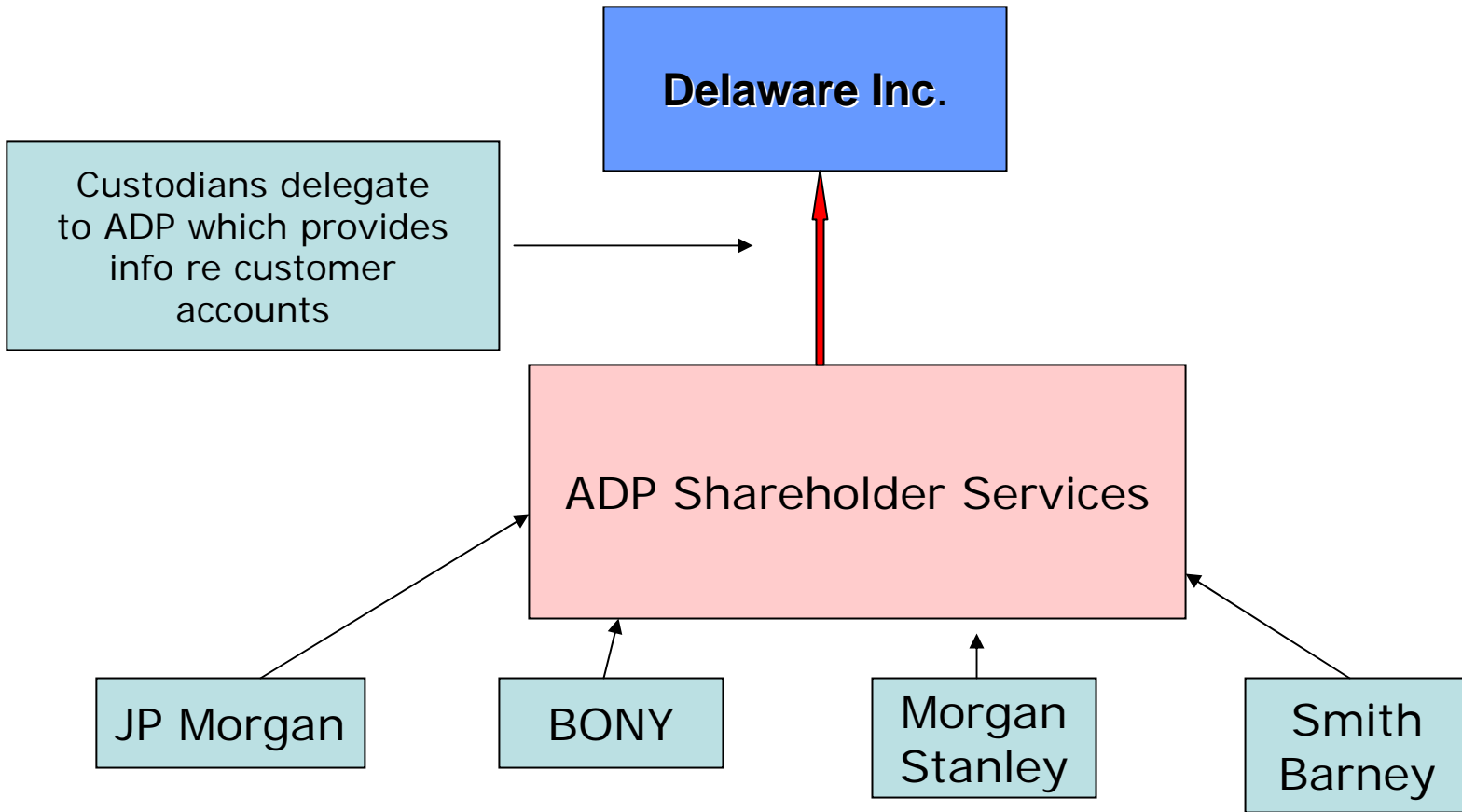




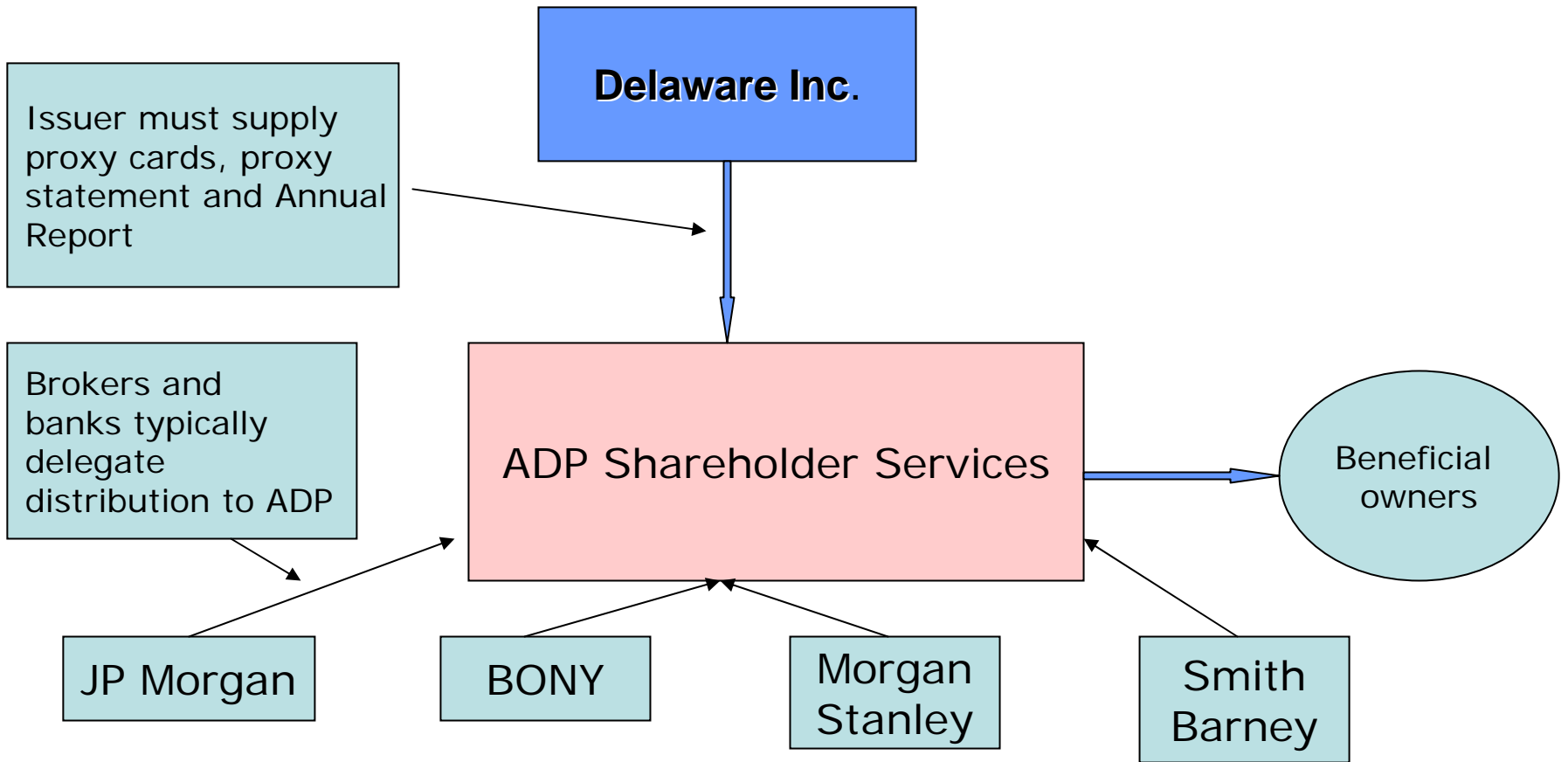
**Figure 4. Finding the Beneficial Owners:  
issuer inquiry**



**Figure 5a. Finding the Beneficial Owners:  
search cards**



**Figure 5b. Identifying the number of accounts and shares**



**Figure 6. Distributing the materials**

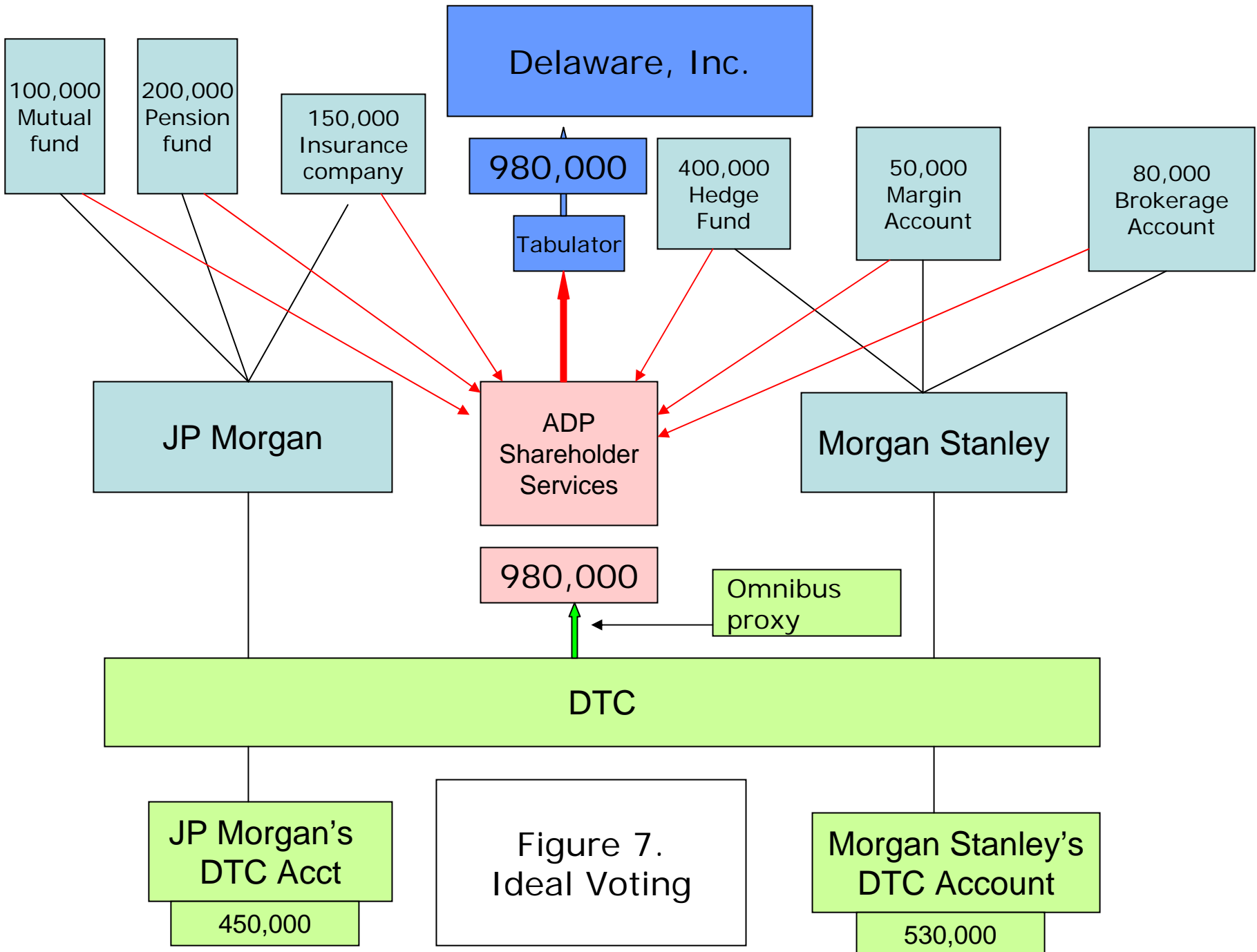
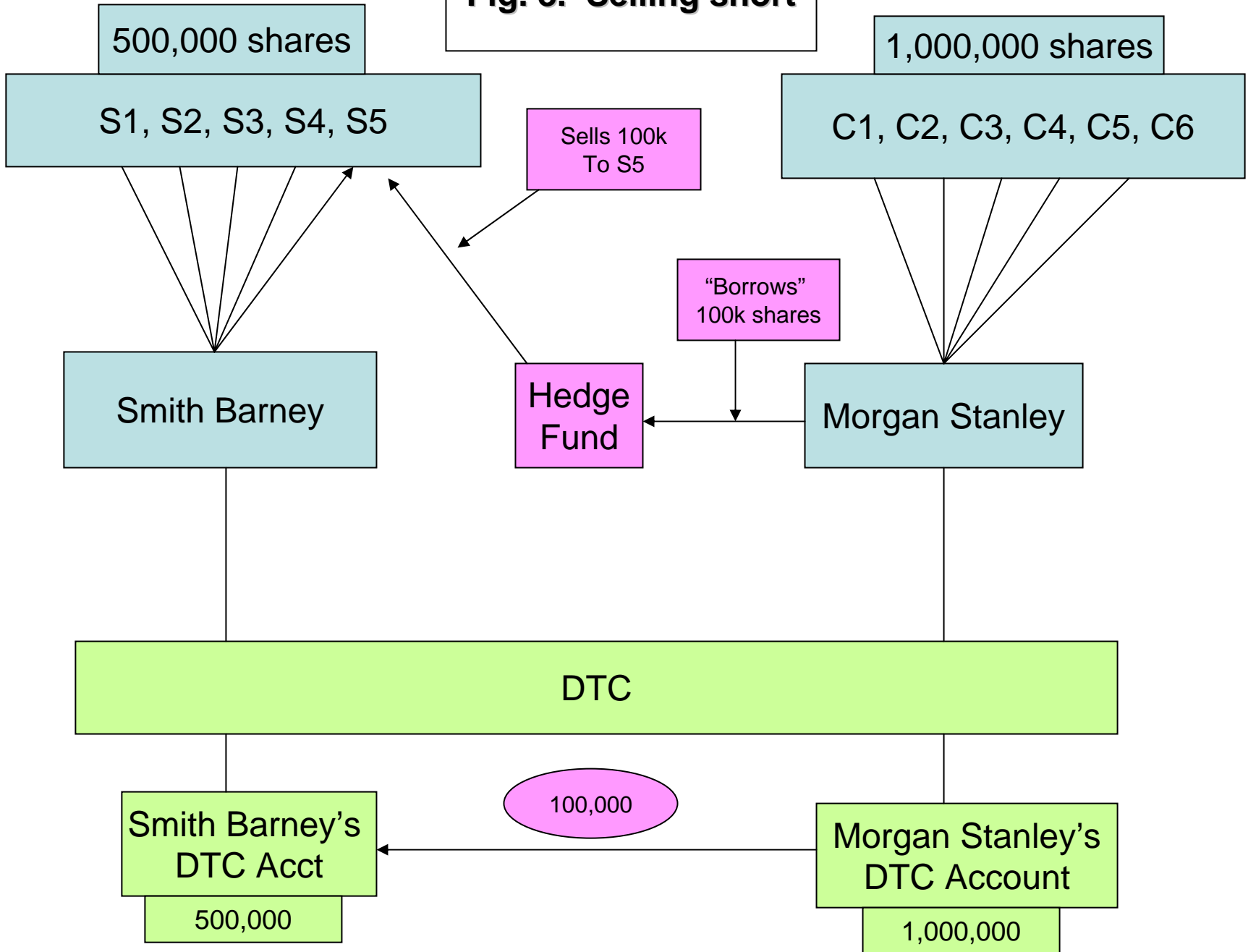
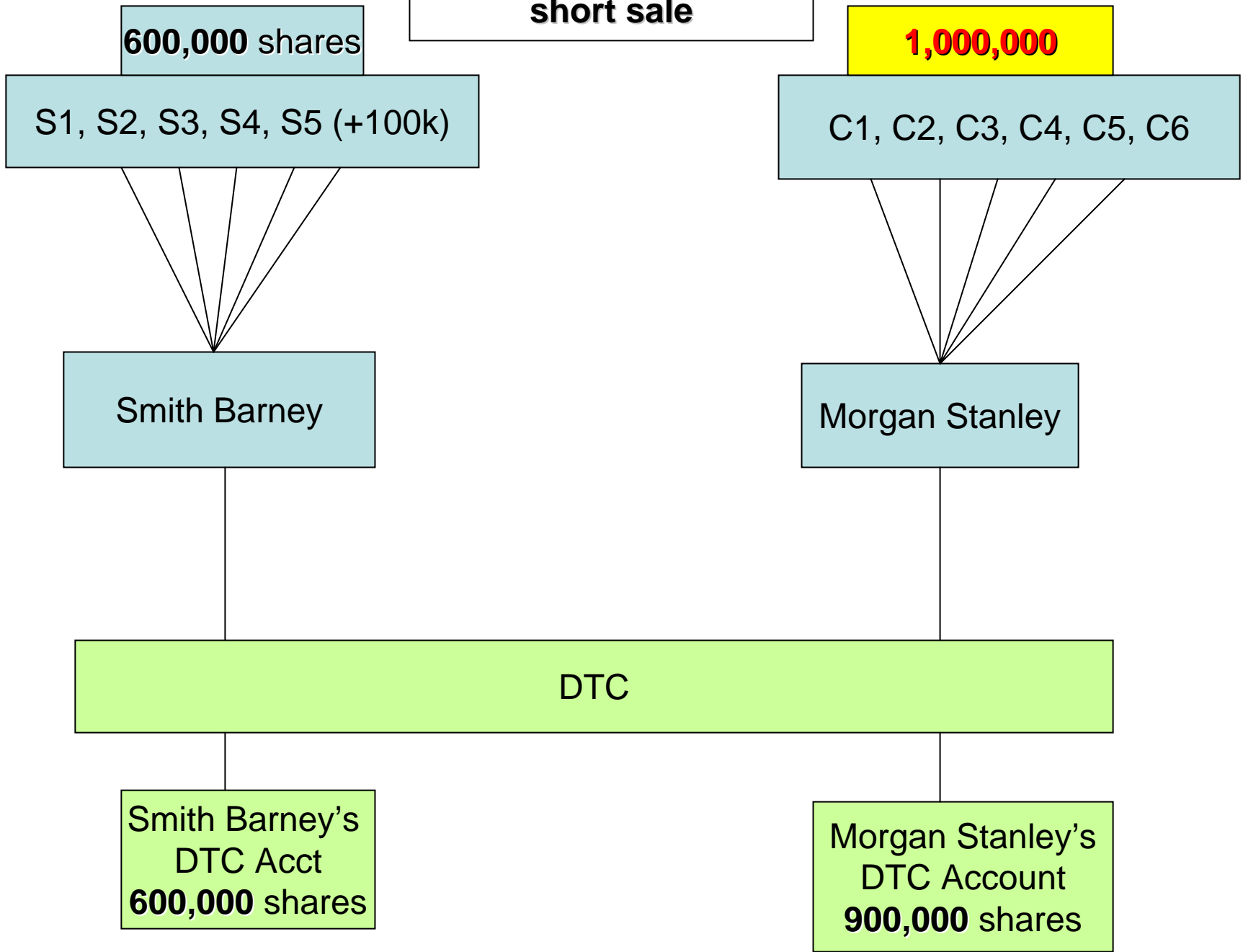


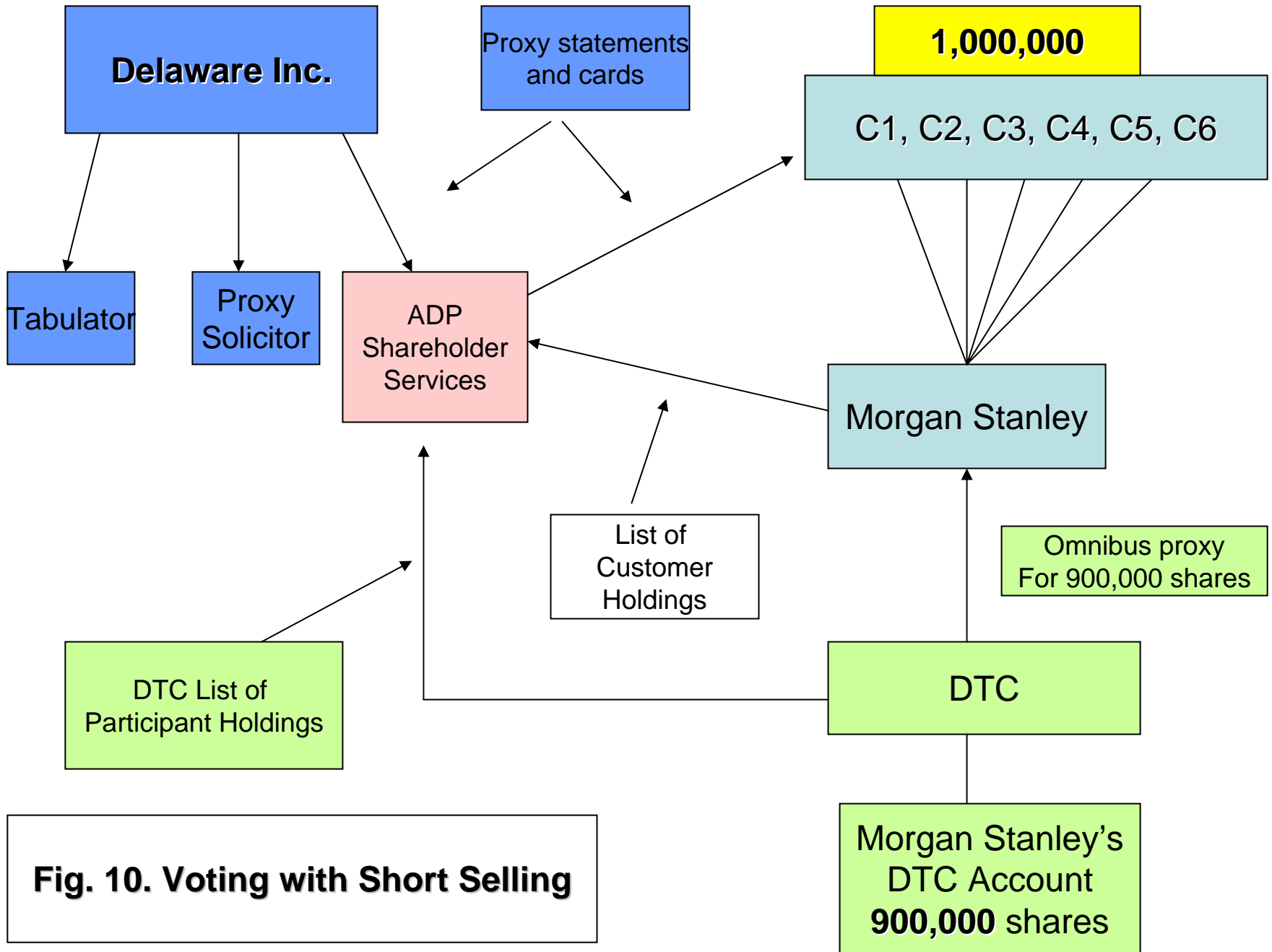
Figure 7.  
Ideal Voting

**Fig. 8. Selling short**

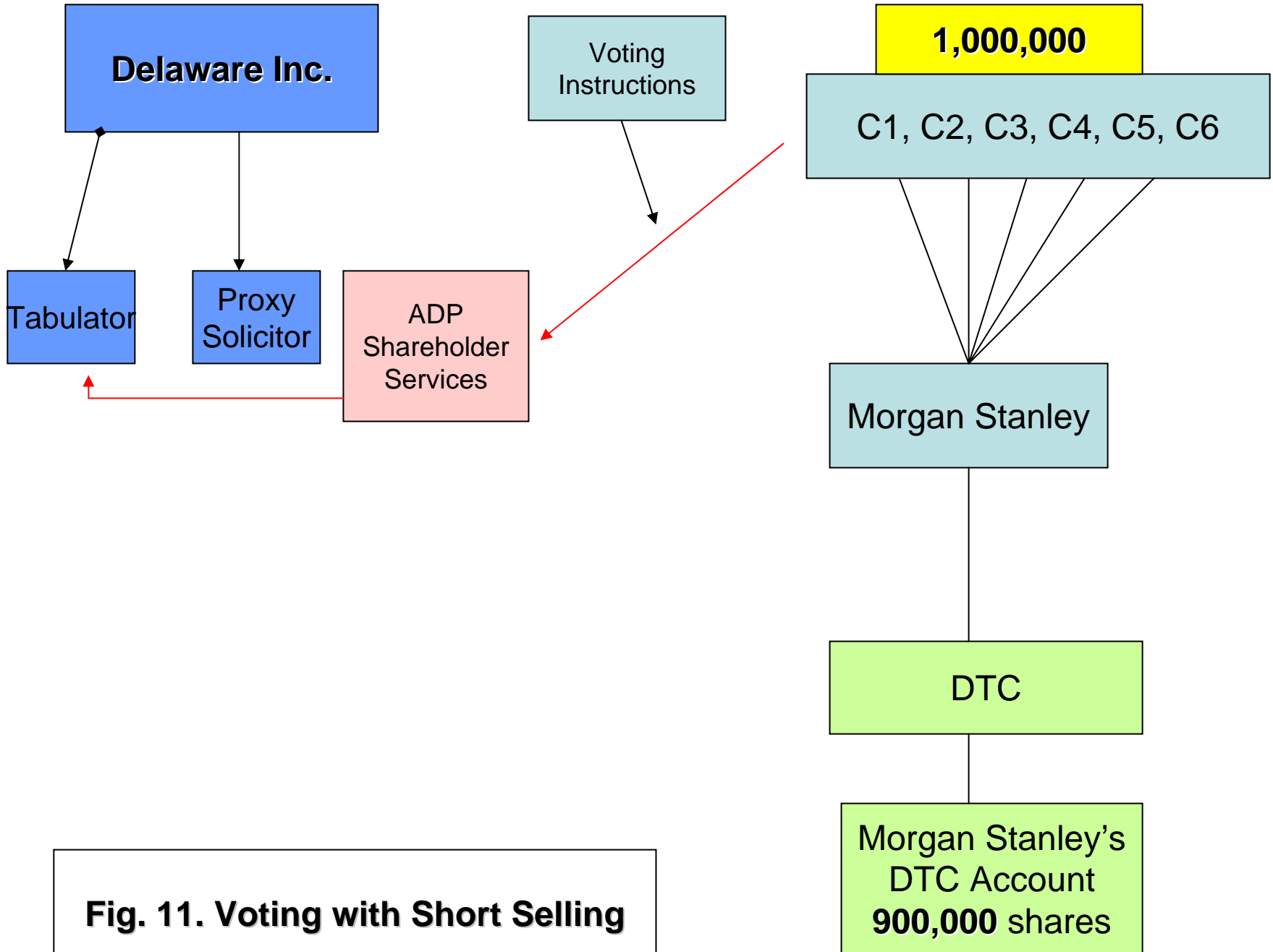


**Fig. 9. Holdings after short sale**





**Fig. 10. Voting with Short Selling**



**Fig. 11. Voting with Short Selling**

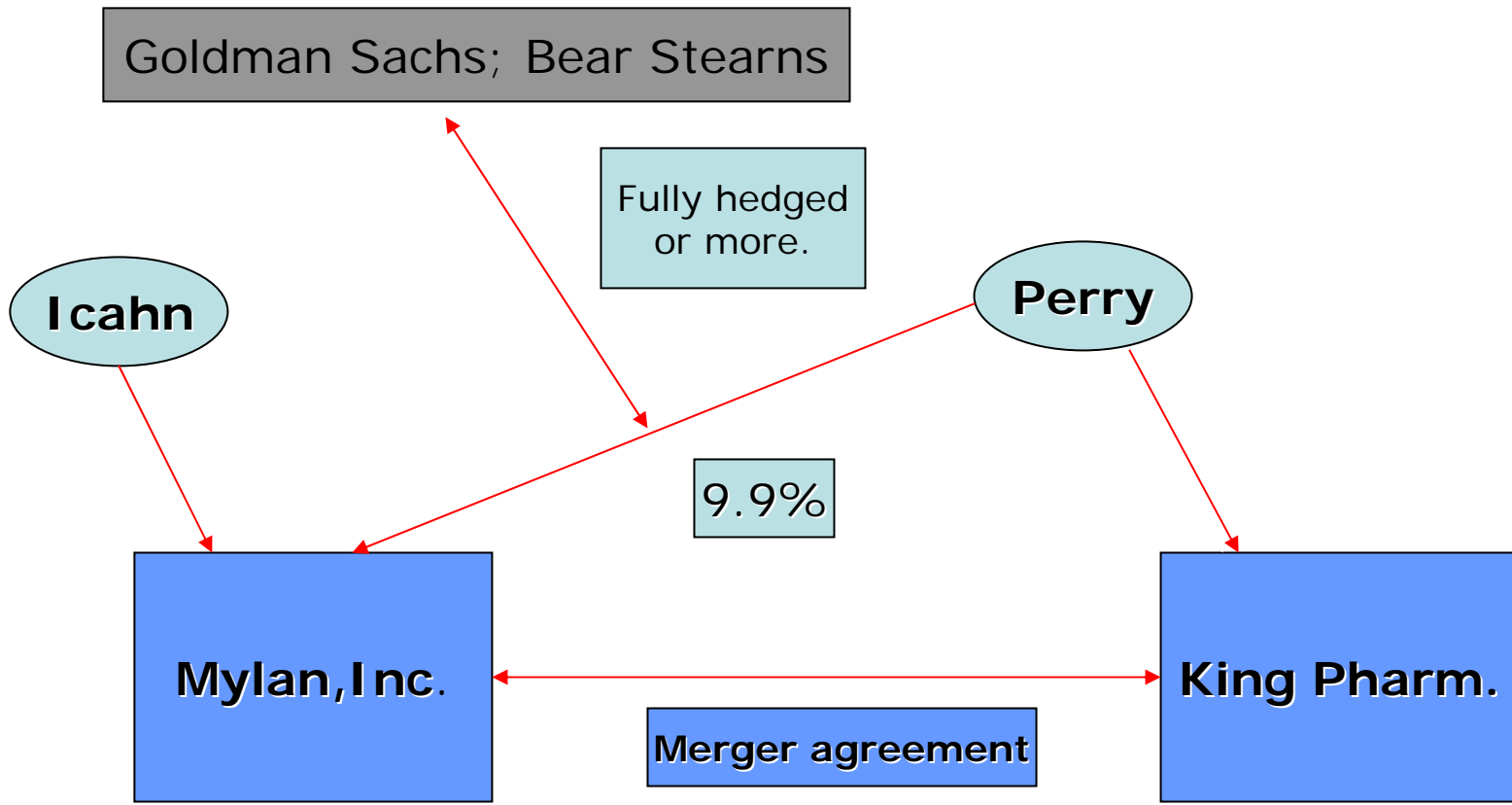


Figure 12. Empty Voting

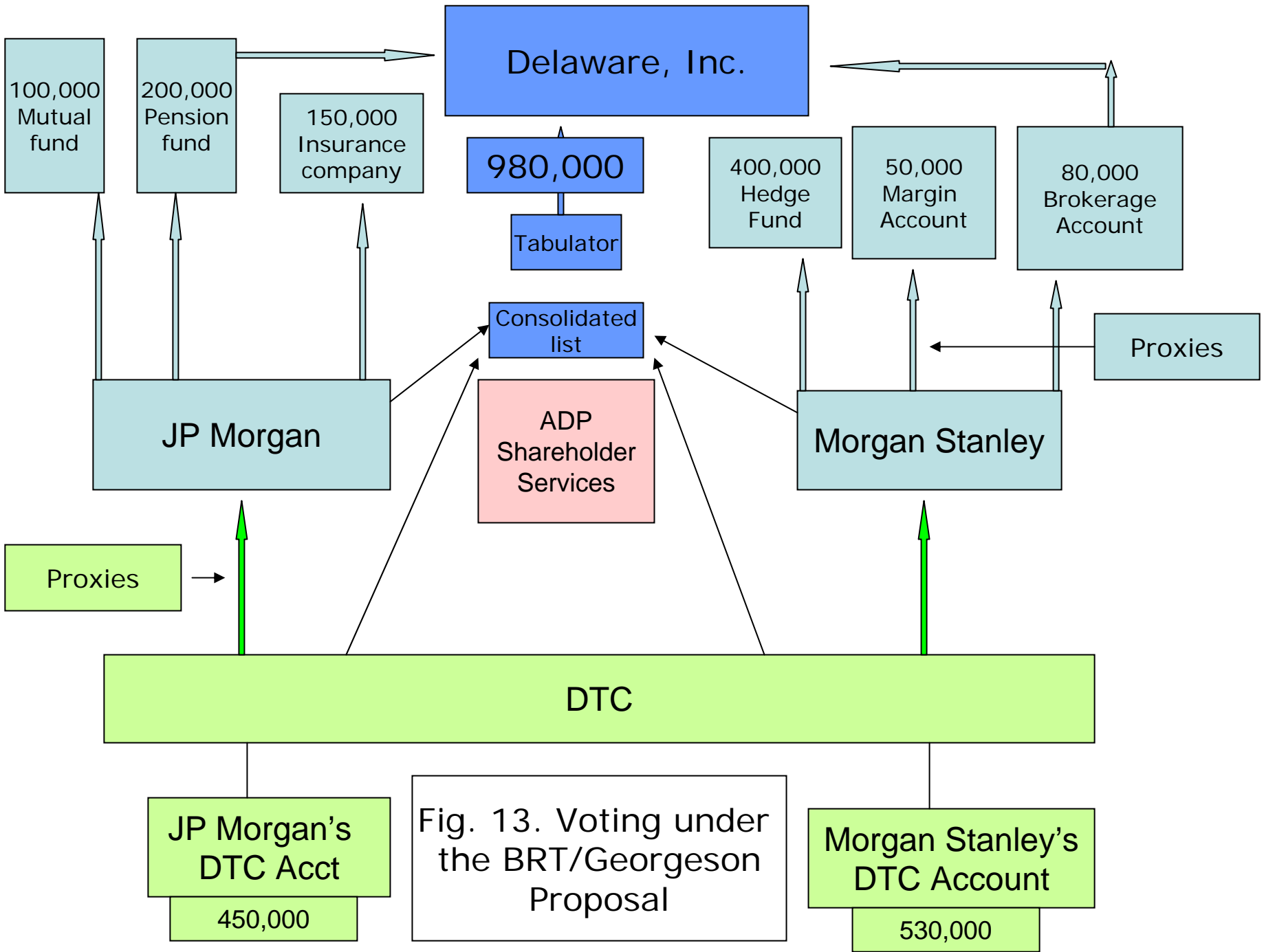


Fig. 13. Voting under the BRT/Georgeson Proposal

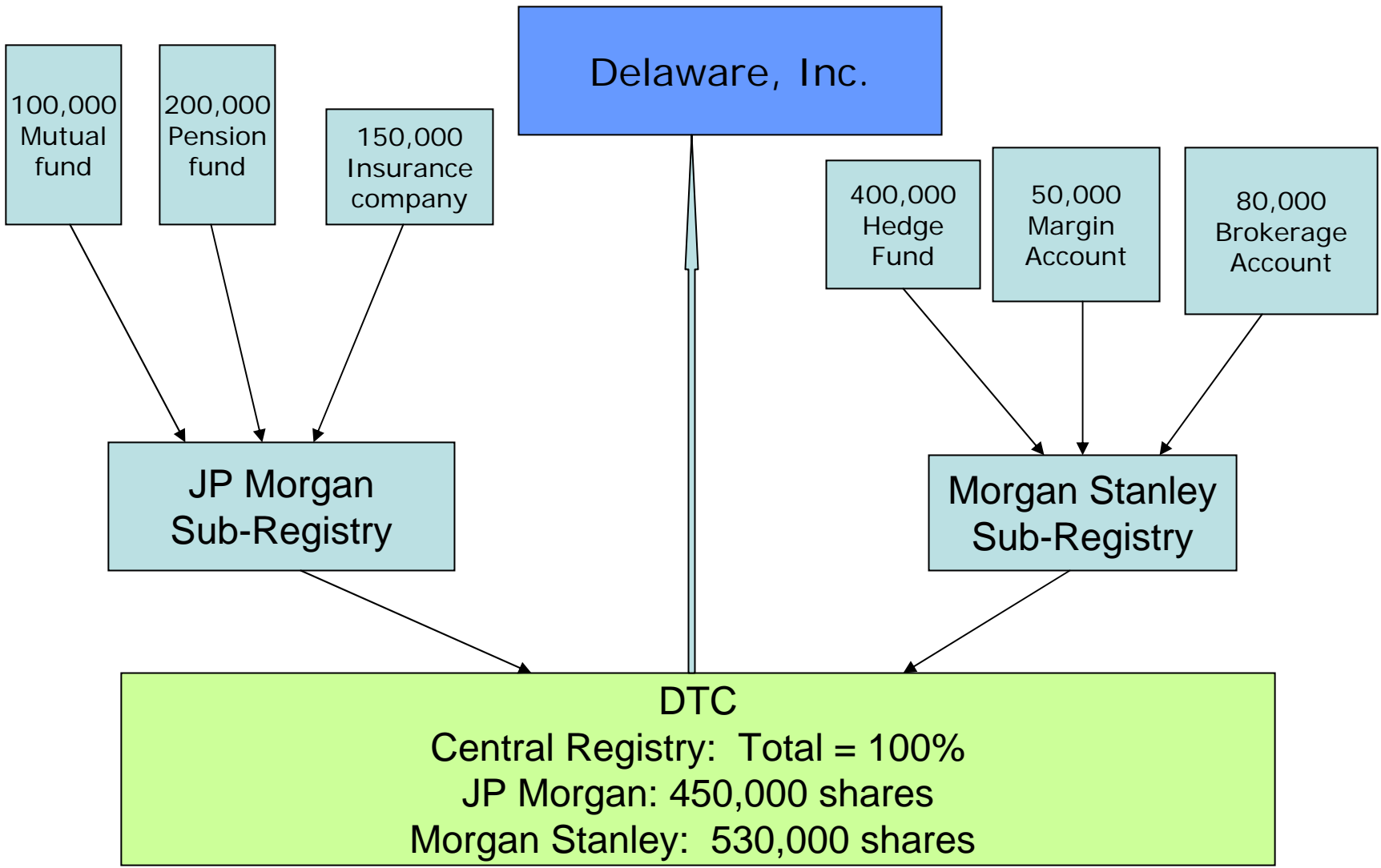


Fig. 14. Share holding in a pure book-entry system

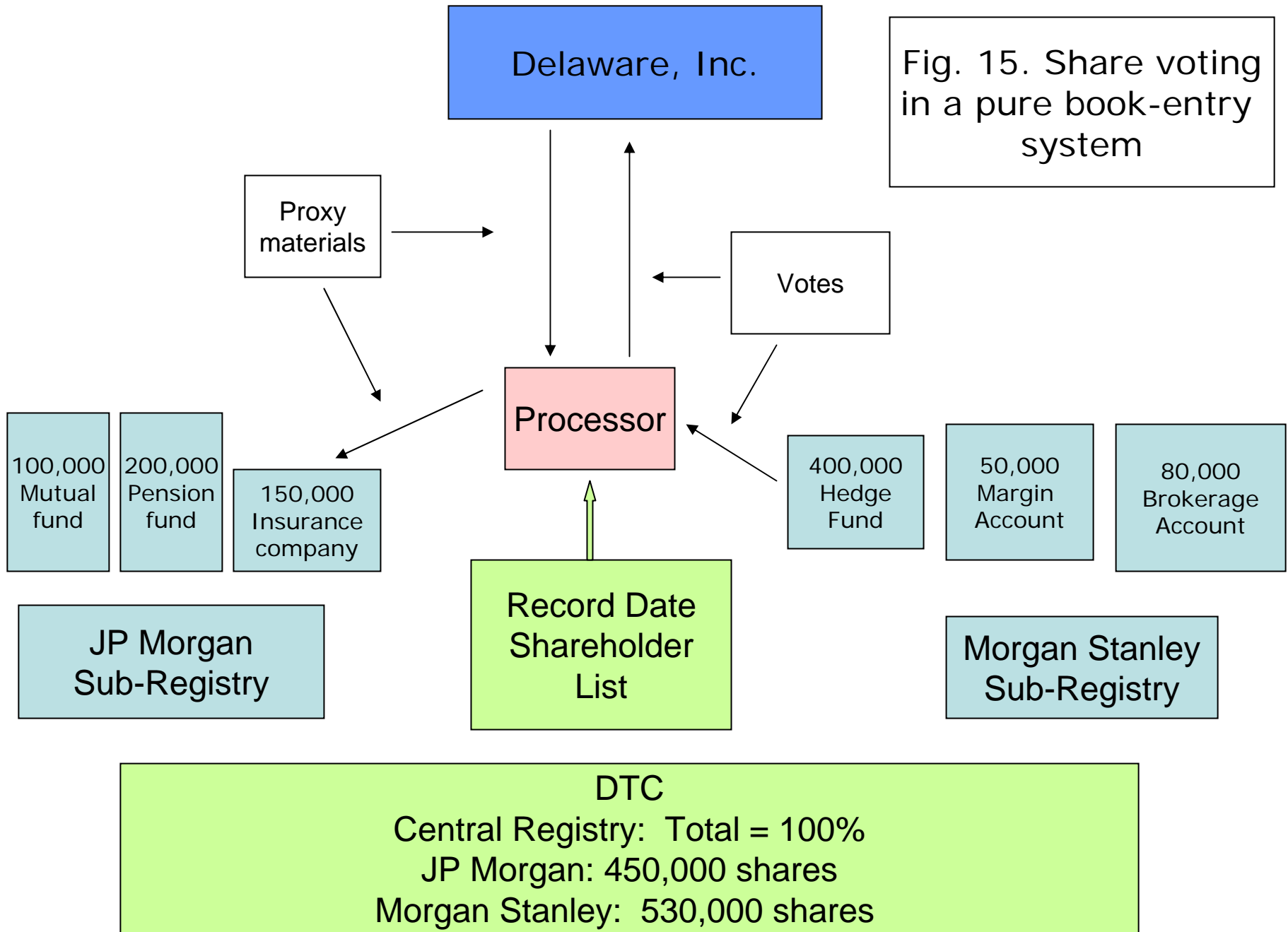


Fig. 15. Share voting in a pure book-entry system