

SHAREHOLDER DISENFRANCHISEMENT

THE UNINTENDED DISENFRANCHISEMENT OF SHAREHOLDERS (HOW CERTAIN EVERYDAY PRACTICES OF BROKER-DEALERS HAVE DETRIMENTAL CONSEQUENCES FOR SHAREHOLDERS)

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Shareholders who hold their shares in brokerage accounts generally assume that they will be able to fully exercise their rights to vote those shares and to take advantage of all the economic benefits of share ownership. As a practical matter, however, the ability to fully enjoy these rights and benefits will depend on a number of factors entirely out of their control. In fact, shareholders are routinely disenfranchised and are otherwise disadvantaged as a result of common practices of broker-dealers relating to the failure to adequately track the holdings of beneficial owners.

This disenfranchisement is a collateral impact of the short selling of securities. Short selling has the effect of creating more “long” holders of a security than are actually outstanding. For example, if there are ten million shares of an issuer outstanding and an investor sells short one million shares that she has borrowed, there are now eleven million shares held “long” by beneficial shareholders who may otherwise expect to exercise the full rights of share ownership. This fundamental mismatch between the number of long holders and record holders is very difficult to reconcile under the current legal and operational framework and can lead to significant adverse consequences for all shareholders.

VOTING AND OTHER RIGHTS UNDER STATE LAW

Shareholder ownership and voting rights are fundamentally derived from state law. In Delaware and New York, for example, voting rights belong to the holder of record on the record date selected by the issuer. The laws of those states provide that the issuer may set a record date in advance of a shareholder vote, and that those persons listed as registered

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owners of the shares on the issuer's books as of that date are entitled to notice of and to vote at the shareholder meeting.¹ The same analysis applies to dividends and other corporate distributions or rights. In these and other states where corporations are domiciled, record ownership, rather than beneficial ownership, is the bright line test that enables issuers to rely on their list of registered owners in determining who has the rights attributable to what shares. Delaware and New York view custodial arrangements and any difficulties identifying the voting party associated with those arrangements, as matters solely between shareholders and their broker-dealers and not something with which the issuer need be concerned.²

STOCK LENDING AND SHORT-SELLING PRACTICES COMPLICATE THE ALLOCATION OF SHAREHOLDER RIGHTS

Of course, most shares of publicly traded companies are not registered in the issuer's records under the name of the beneficial owner. Instead, an estimated seventy to eighty percent of all public company shares are held in "street name" through custodians, such as banks and brokerage firms, with the custodians, in turn, holding the shares through accounts at Depository Trust Company (DTC), a depository institution and the "record owner" registered on the books of the companies.³

There has also been a longstanding industry and regulatory goal of moving to a one day settlement system (known as T+1, or trade date plus one) instead of the current three day settlement (T+3). It has been recognized that for T+1 to work, all shares must be held in street name so as to facilitate the exclusively electronic transfer of shares, as the physical delivery of share certificates in that time frame is impracticable. Thus, the time may not be far off when one hundred percent of the shares of public companies are held of record by DTC.⁴

Account holders must rely on their broker to ensure that the issuer is informed regarding their beneficial ownership. For example, when an issuer asks shareholders to vote on a matter, the custodian of the shares held in street name is responsible for ensuring that proxy materials are

1. See DEL. CODE ANN. tit. 8, § 213 (2008) and N.Y. BUS. CORP. §§ 604 and 611 (Consol. 2008).

2. See, e.g., *Salt Dome Oil Corp. v. Schenck*, 41 A.2d 583 (Del. 1945) (Court of Chancery found that shareholders of a company who objected to its merger but who were not the holders of record of the shares on the company's books were not "shareholders" for purposes of the law entitling shareholders to object to a proposed agreement of merger); *Matter of the Application of Flagg-Utica Corporation*, 14 Misc 2d 476 (1958) (where proxy approving proposed sale was signed by record holder of stock, the beneficial owner of stock was not entitled to an appraisal). See also MODEL BUS. CORP. ACT § 7.07 (2002).

3. Actually, such shares are registered in the name of DTC's nominee company, Cede & Co.

4. See Report and Recommendations of the Proxy Working Group to the New York Stock Exchange (June 5, 2006), available at http://www.nyse.com/pdfs/PWG_REPORT.pdf.

distributed to its customers who are beneficial owners. Most custodians contract with an outside service provider (such as Broadridge Financial Solutions, Inc. (Broadridge)) to handle the administrative process of distributing proxy materials, tabulating votes and responding to requests for shareholder lists. However, brokers frequently give these service providers inaccurate data with respect to the number or identity of shares eligible to vote, resulting in inaccurate vote counts. One common reason for this is the broker's improper reconciliation or failure to reconcile margin account securities on loan.⁵

Many brokerage customers hold their securities in margin accounts that allow them to borrow against their shares in order to receive a variety of services. Typically, margin account agreements permit the broker to loan out margin customer securities without informing the customer. Despite any such loan, the shares will still appear in the customer's portfolio and statements. This is because brokers generally lend shares from a central pool and do not usually identify or attribute the shares being lent to a particular customer's margin account. Similarly, proceeds earned by the broker on the lending transaction are retained by the broker and are not shared with the specific customers from whose margin accounts they were borrowed.

Securities are frequently loaned out by brokers to enable short selling. Because "naked" short selling is not permitted, the short seller must "borrow" shares from other holders in order to sell them.⁶ The transaction begins with the investor placing an order to sell shares she does not own. During the pendency of the trade the brokerage firm seeks to borrow the shares on the seller's behalf from one of three sources: the brokerage firm's own inventory, another customer's account, or another brokerage firm—and then settles the trade by delivering these shares to the

5. *Id.*

6. Recently, the Securities and Exchange Commission (SEC) enacted a number of measures to better enforce existing rules against naked short selling. Existing rules allowed brokers to sell stock short for their customers as long as they reasonably believed that they could locate the needed shares and deliver them in time. Under a new rule that originally went into effect as of July 21, 2008 pursuant to an emergency order, brokers acting for short sellers in connection with shorts are required to make formal arrangements to borrow the shares before selling them (Emergency Order Pursuant To Section 12(k)(2) Of The Securities Exchange Act of 1934 Taking Temporary Action To Respond To Market Developments, Exchange Act Release No. 58166 (July 15, 2008) *available at* <http://www.sec.gov/rules/other.shtml>) and which was again temporarily reinstated on September 18, 2008 in a slightly altered form (temporary Rule 204T of Regulation SHO, Emergency Order Pursuant To Section 12(k)(2) Of The Securities Exchange Act Of 1934 Taking Temporary Action To Respond To Market Developments, Exchange Act Release No. 58572 (Sept. 17, 2008) *available at* <http://www.sec.gov/rules/other.shtml>) and more recently adopted as an interim final temporary rule through Amendments To Regulation SHO, Exchange Act Release 58773 (Oct. 14, 2008) Fed. Sec. L. Rep. (CCH) ¶ 61706 (Oct. 17, 2008)). The new rule is intended to prevent multiple brokerage firms from looking to the same pool of borrowable shares and potentially overestimating the number of shares available to cover short sales at any given time. The new rule highlights the increasing attention that regulators are paying to the accuracy of broker recordkeeping in this area.

buyer. The proceeds of the sale are transferred to the account of the short seller. The short position is later closed out when the short seller purchases shares to cover the position and the borrowed shares are returned to the original source.

FAILURE TO RECONCILE BENEFICIAL OWNERSHIP
CAN LEAD TO OVER-VOTING

Generally, brokers direct proxies to be sent to margin account customers without determining whether some or all of the related shares have been loaned out to cover a short sale transaction. In such instances, the broker permits the margin customer to cast votes for the shares even though the market purchaser of the loaned shares would similarly receive proxy materials either directly from the issuer or her own broker (possibly even the same broker). Thus, the loaned shares could potentially be voted twice if both “holders” act on the proxy materials—an event referred to as over-voting.

As a legal matter, the rights of the beneficial holder of securities held in street name are established by contract. The margin account agreement typically addresses these issues in a vague way, providing that in certain instances the customer “may” not have the right to vote shares held in the account. Of course, most account holders are likely unaware of this potential contractual disenfranchisement.⁷ As a practical matter, however, the actual shareholder rights of most brokerage firm customers are established by very imperfect industry practices.

REGULATORY ACTION ON OVER-VOTING

The rise of majority voting standards and the increasing activism of institutional investors and hedge funds have increased the likelihood that over-voting may improperly affect election outcomes because elections are more likely to hinge on fewer votes. The controversial merger between Compaq and Hewlett Packard was approved by just 51.4 percent of the shares, and the AXA/MONY merger was approved by only a margin of 1.7 million shares for a total of 53.8 percent of the total outstanding

7. For example, the margin agreement of a prominent broker-dealer reads as follows: “In return for the extension or maintenance of any credit by [broker], [customer] acknowledges and agrees that the securities in the [customer’s] account, together with all attendant rights of ownership, may be lent to [broker] or lent out to others to the extent not prohibited by applicable laws, rules and regulations. In connection with such securities loans, and in connection with securities loans made to [customer] to facilitate short sales, [broker] may receive and retain certain benefits to which [customer] will not be entitled. [Customer] understands that, in certain circumstances, such loans could limit [customer’s] ability to exercise voting rights, in whole or part, with respect the securities lent.” The Margin Lending Program Client Agreement, Merrill Lynch (current as of 10/27/08).

shares at a time when 6.2 million shares were out on loan.⁸ In addition to uncertainty and inaccuracy, the small margins of victory also mean that the system is vulnerable to manipulation. As a result, regulatory agencies, including the New York Stock Exchange (NYSE), have expressed growing concern about over-voting and improving the oversight of proxy collection and submission.⁹

While it is permissible to outsource the administrative task of distributing, gathering and tabulating proxy materials to proxy servicing agents, such as Broadridge, it does not relieve brokers of the responsibility under NYSE Rule 452 to supervise the process, maintain adequate books and records, and ensure that the rights of beneficial shareholders are protected. This responsibility includes “initial and continuing due diligence to assure that the service provider is capable of collecting and reporting the customer votes and that the source of share information is accurate.”¹⁰

Brokers are given a great deal of flexibility in terms of how they choose to comply with the NYSE’s over-voting rules. So long as a firm performs a reconciliation—whether it is before or after the mailing of proxies to its customers—they are in compliance with the rule. Although there is considerable variance across the industry as to actual practices, even the best practices advocated by the industry’s trade association allow for only very rough justice. The Securities Industry and Financial Markets Association (SIFMA) encourages brokers to (1) do a reconciliation, on or soon after the record date, of long customers to street-side holdings so that they can anticipate over-reporting situations and ensure that their combined holdings are accurately reflected in their proxy service provider’s system; (2) utilize a service such as the “Over-Reporting Prevention Service” provided by Broadridge that compares a broker-dealer’s re-

8. See Marcel Kahan and Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227 (2007).

9. Between February 2006 and March 2007, NYSE imposed fines ranging from \$250,000 to \$1 million against various broker-dealers for over-voting violations ranging from failing to timely reconcile stock records on beneficial ownership in connection with proxy voting, keeping inadequate or inaccurate records, and transmitting inaccurate information to proxy services providers that resulted in over-voting. Deutsche Bank Securities Inc. N.Y.S.E. Hearing Board 05-45 (Feb. 2, 2006) *available at* <http://www.nyse.com/pdfs/05-045.pdf>; (\$1 million fine); UBS Securities LLC, N.Y.S.E. 06-55 (April 18, 2006) *available at* <http://www.nyse.com/pdfs/06-055.pdf> (\$600,000 fine); Goldman Sachs Execution & Clearing N.Y.S.E. Hearing Board 06-61 (May 4, 2006) *available at* <http://www.nyse.com/pdfs/06-061.pdf> (\$500,000 fine); Credit Suisse Securities (USA) LLC N.Y.S.E. Hearing Board 06-54 (April 18, 2006) *available at* <http://www.nyse.com/pdfs/06-054.pdf> (\$250,000 fine); and First Clearing, LLC N.Y.S.E. Hearing Board 07-28 (March 8, 2007) *available at* <http://www.nyse.com/pdfs/07-028.pdf> (\$325,000 fine). Supervision of Proxy Activities and Over-Voting, N.Y.S.E. Info. Mem. 04-58, (Nov. 5, 2004) *available at* <http://www.nyse.com/RegulationFrameset.html?displayPage=http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom?openview&count=250&RestrictToCategory=currentyear>.

10. *Id.*

ported position to its DTC position, flags any differences, and enables the broker-dealer to make appropriate adjustments before authorizing submission of the votes to the issuer; (3) if more than one account needs to be adjusted in order to reconcile the votes, adjust the vote fairly and equitably;¹¹ and (4) review their agreements to ensure that there is adequate disclosure regarding proxy voting so that customers understand that their number of shares eligible to vote may be adjusted downward.¹²

Other than as described above, there are no standard or required procedures a broker is required to undertake in the event of over-voting. These procedures are almost entirely opaque in specific circumstances and are mostly accomplished without regard for the actual votes by holders who expect to hold voting power in the issuer. Here is how it can work in practice: If a broker receives ten percent more votes than the number of shares it holds on record with DTC, the yes and no totals may each be reduced by ten percent. This proportional adjustment is completely in keeping with current regulatory requirements, but it can result in throwing out valid ballots to make room for ineligible votes. And though this may seem like a somewhat reasonable solution from the broker's perspective, an individual's voting rights may be entirely disenfranchised. Even worse, if the broker fails to separately reconcile the securities held in accounts that are not subject to securities lending practices (cash accounts) from those held in margin accounts, the votes of cash account holders may be cut back without the holder ever having been warned of this possibility. Other common and accepted methods of dealing with over-voting either by the broker or the tabulator include counting votes on a "first in, first voted" or "last in, first voted" basis, or disregarding altogether a vote submitted by a broker-dealer. Of course, all of these methods lead to the same sort of voter disenfranchisement for beneficial shareholders.

STOCK LENDING AND SHORT-SELLING PRACTICES ALSO COMPLICATE THE TAX IMPACT OF DIVIDEND PAYMENTS

A number of commentators have questioned why, if brokers can keep track of who is eligible to receive a dividend and who should receive a payment in lieu of dividend in connection with borrowed shares, can they not properly allocate voting rights?¹³ The answer, it appears, is that many brokers do not in fact keep track of individual dividend allocations.

11. The NYSE Rule requires that the method of fixing any over-voting situation be proportional and equitable among all clients, such as by impartial lottery or pro-ration. See Letter from the Securities Industry Association (now known as SIFMA) to Anand Ramtahal of the N.Y.S.E. (April 26, 2005) available at http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/6136.

12. See Suggested Practices Guidelines for Proxy Processing, S.I.F.M.A. (September 2006) available at <http://www.sifma.org/services/techops/pdf/ProxyGuidelinesSep2006.pdf>.

13. See Broc Romanek and Dave Lynn, Overvoting: The Next Big Scandal?, TheCorporateCounsel.net Blog (Oct. 3, 2006) available at <http://www.thecorporatecounsel.net/blog/archive/001127.html>; Bob Drummond, Corporate Voting Charade,

Just as brokers cannot delegate their responsibility to supervise the process of distributing, gathering and tabulating proxy materials as described above, the Internal Revenue Service has advised that brokers who engage in securities lending transactions, short sales, or other similar transactions on behalf of their customers in the normal course of the brokers' trade or business must meet their reporting responsibilities with respect to payments in lieu of dividends.¹⁴ U.S. tax law requires brokers to notify customers when dividends are issued for shares on loan. In most cases, when a dividend is issued on shares that have been loaned out, the dividend is paid to the investor who has borrowed or purchased the borrowed shares, and the borrower then pays the shareholder who loaned him the stock a cash equivalent referred to as a "dividend payment-in-lieu." Just which type of payment is made—a true dividend or a dividend payment-in-lieu—is significant for tax purposes since true dividends receive capital gains tax treatment and are taxed at a lower rate while payments in lieu are treated as ordinary income and are therefore usually taxed at a higher rate.

However, the dividend payment-in-lieu regulatory framework allows brokers to be just as indefinite when identifying customers who should receive substitute payments as they are when identifying voting rights. Section 1.6045-2(f)(2) of the Internal Revenue Code (IRC) provides for a number of alternate methods that a broker can use to determine who should receive a dividend payment-in-lieu rather than the lower taxed dividend.

As one would expect, brokers may allocate dividend payments-in-lieu to the specific owners known to have had their shares loaned out based on the broker's records. If, however, a broker's records do not specifically identify the owner of each share of stock that was loaned out, Section 1.6045-2(f)(2)(ii) of the IRC permits a broker to pool together all of the issuer's shares held in street name by the broker and allocate the dividend payments-in-lieu among the owners on a somewhat random basis. Specifically, the broker is required to allocate the payments-in-lieu among all shares of stock of the same class that were lent by the broker (including those shares held for the broker's own account) by creating two pools of the loanable shares - with one pool consisting of all the loanable shares of customers who are individuals and the other pool consisting of all loanable shares of non-individual customers. The broker then must allocate the dividend payments-in-lieu between the two pools in the same proportion that the loanable shares held by the customers in those pools bears to the total number of loanable shares available to the broker from the customers in each pool. The customers within each pool that are to

BLOOMBERG MARKETS (April 2006) *available at* <http://www.investigatethesec.com/drupal-5.5/files/Bloomberg%20Proxy.pdf>.

14. *See* The Jobs and Growth Tax Relief Reconciliation Act of 2003 - Information Reporting for Payments in Lieu of Dividends, Internal Revenue Notice 2003-67 (Oct. 6, 2003) *available at* http://www.irs.gov/irb/2003-40_IRB/ar18.html.

be allocated the dividend payments-in-lieu are then chosen either on a purely random lottery basis or on a first in, first out basis. This means that the customers who receive a dividend payment-in-lieu rather than a true dividend, and thus suffer adverse tax consequences, may not be the same customers whose shares were actually lent out. Thus, like voting rights, the allocation of dividend or dividend payments-in-lieu to margin customers is frequently established through imperfect methods, which may have negative tax consequences for some share owners.

We understand that some brokerage firms attempt to close out stock that was loaned out prior to the record date for dividends, thus reducing as much as possible the allocation procedures that are otherwise necessary, as well as the attendant negative tax consequences for their customers. Nonetheless, closing out these loans can be challenging at times depending on liquidity and short interest in the particular security, and beneficial shareholders can still wind up in a very different tax position from that they expected.

MARGIN ACCOUNTS MAY ALSO HAVE SERIOUS ECONOMIC CONSEQUENCES FOR SPAC INVESTORS

With the rise of Special Purpose Acquisition Companies (SPACs), the issue of voting and economic rights of beneficial amounts has taken on a new significance. SPACs are shell or blank-check companies that have no current operations but that go public with the intention of merging with or acquiring an operating company with the proceeds of the SPAC's initial public offering (IPO). Generally, the proceeds raised in the IPO for the SPAC are held in trust to be used at a later date for the merger or acquisition. A SPAC then must sign a letter of intent for a merger or an acquisition within a specified timeframe or else dissolve and return the assets held in trust to the shareholders. The shareholders of the SPAC typically have the right to approve or reject the proposed business combination.

Typically, when a deal is proposed, a shareholder has three options: the shareholder can approve the transaction by voting in favor of it, elect to sell his shares in the open market, or vote against the transaction and seek to redeem his shares for a pro-rata share of the trust account. If the deal is not approved, all shareholders receive their pro-rata share of the trust account. However, if the deal is approved, up to twenty percent of the dissenting shareholders may be redeemed.

If a dissenting shareholder's vote is cut back due to over-voting at the broker/dealer, generally, such shareholder will not only be disenfranchised for purposes of the approval vote, but would also be at significant financial risk due to the inability to seek redemption for all his shares. In fact, we are aware of a situation where a shareholder sought a certified proxy from his broker in order to vote in person at the meeting (as a non-record holder a certification is usually required for an in-person beneficial shareholder vote to be tabulated) in an attempt to secure such

redemption rights. The broker was unable to provide a certification for the full number of shares he owned due to over-voting. This risk has led at least one broker-dealer to prohibit shorting of SPAC shares entirely.

BENEFICIAL SHAREHOLDER RIGHTS WILL REMAIN UNCERTAIN UNTIL A
PROPER RECONCILIATION METHOD IS ADOPTED

Efforts by some brokers to close out lending positions prior to record date goes a long way toward reducing investors' exposure to these problems. However, to ensure that the rights of beneficial owners are fully respected, reconciliation procedures should include an examination of the actual holdings of brokerage customers in these situations. Moreover, it seems to us that in fairness customers should be properly informed of both the potential and actual consequences of these actions. For instance, if a margin account customer's shares have been lent out and the lending positions will not be closed out prior to record date, the customer should be alerted to this fact. This could be accomplished by flagging the securities lent on record date in a customer's portfolio. In any event, brokers and proxy tabulating services should ensure that cash account customers are never subject to an over-voting cutback by segregating cash account votes in all reporting to proxy tabulating services.

In considering a regulatory solution, it is instructive to note one imposed in another context. By providing that the shares eligible to be tendered in connection with a tender offer include those securities to which either the customer has title or "would have title but for having lent such securities," Securities Exchange Act Rule 14e-4 prevents shareholders with margin accounts from being disenfranchised in a partial tender offer. This solution works in the partial tender offer context even though short sales create more net long holders of securities than are actually outstanding, because the offeror purchases only up to a specified amount and tendering shareholders are cut back pro rata as necessary. Though the Rule 14e-4 solution to this long holder/record holder mismatch still results in negative consequences for shareholders due to potentially greater cutbacks than might otherwise occur, this bit of rough justice is reasonable in its context. This solution, however, cannot be applied to the problems enumerated above, because recognizing all long holders as shareholders would hopelessly confuse the record holder concept.

It seems the only real regulatory solution is to require a complete reconciliation of all account positions on record date for each of these corporate actions, while at the same time specifically notifying those accounts that are lenders of securities that they have foregone their rights as shareholders with respect to the action in question. If the industry continues to avoid rigorous reconciliation, it does so at the risk of customer litigation and regulatory action. In the meantime, activist shareholders and others who hold their shares in street name have no real way to ensure they will have the voting and other rights to which they thought they would be entitled when they purchased the shares.