The Hanging Chads of Corporate Voting[†]

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Abstract

Never has voting been more important in corporate law. With greater activism among shareholders and the shift from plurality to majority voting for directors, the number of close votes is rising. But is the basic technology of corporate voting adequate to the task? In this Article, we first examine the incredibly complicated system of US corporate voting, a complexity that is driven by the underlying custodial ownership structure, by dispersed ownership and large trading volumes, and by the rise in short-selling and derivatives. We identify three ways in which things predictably go wrong: pathologies of complexity; pathologies of ownership; and pathologies of misalignment of interests. We then discuss the current legal treatment of these pathologies and consider a variety of directions for reform, ranging from incremental modifications to fundamental redesign. We show that, absent a fundamental reconstruction of the ownership structure, the existing system will continue to be noisy, imprecise and disturbingly opaque. The problems with the existing system pose fundamental challenges for both proponents of direct shareholder democracy, who advocate more extensive voting rights for shareholders, and for proponents of indirect shareholder democracy, who advocate deference to a board of directors the legitimacy of which ultimately also rests on shareholder elections.

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Introduction

Never has voting been more important in corporate law. As Eileen Nugent, a leading M & A practitioner commented, "when you are in the trenches, every vote counts."[1]

With the activism of institutional investors and hedge funds in corporate governance and corporate control, there are more and more closely fought merger votes. The controversial merger between Compaq and HP squeeked through with the approval by 51.4 percent of the shares.[2] The AXA/MONY merger was only approved after a change in the record date and then only by a margin of 1.7 million shares (53.8 percent) at a time when 6.2 million shares were out on loan.[3] The Transkaryotic merger was approved by just 52 percent of the shares.[4]

Director elections have likewise become much more important. In takeover contests, Delaware law, by upholding the poison pill, has channeled the decision into the annual meeting. The prevailing mode of hostile acquisitions has become a bid coupled with a proxy contest so as to replace the directors and remove the poison pill. With the rise of hedge funds, the number of regular proxy contests, unrelated to takeovers, has also gone up. In a 2006 proxy contest, Nelson Peltz succeeded in electing two of five candidates to the Heinz's board.[5] The margin of victory by the Peltz nominees was about 8 million shares out of 250 million voted, or 3.5 percent.[6] At El Paso Corp., a Houston-based energy company, incumbent directors were reelected by approximately 17.2 million votes at a time when the latest figures showed active short sales of almost 76 million borrowed shares.[7] 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 plurality standard. At CVS Caremark, which has adopted a "majority vote" rule for director elections, Roger Headrick was narrowly reelected to the board on the basis of votes cast by brokers who had not received instructions from their clients.[8]

Finally, shareholder proposals at the annual meeting, both mandatory and precatory, are now a fixture of the landscape and an important part of the governance

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[1] Eileen Nugent, Skadden Arps, personal communication.
[2] Balotti at 7-23.
[3] Floyd Norris, Holders of MONY approve $1.5 billion sale to AXA, NYT 5/19/04 at p.4; Bob Drummond, Corporate Voting Charade, Bloomberg Markets April 2006 at p. 96.
[4] *In re: Appraisal of Transkaryotic Therapies, Inc.*, Civil Action No. 1554-CC (May 2, 2007).
[5] Teresa Lindeman, Dissidents Join Heinz's Board, Both Sides Pledge Cooperation, 9/16/06 Pittsburgh Post-Gazette at A-1.
[6] See Heinz Co. Form 10-Q for quarter ended Nov 1, 2006, p. 16 (our estimate is derived from the difference between the votes for Peltz, 136 million, and the votes of three board nominees that Peltz wanted to replace but that were elected (128 million for Bunch, Drosnick and O'Reilley). It is likely that the board candidate with the next lowest vote (who was not elected) had approximately the same votes as these three.
[7] Bob Drummond, Corporate Voting Charade, Bloomberg Markets April 2006 at p. 102.
[8] Kara Scannell, 'Broker Votes': Opponents May Win One, WSJ June 13, 2007 at C1.

structure, with numerous close contests.[9] For example, at Alaska Air Group's May 2005 meeting, a bylaw amendment requiring shareholder approval for anti-takeover plans fell 2.4 million votes short of the required 75 percent approval at a time when 4 million shares had been sold short.[10]

But is the existing voting system up to the task? Can it meet the demands that are placed on it? How confident can we be that the reported outcomes of close corporate votes reflect the votes actually cast and that the right set of shareholders was afforded effective voting rights?

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 0.03 percent margin of victory.[11] We learned that the voting system could not answer the question "who won?" and then had to improvise a procedure to break the statistical tie. What are the hanging chads of corporate voting? And do we have adequate procedures for breaking statistical ties?

In Part I, we provide background on when shareholders vote, which shareholders have a right to vote, how votes are counted and how voting disputes are resolved. In Part II, we discuss how shares are actually held, transferred and voted in the US system, in which approximately 80 percent of the shares are held by nominees. In Part III, we analyze the various pathologies that infect the shareholder voting system and review the legal treatment of the problems that arise. The pathologies of voting 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 potential misalignment between voting rights and economic interests ("pathologies of misalignment").

Part IV considers a variety of directions for reform, ranging from increased judicial scrutiny to a fundamental redesign of the system. Although a fundamental redesign would significantly improve matters, even a major reform will not eliminate all problems because many of the pathologies we discuss are intrinsic to a system in which shares are widely but indirectly held and in which thousands of votes are taken every year.

Our analysis poses challenges for proponents of shareholder right as well as for advocates of managerialism. The inescapable complexity, combined with the already well studied issues of shareholders' rational apathy and free rider problems, detract from the case for shareholder voting. To what extent should we put matters to a shareholder vote

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[9] According to Yair Listokin, between 1997 and 2004, there were 714 "close votes" on proposals put to shareholders where a vote is defined as "close" if the margin of victory or defeat is 10% or less. Yair Listokin, Management Always Wins the Close Ones, working paper 2007 at Table 3.

[10] Bob Drummond, Corporate Voting Charade, Bloomberg Markets April 2006 at p. 102.

[11] Bush v. Gore, 531 US __ (2000) (Florida division of elections reported a Bush margin on 1784 votes out of more than 5.8 million cast).

if we cannot trust in the outcome? By the same token, however, the legitimacy of the exercise of governance powers by the board of directors, and by management appointed by the board, rests on the fact that directors are been elected by shareholders. If board elections either take the form of Soviet-style votes – with one candidate per open seat who is elected with a huge margin – or of contested elections with a close outcome, why is it that management should call the shots?

I. Corporate Voting Law: A Brief Introduction

In this Part, 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 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, most set by Delaware law, some by tax law and some by stock exchange rules. Under Delaware law, shareholders elect the board of directors.[12] Under Delaware law, a director is generally elected by a plurality of the votes cast, but many companies have recently opted to require the vote of a majority of the shares cast to elect a director.[13] For matters other than the election of directors -- such a by-law amendments[14] or precatory shareholder resolutions -- the basic decision rule is the affirmative vote of a majority of shares present. Mergers, a sale of all or substantially all the assets, and amendments to the certificate of incorporation, however, require the approval of a majority of the shares entitled to vote.[15] Finally, Delaware case law, while not requiring shareholder approval of self dealing transactions or executive compensation, provides a variety of inducements for it.

Under NYSE rules, shareholder approval is also required if a transaction involves the issuance of stock that increases the number of outstanding shares (or voting power) by 20 percent or more.[16] In addition, shareholders 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 shareholders. Similarly, and without regard to tax

[12] §§211(b), 216.
[13] Delaware permits companies, for these and other matters, to adopt a higher approval threshold than the one provided by Delaware law. See §216(2). Note that Delaware recently made changes to its statute regarding director elections. See 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") and §141(b) ("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.").
[14] 109.
[15] §251(c) (mergers); §271 (sale of all assets); §242 (charter amendments).
[16] NYSE Listed Company Manual 312.03(c).

treatment, the NYSE Listing Requirement require that equity compensation plans be approved by the shareholders of listed companies.[17]

b. Who gets to vote?

With annual turnover of shares in a public company on the order of 99 percent, the shareholder base is constantly in flux. It is thus necessary to define both a date as of which a list of shareholders qualified to vote is determined and a mechanism for determining the identity of the shareholder entitled to vote as of that date.

State corporate law supplies both. Under DGCL §213, a "record date" is fixed in advance of any vote and "shall not be more than sixty nor less than ten days before the date" of the meeting. The persons who, as of the record date, are listed as registered owner of the shares on the company's books are entitled to notice of, and to vote at, the shareholder meeting.[18]

State corporate law thus puts record ownership, rather than beneficial ownership, at the center of the system. Firms are entitled to rely on 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.[19] To be sure, record owners may authorize others to vote in their stead by means of a proxy.[20] But, in the absence of a transfer by proxy, the record owner of the shares is entitled to vote the shares held even when the person holds the stock in a fiduciary capacity.[21]

Delaware has steadfastly refused to modify its reliance on record ownership in the voting context. It has done this not because it is unaware of custodial ownership structures discussed below, 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. Whatever flaws are generated by giving entitlements to record owners, it has the benefit that the owner is clearly specified and known to the company.

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. Going back at least to 1945, the Delaware Supreme Court reasoned in *Salt Dome Oil Corp. v. Schenck*[22] that "[t]he corporation ought not to be involved in possible misunderstandings or clashes of opinion between the nonregistered and registered holder of shares. It may

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[17] NYSE Listed Company Manual 303A.08, 312.03(a).
[18] 219
[19] Berlin v. Emerald Partners, 552 A.2d 482 (Del. 1988); Schott v. Climax Molybdenum Co., 38 Del. Ch. 450, 154 A.2d 221 (Del. Ch. 1959).
[20] 212c.
[21] 217(a).
[22] 41 A.2d 583 (Del. 1945)

rightfully look to the corporate books as the sole evidence of membership."[23] The law governing appraisal rights follows a similar pattern.[24]

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[23] This focus has continued. For example, in *Enstar v. Senouf* , 535 A.2d 1351, 1354-55 (Del. 1987), 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. 234192 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."). See, also, American Hardware Corp. v. Savage Arms Corp., 136 A.2d 690 (Del. 1957); Giant Portland Cement, 21 A.2d 697 (Del Ch 1941).

[24] With regard to appraisal rights, Del §262(a) explicitly defines the stockholders entitled to appraisal as "a holder of record of stock in a stock corporation," thus making record ownership the key measure. Accordingly, an appraisal action can only be brought by or on behalf of the record owner. Enstar Corp. v. Senouf, 535 A.2d 1351 (Del. 1987); Carl M. Loeb, Rhoades & Co. v. Hilton Hotels Corp., 43 Del. Ch. 206, 222 A.2d 789, 792 (Del. 1966); Olivetti Underwood Corp. v. Jacques Coe Co., 42 Del. Ch. 588, 217 A.2d 683 (Del. 1966); Coyne v. Schenley Indus., Inc., 38 Del. Ch. 535, 155 A.2d 238 (Del. 1959); Raynor v. LTV Aerospace Corp., 331 A.2d 393 (Del. Ch. 1975); Application of General Realty Utilities Corp., 28 Del. Ch. 284, 42 A.2d 24 (Del. Ch. 1945), see also Balotti & Finkelstein, §§4.43[B], 9.44[F]; Folk on the DGCL, §262.5. This can work to the benefit of beneficial owners. In a recent case, *In re: Appraisal of Transkaryotic Therapies, Inc.,* Civil Action No. 1554-CC (May 2, 2007), the Delaware Chancery Court permitted hedge funds, who had acquired shares post record date, to pursue an appraisal in reliance on the fact that the record holder (Cede & Co.) had a sufficient number of shares that had not been voted for the merger, without establishing that the shares that the hedge funds had acquired were themselves among the shares that qualified for appraisal. The Chancellor quite explicitly noted that the effect of the ruling would be to allow arbitrageurs "to buy into appraisal actions by free-riding on Cede's votes on behalf of other beneficial holders," id., but held that the statute's focus on record holders dictated the outcome: "Only the record holder possesses and may perfect appraisal rights. The statue simply does not allow consideration of the beneficial owner in this context."

By contrast, the courts show more flexibility in other contexts. With regard to acting by consent under §228, "generally only persons whose names appear on the stock ledger as stockholders or hold proxies from record holders are qualified to execute a written consent." Folk on the DGCL at §228.4.3 citing cases. On the other hand, Delaware courts have held that beneficial owners may execute the consent so long as they indicate who the record holder is and have the right to vote the shares. Olson v. Buffington, CA 8042, 1985 Del. Ch. LEXIS 494 (July 17, 1985). In the case of shareholder derivative suits, an equitable remedy, the Delaware statute does not specify whether record ownership is required and the courts have not generally required it. See, e.g., Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A.2d 106 (Del. Ch. 1948); Gamble-Skogmo, Inc. v. Saks, 35 Del. Ch. 503, 122 A.2d 120, 121, 1956 Del. LEXIS 56 (Del. 1956). In litigation under §225 (Contested Election of Directors; Proceedings to Determine Validity), both record holders and beneficial holders may bring suit. Rosenfield v. Standard Elec. Equip. Corp., 32 Del. Ch. 238, 83 A.2d 843 (Del. Ch. 1951). Balotti & Finkelstein, §13.10 ("An equitable owner of shares is considered a stockholder and may maintain a derivative action.")

Federal securities law is even less focused on record ownership. With regard to shareholder proposals, SEC rules provide that, in order for a shareholder holding in nominee name to put a proposal on the issuer's proxy statement, it must prove its eligibility either by submitting a written statement from the record holder verifying that the proponent, at the time the proposal was submitted, had held continuously for at least one year or, if it has filed 13Ds, 13Gs, or other SEC reports indicating ownership, by means of those filings. Rule 14a-8. Under §§10(b) and 16(b), suit can typically be brought by either the beneficial or record owner. Blau v. Lamb, 314 F.2d 618, 620 (2d Cir. 1963), *cert. denied,* 375 U.S. 813.

c. Counting the Votes

Once votes are cast, they are counted to determine whether the required threshold has been reached. This 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."[25] Where more than one valid proxy is given for a share, the later proxy revokes the earlier proxy. Determining the validity of proxies and the tally of votes is the responsibility of the inspector, appointed by the corporation.[26]

d. Resolving Close Contests under Current Delaware Law

Not surprisingly, Delaware has encountered close contests. In resolving any controversies, Delaware has adopted a formalistic approach that promotes certainty and speed over accuracy and perfection.[27]

In contested votes, an independent inspector is appointed by the company.[28] The inspector's role is "ministerial", not "judicial."[29] 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.[30]

Under §231(d), the inspector is limited in the materials he may use in determining the validity of proxies to "…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."[31] This part of §231(d) largely codifies longstanding Delaware practice.[32] In addition, the inspector may consider other reliable information, but only for "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.*"(emphasis added).[33] This exception recognizes that the

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[25] 212(b).
[26] 231
[27] DGCL §225 provides the statutory basis for judicial review of contests.
[28] Balotti et al, Meetings, §10.1 at 10-5 to 10-6.
[29] Berlin v. Emerald Partners, 552 A.2d 482, 491 (Del. 1989).
[30] Id. at 491.
[31] §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.
[32] Official Synopsis, 67 Del. Laws Ch. 376, §9 (1990), cited in Seidman at n. 14.
[33] Up until 1990, Delaware took an even narrower view on what materials may be considered.. Under the doctrine of *Williams v. Sterling*, 273 A.2d 264 (Del. 1971). the inspector could not look to *any* extrinsic evidence at all. In 1989, in *Concord Financial v. Tri-State*, 567 A.2d 1 (Del. Ch. 1989), the Delaware Chancery Court reaffirmed the *Williams* refusal to consider extrinsic evidence, and held that the inspector erred in considering extrinsic evidence of an obvious clerical error to resolve an outcome determinative

realities of custodial ownership increase the likelihood of clerical and other errors and grants inspectors some latitude in resolving overvotes. But even this latitude is constrained. In *Seidman v. G.A. Financial*,[34] the court invalidated proxies for 233,376 shares because of an overvote of 824 shares because the inspector was not able to obtain reliable information from the proxy clerk to resolve the overvote.

e. Voting by Registered Owners: the Delaware Paradigm

The Delaware voting paradigm described in the previous sections is thus straightforward. 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 their formal validity (but not, for example, whether they reflect the voting instructions of beneficial owners) and comparing them 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 hold shares directly. This, of course, is not what happens in publicly held corporations, in which around 70-80 percent of the shares are held by nominees.[35]

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 – where shareholders held share certificates that were registered with the issuer and transferred by the transfer agent upon delivery of the certificate after a sale – is unworkable.[36]

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overvote. In response, in 1990, the Delaware legislature amended §231 to provide the exception discussed in text.

[34] 837 A.2d 21 (Del. Ch. 2003).

[35] SEC Release No. 34-38506 (Mar. 14, 1997) at n.5.

[36] For a discussion of why investors prefer to hold shares in street name, see John C. Wilcox, John J. Purcell III and Hye-Won Choi, "Street Name" Registration & the Proxy Solicitation Process, Chapter 12 in Practical Guide to SEC Proxy and Compensation Rules **(**Third Edition**)** *by Amy L. Goodman, Esq., John F. Olsen* (2006 Supplement) Aspen at 12-3 to 12-4.

Indeed, 40 years ago, 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.[37] Since then, it has become the policy of the United States Federal Government to encourage custodial ownership to facilitate clearing and settlement of securities trades.[38] By now, most shares of publicly held corporations 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 company.[39] Without such a system of custodial ownership, 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.

Because there are important differences between bank and brokerage custodians, we will discuss them separately. Figure 2 provides an overview.

[Figure 2]

i. Bank Custodians

Bank custodians mostly hold shares for mutual funds, pension funds, insurance companies, endowments and trusts. The leading custodian banks are Bank of NY Mellon, JP Morgan, State Street, and Citigroup which, collectively, hold about $30 trillion in assets.[40]

The bank custodians are, in turn, participating members of DTC which holds the actual shares. The DTC account holds all the bank's shares in a fungible bulk, without any subdivision into separate accounts of the custodian's customers. It is only the bank custodian's records that indicate how many shares are held in which accounts and who has voting and trading authority. Often an institutional investor will allocate money to

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[37] 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.

[38] See SEC, Final Report on the Practice of Recording the Ownership of Securities in the Records of the Issuer in other than the name of the beneficial owner of such securities (December 3, 1976) at p. 12 ("In Section 17A of the Act Congress directed the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions. The Commission believes that the practice of registering securities in other than the name of the beneficial owner is essential at this time to the establishment and refinement of such a system and is consistent with the purposes of the Act, with particular reference to Section 17A."). 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

[39] UCC Art. 8 prefatory note. Although there were once other depositories, DTC is now the sole US depository institution.

[40] http://www.globalcustody.net/us/custody_assets_domestic/.

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 investor, 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 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, trade processing and settlement. When, for example, an account holder 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 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 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.[41] The allocation of the fees generated by securities lending between the custodian and the customer is a matter of negotiation, and the amounts involved can be substantial. According to a 2001 estimate, beneficial owners earn about $5 billion a year in fees from securities lending.[42] For the year ending March 31, 2006, CalPERS alone made $129.4 million on its securities lending business.[43]

ii. Broker Custodians

Brokers also act as custodians for their customers. Like bank custodians, brokers will have accounts at DTC where their shares are held in fungible bulk.

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.

Some individual customers hold their shares in margin accounts, which allows 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 generally available to be lent out by the broker. Brokers do not typically identify or attribute the shares lent to specific margin

[41] 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.
[42] Euromoney Institutional Investor, Mark Faulkner, Lending message fails to get through (December 1, 2001).
[43] http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2006/june/approves-investment-contracts.xml

accounts and the broker retains all the proceeds from the lending, whether or not any margin debt is outstanding.[44] When shares are held in regular, non-margin accounts, typically the broker may not lend out the shares without permission of the account holder.

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

In corporate law, we have a conception of who the shareholder is (the beneficial owner), and what the shareholder has (a right to vote, a right to seek appraisal, a right to sue, a right to dividends, a right to sell, etc.). Much of corporate law thinking and scholarship, both in the academy, the courts, the legislatures, agencies, newspapers and elsewhere, proceeds from some version of this "beneficial-owner-as-shareholder paradigm."

Earlier, we showed that, under the Delaware law of corporate voting, the beneficial owner is not exactly treated like the "shareholder" of this paradigm. In this section, we turn to the structure of property rights under Article 8 and show that it, too, substantially diverges from the beneficial-owner-as-shareholder paradigm. Understanding both the legal structure of corporate voting and the legal structure of share ownership is necessary in order to comprehend the pathologies we discuss below and the potential solutions.

The vast volume of securities trading has led to a transformation of the structure and content of property law as it applies to securities. Since 1973, there has been a concerted effort to change property law in order to minimize the number and impact of failed trades. Article 8 of the UCC establishes a property rights regime for securities that is designed for modern, indirect shareholding. See figure 3. Under Article 8, the beneficial owner of the share held in a custodial account with an intermediary (such as a broker) is considered to be the holder of a "securities entitlement" [45] in a "financial

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[44] See, e.g., the 2007 Charles Schwab margin account agreement ¶8 (Loan Consent), http://www.schwab.com/cms/P-221808.9/cct_opt_margin_short_acct.pdf?cmsid=P-221808:

> You agree that Securities and Other Property held in your margin account, now or in the future, may be borrowed (either separately or together with the property of others) by us (acting as principal) or by others. You agree that Schwab may receive and retain certain benefits (including, but not limited to, interest on collateral posted for such loans) to which you will not be entitled. You acknowledge that in certain circumstances, such borrowings could limit your ability to exercise voting rights or receive dividends, in whole or in part, with respect to the Securities and Other Property lent. You understand that for Securities and Other Property that are lent by Schwab, the dividends paid on such Securities and Other Property will go to the borrower. No compensation or other reimbursements will be due to you in connection with such borrowings. However, if you are allocated a substitute payment in lieu of dividends, you understand that such a payment may not be entitled to the same tax treatment as may have been applied to the receipt of a dividend. You agree that Schwab is not required to compensate you for any differential tax treatment between dividends and payments in lieu of dividends. Schwab may allocate payments in lieu of dividends by any mechanism permitted by law, including by using a lottery allocation system.

[45] UCC 8-102(7) (defining 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

asset"[46] which is ultimately held by a depositary.[47] A customer becomes an entitlement holder as soon as the intermediary makes a book entry indicating that the customer has bought shares.[48] One important effect of this structure is that a brokerage customer can become an entitlement holder even if the broker has not, in fact, acquired the shares credited to the customer's account, and even if the broker does not own a single share of the security.

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 makes clear that the interests of the customers who holds a certain security is not an interest in any particular item of property, but rather is a pro rata interest in all like securities of the intermediary held in common by all other customers who own the same security.[49] As a "securities entitlement holder", the customer has a superior claim in the securities against general creditors of the securities intermediary. Its claim, however, is

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acquires a security entitlement by virtue of Section 8-501(b)(2) or (3), that person is the entitlement holder.)

[46] "Financial assets" include shares.

[47] UCC 8-501(b)(1).

[48] UCC 8-501(c).

[49] UCC 8-503(c), (d), and (e) provides that:

Moreover, 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) to (e) sharply limits the methods by which an entitlement holder may enforce its rights. These sections provide:

(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.

inferior vis-a-vis a purchaser of that security from that intermediary and any creditor of the intermediary who has obtained a security interest.[50]

The UCC, unlike the Delaware voting paradigm, thus explicitly takes account of the modern system of custodial ownership. But by adapting to the complexities created by custodial ownership, it loses determinacy with respect to the key shareholder rights in corporate law. While the informal corporate law paradigm views the shareholder as the owner of a thing – a share – the UCC has customers who jointly own an interest in a fungible mass, with no specific shares attributed to any specific customer. The misalignment between the property rights implicit in the beneficial-owner-as-shareholder paradigm and the property concepts from Article 8 comes to the fore in the problem of overvoting.

c. How Nominee Shares are Voted

That shares are held in street name greatly complicates the voting process. Before votes can be tabulated, one must identify and locate the beneficial owners, distribute proxy materials to them, and collect their votes. In this section, we discuss these steps in greater detail.

i. Step 1: Finding the Beneficial Owners

To find the beneficial owner, the issuer sends an inquiry to DTC in which it asks for a list of participant custodians who hold shares of the issuer in its account (Figure 4). Depositories are obligated to identify participants promptly and to indicate the number of shares owned by each as of the date of the inquiry.[51] If there is a discrepancy between the number of shares held by DTC as indicated by the corporation's share 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 (Figure 5a).[52] Upon receipt of the search card, banks and brokers must provide the information requested (Figure 6). Most custodians delegate the task of processing proxies and other corporate communications to Broadridge (known as ADP Shareholder Services until its recent spinoff), the dominant provider of proxy services. Broadridge then provides this information to the issuer.

Custodians operate on a tight schedule. Brokers must respond to search card inquiries within seven business days of receipt. Banks must identify all respondent banks within one business day of receipt of the search card.[53] They then have seven business days to indicate the approximate number of beneficial owners holding the issuer's shares

[50] UCC 8-511.
[51] SEA Rule 17Ad-8(a) (and can charge for doing so: SEA Rule 17Ad-8(b))
[52] This is required under SEA Rule 14a-13
[53] 14b-1(a)(3).

directly with that bank (i.e., not counting respondent banks).[54] When the issuer receives the initial response from banks identifying respondent banks, it sends search cards to the respondent banks, and the process is then repeated for subsequent layers until the lowest tier of respondent bank has provided the issuer with the number of its customers holding stock of the issuer. See Figure 5b.

Under the NOBO/OBO system, the banks and brokers must provide the identity of the account holders to the issuer unless an account holder has affirmatively opted to be an "objecting beneficial owners" (OBO).[55] Approximately 75 percent of beneficial owners object to disclosure of their names, with the result that roughly 52-60 percent of the shares of public companies are held by OBOs.[56] Issuers, thus, cannot communicate directly with this large segment of shareholders. Broadridge, however, as an agent of the custodians, has access to this information even for OBOs and thus plays the critical role of distributing the proxy materials.

[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 custodian with sufficient copies of the proxy card packet (proxy cards, annual report and proxy statement). Upon receipt of the materials, custodians have five business days to forward them to beneficial owners. Typically, Broadridge performs all of these tasks as an agent for the custodians. See Figure 6. The issuer is also required to pay the costs of this distribution.[57] The NYSE and NASD have rules setting the charges that Broadridge, acting on behalf of brokers, may charge listed firms.[58] Banks, with no similar organization to set rates, typically follow the NYSE rates.[59]

[INSERT Figure 6]

The arrival of the "notice and access" model of delivery of proxy material on July 1, 2007 may change things dramatically. Recently, the SEC adopted amendments to the proxy rules permitting public companies to furnish proxy materials to shareholders by posting them on an internet website and providing the shareholders with notice of the internet availability of the materials.[60] If shareholders have previously elected to receive proxy materials by electronic delivery, this notice will be sent by email. If not, it will be sent by regular mail. Shareholders will then have the option to request paper copies of

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[54] 14b-(2)(a)(2).
[55] SEA Rule 14b-1(b)(3) (brokers), 14b-2(b)(4)(ii)(B) (banks).
[56] Business Roundtable Request for Rule Making Concerning Shareholder Communication (April 12, 2004) at n.2, based on information from ADP.
[57] Rule 14a-13(a)(5).
[58] NYSE rule 465; NASD?
[59] Rule 14b-2(g)
[60] 17 CFR PARTS 240, 249 and 274 [RELEASE NOS. 34-55146; IC-27671; File No. S7-10-05] RIN 3235-AJ47 "INTERNET AVAILABILITY OF PROXY MATERIALS"

the proxy materials. When a company chooses to use "notice and access", custodians will have to send their own notices to their customers, the beneficial owners, and a beneficial owner may then request written materials. This new model, like many other aspects of the internet, creates a great deal of uncertainty over what the system will look like going forward.[61]

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.[62]

To enable the ultimate beneficial owners to vote, banks and brokers must provide them either with an executed proxy card or a request for voting instructions.[63] They typically do the latter. Broadridge is again the key player at this stage. When everything works perfectly, Broadridge receives voting instructions, verifies receipt, verifies that the signatories have voting authority, executes the proxy on behalf of its custodian (bank or broker) principal aggregating the instructions it has received, and then forwards the proxies to the "tabulator." See Figure 7.

iv. Step 4: Tabulation

The final step in the process is the tabulation of the votes. The tabulator is charged with the task of checking the validity of proxies received – many of which will

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[61] See, e.g., Broadridge Form 10 at p. 11 describing how the new model may affect its business:

> The adopted changes, and the proposed changes, if adopted, will have a significant effect on our business. For those companies that choose the notice and access option, we will continue to mail notices to those stockholders who have not elected to receive proxy materials electronically. Therefore, the volume of items to be mailed will most likely remain unchanged. However, the weight of the packages will be less, resulting in lower revenues per distribution. At the same time, some stockholders may elect to continue to receive paper copies of proxy materials. Certain of these mailings may not receive the benefit of volume discounts, resulting in higher revenues per distribution. We also anticipate deriving additional revenue from the fulfillment services that we expect to provide for individually ordered paper proxy materials and for the establishment of procedures such as toll-free numbers and websites to accommodate the requests of stockholders to receive paper proxy materials for up to one year after the conclusion of the meeting or corporate action to which the materials relate. Additionally, we may derive revenue from new services such as the creation of access notices and the creation and maintenance of a new database of stockholders requesting paper proxy materials. We do not at this time know how many companies will choose the notice and access option, nor do we know how many stockholders will elect to continue to receive paper copies of proxy materials. As a result, we cannot at this time predict the net effect of the SEC's new electronic access rules on our Investor Communication Solutions business.

[62] 14b-2(b)(i).

[63] 14b-1(b)(2)(for brokers); 14b-2(c) (for banks).

have been executed by Broadridge -- and checking to make sure that the number of nominee shares voted equals the number of shares that DTC indicates are held in nominee name. The issuer retains the tabulator which is often the issuer's transfer agent.[64] More recently, Broadridge has also been expanding into this business.[65] In contested votes, an independent inspector is often retained to count the proxies. IVS Associates is the leading firm.[66]

[INSERT Figure 7]

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

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 the one anticipated by the Delaware legal structure. There are around 12,000 reporting companies.[67] All of these companies hold annual meetings and are subject to the SEC proxy rules when they solicit proxies. Finally, annual meetings are seasonal, with most taking place during the second quarter of the calendar year.[68] Broadridge delivers more than one billion communications to investors per year.[69] It is an accident waiting to happen.

An aggravating factor is that, for 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. Federal law requires custodians to assist in the identification of beneficial owners, distribution of materials, and collection of proxies. Custodians typically delegate that task to Broadridge, 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 pathologies caused by the sheer complexity of the system. Second, there are pathologies caused by a misalignment of the property concepts implicit in the beneficial-owner-as-shareholder paradigm and the property rules that, in fact, govern the voting of shares held by nominees. Third, there are pathologies caused by a misalignment between voting rights and economic interests.

a. Pathologies of Complexity

i. Pathology 1: Materials don't arrive

[64] See, e.g., http://www.amstock.com/corporate/corporate_proxy.asp
[65] http://www.investquest.com/iq/a/adp/ne/news/bs/adp011707.htm
[66] http://www.ivsassociates.com/html/index2.htm
[67] Cite.
[68] Broadridge Form 10 (Amendment 4) at p. 47.
[69] Id at p. 3.

The corporate voting system operates on a tight 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; DTC must respond; the issuer must send out search cards to the custodians; the custodians must respond; often this process has to be repeated for multiple tiers of custodians; then, and only then, can the issuer mail the materials to Broadridge, which then distributes them to the shareholders. 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.

Why does it matter if materials do not arrive? Most obviously, it deprives the beneficial owners of their right to vote. Moreover, it is likely that the beneficial owners most affected by materials not arriving are individual investors. The failure of materials to arrive will correspondingly increase the relative influence of the institutional shareholders.

But the effects are more complex. "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[70] At least until recently, brokers have tended to vote uninstructed shares in accordance with recommendations of the board of directors. Thus, with respect to such shares, any non-arrival of materials translates into more pro-management votes. [71]

Bank custodians, however, are not covered by this rule and the agreement between the custodial bank and its customer typically does not permit banks to vote uninstructed shares. Thus, with respect to shares held by banks, and for non-routine matters also with respect to shares held by brokers, any non-arrival of materials translates into the shares not being voted at all.

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[70] "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." Rule 452. 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)." For more on the broker non-vote, see Wilcox, Purcell and Choi, supra, at 12-8 to 12-9.

[71] Note, however, that the universe of "routine" matters may soon be shrinking. 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. REPORT AND RECOMMENDATIONS OF THE PROXY WORKING GROUP TO THE NEW YORK STOCK EXCHANGE (June 5, 2006).

What, in turn, is the effect of a failure to vote? First, it may make it more difficult for issuers to meet their quorum requirements.[72] Second, for matters requiring an affirmative vote by a majority of the shares *entitled to vote* – such as merger or charter amendments – a failure to vote is equivalent to a "no" vote. Since these matters are generally proposed by the board, any non-arrival of materials translates into a vote *against* management recommendations.

Matters are even more complex where some of the items on the ballot are routine and others are non-routine. As long as brokers continue to exercise their authority on routine matters, the respective shares will count towards the quorum requirements and be deemed present at the meeting, but will abstain from casting a vote on the non-routine matters. But, for some purposes, such abstentions are treated differently from a failure to send in any ballot. Specifically, in uncontested director elections, an "abstention" takes the form of "withholding" of authority to vote in favor of the nominee and is thus indistinguishable from a vote by a holder who is affirmatively opposed to the nominee. The number of votes withheld is the key indicator of shareholders' dissatisfaction with the incumbent management. Moreover, for companies that have adopted a "majority vote" requirement for director election, sufficient withhold votes have the legal effect of the director not being elected or forcing him to resign. For director elections, abstentions thus are, in effect, *anti-management* votes. Shareholder proposals, similarly, require a majority of shares voting, such that abstentions have a similar effect as "no" votes. But since shareholder proposals are typically opposed by management, an abstention on them is equivalent to a *pro-management* vote.

ii. Pathology 2: Votes that are not counted

Consider the following incident.[73] A 9 percent holder received proxy materials from Broadridge for an "uncontested" election of directors that indicated that voting instructions had to be received by 11:59 pm on the day before the annual meeting. At 11 pm, to show its displeasure with current management, the holder gave instructions that its votes should be withheld from all nominees. When the results were announced, the company stated that 95 percent of shares voted had been cast for the nominees. When the holder inquired, it discovered that the tabulator had stopped tabulating votes at 4 pm on the day before the meeting in order to prepare its report in a timely manner. As a result, the holder's votes were not included.[74]

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[72] The default quorum requirement is set at 50%, but it can be lowered by a charter provision to as little as 33.3%.

[73] The following is based on a confidential personal communication with one of the authors.

[74] 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

Early closing is only one aspect of a more general problem of votes not being counted. Consider a tabulation anecdote involving a routine annual meeting at Unilever:

> The agenda included no contentious issues, and there was no sign of shareholder unrest. But executives at the Anglo-Dutch consumer products company, maker of Dove soap, Hellmann's mayonnaise and Lipton tea, noticed that the shareholder vote total was suspiciously low. So they called major institutional investors and discovered that seven of them had simply not bothered to take part, and that votes from another three had never been delivered to Unilever because of a coding error by Institutional Shareholder Services ….[75]

Oesterle and Palmiter recount the earlier, nightmare 1993 proxy season:

> The leaky dam of proxy tabulation burst in the 1993 proxy season when various institutional investors blew the whistle on [Broadridge], a tabulation firm that handles over seventy percent of all corporate proxy solicitations. Several investors claimed [Broadridge] had not tallied their proxies in a "just vote no" campaign against Paramount Communications. The Paramount miscount was only the tip of the iceberg. During the solicitation period before the 1993 spring annual meetings, [Broadridge] had experienced significant difficulties: Proxy materials were sent out late or not at all; [Broadridge] received proxy tabulations late or not at all, causing several firms to struggle to meet quorum requirements or to postpone meetings; electronic tabulation systems failed to function; and proxy solicitors had to solicit proxies several times.[76]

What is the effect of the non-counting of votes? If votes are not counted by mistake, the effect is similar to the one resulting from the non-arrival of materials. And even if the tabulator stops counting early because there are already enough votes in to determine the outcome, there may be an important, albeit symbolic, effect: the margin of

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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."

Typically, the polls are opened officially during the meeting to receive proxies and ballots (from those shareholders present). The official closing of the polls is more complicated. In a "simple, uncontested meeting", the results of any vote may be tabulated and announced without adjournment. Balotti et al, Meetings of Stockholders at §8.12. On the other hand, when a vote is close, the polls can be kept open while the company's proxy solicitor works to find more votes. This discretion likely explains Listokin's finding that management is overwhelming likely to win close contests. If, at the beginning of a meeting, management is short votes, the polls can be held open while the solicitors continuing soliciting votes. The situation is more complicated when a meeting is adjourned (e.g., for thirty days) in order to allow management to round up additional votes for a specific matter. 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.

[75] Steven Brull, Unilever executives anticipated a routine annual meeting last May, 12 February 2004, Institutional Investor – Americas.

[76] Dale A. Oesterle & Alan R. Palmiter, Judicial Schizophrenia in Shareholder Voting Cases, 79 Iowa L. Rev. 485, 510-11 (1994) (footnotes omitted).

victory (in particular the percentage of withheld votes in director elections or the percentage supporting a shareholder resolution) can be an important indicator of the support that management enjoys.

iii. Pathology 3: The Nightmare of Verification

The most troubling pathology of complexity is the system's inability to provide vote verification and an end-to-end audit trail. Any voting system is only as good as its post-voting system of verification. 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 tabulation problems noted above, combined with other inadequacies, yield a system without adequate structures 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. Broadridge, 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.[77] The first multiple proxy is typically issued 15 days prior to the meeting with daily updates from the 9th day.[78] Banks and brokers frequently use so-called 'partials,' i.e., proxies voting less than all of the shares they are entitled to vote.[79] These partial are cumulative, which means that substantial 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."

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 brokers [sic] will vote all their shares for both sides; others will change their vote without revoking previously voted shares of varying amounts."[80]
- "[B]anks 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

[77] Balotti at 10-12-13.
[78] Id.
[79] Id.
[80] Balotti at 10-15, 16. 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 thenumber of shares they voted. . . . Any broker or abnk proxies that cannot be resolved by telephone are not counted, but reported as unresolved." Id. at 10-16.

inspectors are told that these proxies are a combination of accounts which the banks can or cannot identify at this time."[81]

- "[When there is piggybacking],[82] 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."[83]

Verification is made more complicated by inconsistent records. As John Wilcox explains:

> The "shareholder list" used for solicitation and tabulation of votes at shareholder meetings is actually a compilation of public and non-public data collected from different sources on the record date — the Depository Trust Company (DTC) participant position listing (the Cede list), the share register maintained by the issuer or its transfer agent, the customer account records of banks and brokers, and the internal records of investment managers and their agents. As these records are being assembled, no effort is made to conduct an audit or reconcile inconsistent share positions. For example, the number of shares on the DTC omnibus proxy invariably differs from the shares in the Cede account on a company's share register. No procedure is available to reconcile the discrepancy.[84]

Finally, any meaningful verification efforts are hampered by the presence of two parallel tabulation systems: one for registered holders where the inspector matches proxies against a shareholder list; and a second for voting instructions by beneficial holders tabulated by Broadridge. How Broadridge and its customers, the bank and broker custodians, adjust overvotes, revocations, and other problems within its system in entirely opaque. Even less is known about often Broadridge makes clerical errors in compiling its proxy based on the numerous voting instructions provided by beneficial holders or in verifying that the person giving the instructions had proper voting authority. Delaware courts' reluctance to look beyond the tabulation system for registered owners further complicates matters.

The verification nightmare suggests that there may well be discrepancies – sometimes significant ones – between the ballots cast and the voting instructions given by the beneficial holders. This generates random "noise" in the tabulation of votes, which may sometimes favor and sometimes disfavor management, but which always makes the reported results less reliable. If one believes not only that a decision by shareholders (when they are entitled to vote) is important for legitimacy purposes, but also that

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[81] Id. at 10-16.
[82] Discussed above at __.
[83] Id.
[84] John C. Wilcox, Shareholder Nominations of Corporate Directors: Unintended Consequences and the Case for Reform of the US Proxy System, in Shareholder Access to the Corporate Ballot (Lucian Bebchuk, editor, Harvard University Press, 2005) at 6.

shareholder support is related to whether this decision is a good one, then even random noise means that worse decisions will be certified as having received the requisite shareholder support.

b. Pathologies of Ownership: Confusions as to Who "Really" Owns the Shares

The second set of pathologies arises because of a misalignment of the property concepts implicit in the beneficial-owner-as-shareholder paradigm and the property rules that, in fact, govern the voting of shares held by nominees, combined with wide-spread securities lending and short selling. 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

Suppose that an institutional investor wishes to vote its shares only to discover that they have been "lent out"? This happens. There is a story, perhaps apocryphal, of a prominent institutional investor who had sponsored and campaigned vigorously for a shareholder proposal under Rule 14a-8 only to discover after the record date had passed that it had no shares to vote because it had "lent" them out, and that another institution loaned the sponsoring institution shares to prevent the proposal from being disqualified. (Alas, this story make no sense because the rule requires a proponent to hold the shares through the date of the meeting.)[85]

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 that it enables 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 once the price has declined. Because "naked" short selling is illegal,[86] the investor must "borrow" shares in order to sell them now at the high price. Later, it will buy the same shares, hopefully at a lower price, and restore them to the lender.

As this example demonstrates, the terms "lending" and "borrowing" are not accurate. The standard form contract governing equity lending prepared by the Securities Industry and Financial Markets Association (SIFMA) is a "Master Repurchase Agreement."[87] The securities "loan" is really a transfer by a seller (e.g., an institutional investor) of full legal title in securities to a buyer (e.g., a hedge fund). In exchange, the buyer promises to sell back equivalent (but different) shares in the future and to make the

[85] Rule 14a-8.
[86] Reg. SHO.
[87] http://archives1.sifma.org/agrees/master_repo_agreement.pdf. Annex VIII governs the "lending" of equity securities. See http://archives1.sifma.org/agrees/equityannex.pdf.

lender whole for any dividends paid during the loan period, [88] pays a fee and provides collateral. If a shareholder "lends" its shares out before the record date, the shareholder is no longer a shareholder as of the record date and is not entitled to vote, [89] whether or not the "returned" shares are received prior to the meeting. [90]

As noted earlier, securities lending is a huge market and a highly profitable business.[91] 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 out to bid to a third party specialist. As a result, the personnel in the institutional investor with responsibility for voting the shares may not even be aware that the shares are out "on loan."

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 record dates for meetings at which they intend to raise issues or want to vote. But doing so would sacrifice substantial revenue. Here's why. Most securities lending programs combine the shares of a large number of customers. Recalls of lent shares or freezes on lending increase the transaction costs of the entity that handles the lending program. If a participant in a securities lending program regularly recalls or freezes shares in advance of a record date, that entity will simply give preference to the many participants who do not impose such limitations, and will not lend the participant'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.[92]

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[88] Id. at paragraph 4(a).

[89] With regard to ERISA fiduciaries, the Department of Labor addressed the fiduciary's duties in a 1992 letter in which it concluded that "potential inability to vote on proxy proposals that may arise while the loan is outstanding . . . should be considered by a fiduciary as part of the decision to loan shares of stock." Letter to James E. Heard from Ivan L. Strasfeld dated February 20, 1992 quoted in John C. Wilcox, John J. Purcell III and Hye-Won Choi, "Street Name" Registration & the Proxy Solicitation Process, Chapter 12 in Practical Guide to SEC Proxy and Compensation Rules (Third Edition) (Amy L. Goodman, Esq., John F. Olsen , ed.) Aspen (2006 Supplement) at 12-19. Wilcox et al report that "The DOL's letter has been interpreted as requiring ERISA fiduciaries to have some system in place to ensure they are in physical possession of shares on the record date for meetings at which significant proposals are being considered." Id.

[90] Annex VIII provides that "Except as otherwise agreed by the parties, Seller waives the right to vote, or to provide any consent or to take any similar action with respect to, Purchased Securities that are Equity Securities in the event that the record date or deadline for such vote, consent or other action falls during the term of a Transaction." Id. at paragraph 7.

[91] According to a 2004 survey, the total securities lending volume with all U.S. counterparties is estimated to be approximately $1.94 trillion. Of that, about $275 billion comes from margin accounts. The Bond Market Association, Repo & Securities Lending Survey of U.S. Markets Volume and Loss Experience (January 2005) at p. 3, http://archives1.sifma.org/assets/files/repoSurvey0105.pdf.

[92] Nor can the securities lender solve the problem by retaining the vote by securing a proxy from the record holder. The borrower may want to sell the shares prior to the record date in the public market. Requiring the anonymous purchaser of these shares to execute a proxy is obviously impracticable.

A solution is further complicated by the gap between fixing the record date and the date on which the agenda for the meeting is annonced. So suppose that the board announces on January 20 that the record date is February 1.[93] On February 15, it announces – consistent with the bylaws which typically allow the board the fix the date of the annual meeting – that the annual meeting will be April 1 and only then discloses the agenda. If an institution learns at this point that there is an item on the agenda that it wants to vote on, it will be too late to put a freeze on the lending the shares of the issuer: any shares that were lent out as of February 1 will not be able to be voted.[94]

What is the effect on the securities lending surprise? For one, the lender – although economically a beneficial owner of the shares – will not be able to vote. Instead, as an initial matter, the borrower obtains the voting right. Where the whole transaction is done to enable to short sale, the borrower, however, has no beneficial interest in the shares either: to the contrary, the borrower benefits when the share price declines. But then again, if the borrower sells the shares prior to the record date as part of the short sale, the borrower will not have any voting rights either. In that event, voting rights are *de facto* transferred from one entity with a beneficial interest – the lender – to another entity with a beneficial interest – the person who acquires the shares from the borrower.

So why does this matter? Much securities lending is done on behalf of institutional investors. Recent reforms have rested on the assumption that institutional investors are potentially more engaged shareholders than individual investors. Securities lending may thus result in the transfer of votes from institutional investors to shareholders who are, on average, less engaged and informed.

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. On the custodial broker side, the potential mischief is more troubling and less easily resolved. Specifically, securities lending can result in brokers soliciting votes, and receiving instructions, from more holders than they have shares entitled to vote.[95]

The standard margin account agreement between brokers and customers grants the broker the right to "lend" out shares in the account, and to keep the fees for doing so,

[93] Under New York Stock Exchange rules, the issuer must announce the record date ten days in advance. NYSE Listed Company Manual ¶204.21. 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.

[94] 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.

[95] 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.

without notifying the customer.[96] Moreover, 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 that Morgan Stanley has 1,000,000 shares of Delaware Inc. 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]

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 Broadridge of this. Morgan Stanley, however, will give Broadridge a list of *all* its customers' holdings in Delaware Inc. for a total of 1 million shares. Broadridge will then send out proxy materials according to the brokers' customer lists, with the result that it will *solicit* voting instructions for more shares than are in fact entitled to vote.

What if Morgan Stanley customers return sufficient instructions so that Morgan also *receives* voting instructions for more than 900,000 shares? Broadridge clearly should only cast votes for 900,000 million shares, since casting a higher number may result in *all of Morgan Stanley's votes* being invalidated.[97] But cutting down the number of voting instructions to the number of shares the broker is entitled to vote means that someone (who?) must decide whose votes count.[98]

Current practice is that the tabulator notifies 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. But sometimes the broker simply refuses to do so. This is what Deutsche Bank Securities did from 1998 to 2003.[99] 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:[100]

> 26. For 2003, the MFR Examination identified 12 instances, out of 15 tested, in which Respondent over-voted, that is, Respondent submitted more

[96] Cite to Schwab margin account agreement quoted above.

[97] See supra TAN [46]. When there is no reconciliation, there is no standard industry practice for 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." In the Matter of Deutsche Bank Securities Inc., NYSE Request for Review of Exchange Hearing Panel Decision 05-45 (February 2, 2006). at para 11.

[98] The New York Stock Exchange is aware of, and worried about, this problem. NYSE Information Memo No. 04-58 Re: Regulation of Proxy Activities and Over-Voting (November 5, 2004)

[99] In the Matter of Deutsche Bank Securities Inc., NYSE Request for Review of Exchange Hearing Panel Decision 05-45 (February 2, 2006).

[100] Id.

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, 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.

But how *should* the broker reconcile the overvote? The Securities Industry Association (SIA),[101] in cooperation with the NYSE and the SEC, recently examined the alternatives for resolving over-voting in an attempt to establish industry best practices.[102] In principle, there are two ways to reconcile any mismatch: pre-mailing or post-mailing.[103] If reconciled pre-mailing, the number of shares for which voting instructions are solicited is adjusted downward to match the number of votable shares . If reconciled post-mailing, the broker waits if the number of shares for which voting instructions are received exceeds the number of votable shares and makes a downward adjustment only if it does. In effect, in post-mailing, any lent shares are first assigned to the accounts of customers who did not return voting instructions.[104] Any downward adjustment (whether pre- or post-mailing) must be made in a manner that is "proportional and equitable among

[101] The SIA recently merged with the Bond Market Association to become The Securities Industry and Financial Markets Association "SIFMA").

[102] SIA April 26, 2005 letter to Anand Ramtahal (NYSE) from Donald Kittell, available on line at: http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/6136.pdf. See also the SIA's "Proxy Suggested Practices" at http://www.sifma.org/services/techops/pdf/ProxyGuidelinesSep2006.pdf

[103] Broadridge provides a service (the Over Reporting Prevention Service") that compares "a participant's reported position to its DTC position, flags any differences, and enables the participant to make appropriate adjustments." SIA letter at 2. In 2005, 100 brokers representing more than 90% of street positions used the service.

[104] The NYSE appears to permit the practice of assigning voting instructions to shares with respect to which voting instructions have not been received, so long as there is no 'overvote' – i.e., the votes do not exceed the shares in the broker's possession on the record date. Wilcox et al at 12-20 citing letter from the NYSE to the Commerce, Consumer and Monetary Affairs Subcommittee of the Committee on Government Relations dated February 19, 1991.

all clients."[105] Two methods that meet this goal are an impartial lottery among customers and proration (i.e. proportional reduction of each margin account).

There are advantages and disadvantages to pre- and post-mailing reconciliation. Pre-mailing reconciliation allows the client to know from the voting card precisely how many shares it may vote. On the other hand, since only 35 percent of clients usually vote,[106] pre-mailing reconciliation is more costly because it requires reconciliation in a large number of cases where, in fact, the number of shares for which (unreconciled) voting instructions are received does not exceed the total number of shares in the brokerage account. Post-mailing reconciliation has the opposite advantages and disadvantages. Also, waiting for instructions to be received before making a reconciliation means that the broker has a very short time window to reconcile an over-vote, a process that requires a large number of adjustments.

Moreover, post-mailing reconciliation generates another type of problem. Because any lent shares are, in effect, first assigned to the accounts of customers who did not return voting instructions, the number of votes casts will be systematically greater and the number of non-votes correspondingly lower than in the case of where there has been no lending. The effects of this bias in favor of more votes are exactly the opposite of the effects of fewer votes resulting from materials not arriving: any matters where a failure to vote or to submit instructions is equivalent to a no vote become easier to pass. This makes it easier for managers to obtain the requisite votes on mergers, charter amendments, and director elections, but also makes it easier for shareholder proponents to secure the vote needed for the passage of a shareholder resolution.[107] .

The interaction between the accuracy of the vote count and the level of short selling explains why, in close votes, we may have little reason to trust the outcome. When, for example, the AXA/MONY merger was approved by 1.7 million shares at a time when 6.2 million shares were out on loan,[108] can we be confident that it was approved by the votes of people who actually owned the shares?

c. Pathologies of Misalignment between Voting Rights and Economic Interest

[105] SIA letter at 3; Proxy Guidelines at p. 3.
[106] Id.
[107] The pre-mailing proration approach is consistent with the UCC Article 8 structure of property rights. 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." However, since UCC Article 8 is designed to govern custodial arrangements and to minimize failed securities transactions, it is not clear whether it should not be viewed as a source for more general obligations between brokers and customers. Thus, we do not mean to suggest that the pre-mailing proration approach is required by the UCC.
[108] Floyd Norris, Holders of MONY approve $1.5 billion sale to AXA, NYT 5/19/04 at .4; Bob Drummond, Corporate Voting Charade, Bloomberg Markets April 2006 at p. 96.

The concepts of record dates and record holders – albeit necessary (to some extent) to the make a voting system for public corporations workable – result in a discrepancy between beneficial economic stakes in the company on one hand and voting rights on the other hand. Voting rights rest with the record holder on the record date. But that record holder may not have beneficial economic ownership in the company for three reasons:

• The record holder is a street name holder (a bank or broker) who never had a beneficial economic interest.

• The shares have been sold after the record date and before the vote.

• The holder has hedged her economic exposure to the company.

By the same token, a holder may have a beneficial economic interest, but no voting rights (because she is not a record holder, because she has bought the shares after the record date, or because she is a counterparty to a hedging transaction).

The various regulations discussed above are designed (largely, but not wholly, successfully) to deal with the first of these reasons. But they do not address at all the other two reasons for the discrepancy. Thus, in the present regime, there will be some persons with voting rights and no beneficial interest, and others with a beneficial interest and no voting rights. And the number of such persons is larger the more liquid the market for the shares, and the larger the market for derivatives.

Discrepancies between voting rights and beneficial interests can arise in two contexts: first, as an unintended consequence of a transaction undertaken for other reasons (e.g. when a person buys shares after the record date because she believes the stock price will increase); second, for the purpose of obtaining votes without an equivalent economic exposure (e.g. when a person buys shares before and sells them after the record date so that she can vote the shares without having any economic exposure). We will use the term "incidental discrepancies" to connote the former and the term "empty voting" – coined by our colleagues Henry Hu and Bernie Black – to connote the latter.

i. Pathology 6: Incidental Discrepancies

To examine the effect of incidental discrepancies, one has to engage in two inquiries: first, how will investors vote *who have votes but no economic interest*; and second, how would the investors have voted *who have an economic interest but do not have votes*?

As to investors with voting rights and no economic interest, one possibility is that they will not bother to vote at all. In fact, some institutional shareholders have a policy of not voting in such situations.[109] As discussed with respect to pathologies related to

[109] Remarks of Eric Roiters, Fidelity, at Columbia conference.

materials not arriving and votes not being counted, a failure to vote can be, depending on the issue voted on, equivalent to the pro-management vote, equivalent to an anti-management vote,or neutral. Another possibility is that the investor will cast a less informed vote.[110] Again, depending on the issue, this may be a pro- or anti-management vote. Third, in some instances in which there is a relationship, the investor with the voting rights may look to the investor with the economic stake for suggestions on how to vote.[111] Finally, the investor's vote may be influenced by extrinsic factors (e.g. by an attempt to cater favor with management).

As to investors who have an economic interest but no votes, there is no particular reason to believe that their votes will differ from similar investors with both a vote and an economic interest. But even if there is no particular reason to believe that the votes will differ, the fact that some investors with a beneficial stake have no vote will add noise to the voting outcome which may result (on average) in an inferior outcome.

Since institutional investors trade more frequently than individual investors, they are more likely to find themselves in a position where they have purchased shares after the record date, and thus have an economic stake and no voting rights. Though institutions are also more likely to sell shares between the record date and the meeting, they often do not vote in such a situation. Thus, incidental discrepancies are likely to reduce the relative influence of institutional investors.

ii. Pathology 7: Empty Voting

Of late, an esoteric and theoretically interesting pathology has emerged which goes by the name of "empty voting"[112] or "encumbered shares."[113] "Empty voting" refers to instances where some investors *intentionally* become holders of shares on the record date – thus obtaining the right to vote – but divest or hedge their economic interest such that they have no equivalent economic stake in the company. We address empty voting briefly here because it illustrates a particular sort of gaming of a complex system. We do not address it in detail because it has already been the subject of substantial scholarly attention[114] and there is little evidence that it has much real world significance.

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[110] There is no legal prohibition to voting such shares. In Commonwealth Associates v. Providence Health Care, 641 A.2d 155 (Del. Ch. 1993), Chancellor Allen presumed that a post record date sale of shares would carry with it the right to vote the shares. Indeed, he suggested that any contractual agreement to permit the selling shareholder to retain the votes without also retaining "an interest sufficient to support the granting of an irrevocable proxy with respect to the shares" would not be enforceable. See, also, Larry Len and Cook Composites & Polymers v. Fuller, 1997 Del. Ch. LEXIS 78 (Del Ch) ("the 'seller' of stock loses the equitable interest once a specifically enforceable contract of sale is formed. It is the binding nature of this contract and its specific enforceability under the law that gives to the 'buyer' the *present* equitable right as it may be deemed to have, such as the right to compel a proxy from the registered owner or, more directly, to have its vote [*11] counted by the court in an election contest.")

[111]For example, counterparties in swap transactions, typically banks, may look to the holder of the economic interest to get a "wink or a nod" on how to vote.

[112] Hu and Black.

[113] Martin and Parnoy.

[114]The market for record date ownership is described and discussed in Christofferson, Geczy, Musto and Reed, The Market for Record Date Ownership, -- J. Fin. – (forthcoming). See, also, Geczy, Musto and

The most notorious example of empty voting 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 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.[115] Perry then acquired 9.9 percent of Mylan's shares and 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 it could vote purely on the basis of his interest as a King shareholder. See Figure 12.

[Figure 12 here]

The divergence between the interests of Perry and those of other Mylan shareholders is obvious. If the merger was good for King but bad for Mylan, as many Mylan shareholders felt, Perry would still vote its sizeable position in Mylan in favor of the merger and could help push it through. As it happened, Mylan management terminated the merger agreement because King restated its earnings. The success, and legal validity, of Perry's strategy thus was not tested.[116]

Empty voting has different, and more disconcerting, ramifications than incidental discrepancies. In economic effect – albeit not in legal structure[117] -- it resembles vote buying. An investor who goes out of its way to buy votes is both likely to vote the shares, and because that investor decided to divest her economic interest in the company, may well vote them in a manner that reduces the value of the company. [118] Thus, empty

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Reed, Stocks are Special Too: An Analysis of the Equity Lending Market, 66 J. Fin. Econ. 241 (2002). 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.

[115] Robert Steyer, New Player Joins Mylan-King Fray, The Street.com, Nov. 29, 2004.

[116] 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 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.

[117] Vote buying traditionally involved an acquisition of votes without an acquisition of an economic stake. Empty voting involves an acquisition of shares – vote plus stake—and a separate transaction of divestment of the economic stake.

[118] Empty voting, also results in investors who have an economic interest but no voting rights. As to them, the analysis is the same as for incidental discrepancies.

voting, to the extent it occurs, will tend to result in systematically inferior voting outcomes.

d. The Effect of the Pathologies on Corporate Votes

As the preceding discussion shows, the various pathologies have different, and complex, effects on corporate votes. Specifically, the effects of the pathologies can be grouped into several categories. First, whether the pathology generates "noise" – that is, a voting outcome that is less reflective of the outcome that a majority of well-informed shareholders would have votes for. Second, whether the pathology results in fewer shares being voted or in more shares being voted. Third, whether the pathology empowers or disempowers certain groups of shareholders. And fourth, whether the pathology biases the voting outcome in a pro- or in an anti-management direction.

The chart below, Figure 13, summarizes the effects of each pathology with respect to each of these categories. A few comments on the chart are in order. Almost by definition, each pathology generates some noise as each results in discrepancies between, on one hand, investors with effective voting rights and, on the other hand, investors with a beneficial stake in the company. In the case of votes not being counted due to early closing, this "noise" is mainly symbolic as inspectors will only close the polls early if the outcome is not in question. For incidental discrepancies and, even more so, for empty voting, the degree of noise is likely to be high. These pathologies result not only in some voters with economic stakes having no effective voting rights, but in others that have no stakes but do have votes; and, at least in the case of empty voting, those others are likely to exercise these voting rights.

Some, but not all, of the pathologies affect the total number of shares that are likely to have effective votes. Specifically, if materials do not arrive in time or some votes are not counted, the affected shareholders are deprived of effective voting rights. Overvoting means that voting instructions are solicited from more shareholders than are entitled to vote, which will tend to result in raising the number of shares being voted. (But if no proper adjustments are made, overvoting can lead to a wholesale disqualification of votes and thus to fewer shares being effectively voted.) Incidental discrepancies can reduce the number of shares being voted because record owners who do not have a beneficial stake are less likely to bother to vote than beneficial owners.

The number of shares with effective votes, in turn, relates to whether certain shareholder groups gain or lose power. The pathology of materials not arriving is likely to affect primarily individual shareholders. By contrast, institutional shareholders are more likely to be affected by incidental discrepancies because they trade more frequently than individual holders and are thus more likely to acquire shares between the record date and the meeting date. Pathologies 4 and 5, respectively, relate to securities lending of shares mostly held in institutional and individual accounts and thus reduce the voting power of the respective shareholder group. Moreover, securities lending can result in short-sellers having voting rights (if they do not sell the "borrowed" shares prior to the

record date). To the extent that some shareholder groups are more likely to vote a certain way than another, the shareholder group effect will also bias the outcome of a vote.

Finally, the number of shares with effective votes has direct and complex effects on the outcome of a vote. To the extent that brokers have discretionary voting authority over shares for which they receive no voting instructions (and because brokers tend to vote in accordance in management recommendations), having fewer (more) shares for which instructions are received biases the outcome in favor (against) the outcome desired by management.

To the extent that a matter requires for passage a majority of the shares entitled to vote – as is the case for mergers and charter amendments – a non-vote is equivalent to an "against" vote. Fewer shares with effective votes result in more non-votes, which makes passage of these proposals more difficult. More shares with effective votes result in fewer non-votes, and makes passage easier.

Yet other matters are both non-routine and require for passage a majority of the shares *present at the meeting*. This tends to be the case for shareholder proposals under Rue 14a-8 (which are generally opposed by management) and uncontested director elections under a majority voting rule (where management favors the election of the nominees). With respect to these matters, shares that are not at all present at the meeting do not affect the outcome, but shares that are present and abstain are equivalent to "against" votes. Because brokers will often continue to enjoy discretionary voting authority over some matters on the ballot, fewer shares with effective votes can result in more shares being present but not voting on these matters.[119] As a result, the effective rule for electing directors under a nominal "majority voting" rule and for the passage of a shareholder proposal is to require a supermajority of the votes cast.

[Figure 13 around here]

IV. Implications and Avenues of Reform

a. 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

[119] This, however, will not be the case where votes are not counted (Pathology 2). Also, with respect to incidental discrepancies (pathology 6), the anti-management effect of fewer shares with effective votes for director election may be made up by a possible tendency of record owners without economic stakes to vote in favor of management's nominees.

The non-delivery of materials is aggravated by the relatively compressed time frame between the record date and the meeting. This problem can be ameliorated by increasing the time between the record date and the meeting date. But here we confront some of the intrinsic difficulties of the system. 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. The "securities lending surprise" pathology derives from the practice of setting the record date before the meeting and its agenda are announced. In order to allow share lenders to recall their shares in advance of meetings in which they would like to vote, one could require that the board announce the date of the meeting and its agenda at the same time as it announces the record date.[120] Apart from permitting investors to decide whether to freeze/recall shares with greater knowledge of what they will be asked to vote on, this would limit the discretion of management to set a record date strategically in order to affect the outcome of the vote. Prior announcement of the agenda would also enable other investors to buy shares *in order to* influence the outcome of the meeting. As one informed observer commented, "If you did that, can you imagine the volume of trading in advance of the record date?" This could make issuers nervous. But this could as easily be an advantage to the proposal as a problem.

ii. Encouraging Improvements through Judicial Eyebrows

Delaware seeks to maximize certainty by adopting presumptions and ignoring the complexity of indirect ownership. The result, as described above, is a system without vote verification or an effective audit trail. What 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 has been achieved?

Such a shift could lead to a transformation of the system. One of the reasons that the system is inadequate is that no one has an incentive to make it better. Close and skeptical scrutiny by the Delaware courts in voting disputes could create such an incentive. If participants thought that there was a chance that a vote would be rejected because of an inadequate audit trail, they would take greater care at earlier stages to assure that a proper audit exists should a dispute arise. But, for Delaware, close scrutiny may have a significant drawback: in addition to reducing certainty, it would reveal the inadequacy of the voting system and thus potentially impair its legitimacy. Delaware hardly has an incentive to undermine public confidence in a key legitimating practice that is fundamental to the structure of corporate law.

[120] The company may, at that point, not know which shareholder proposals will be on the agenda. But with respect to shareholder proposals, shareholder activists can announce 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.

b. Renovating the Structure: The Business Roundtable/Georgeson Proposal

In connection with the shareholder ballot access proposal, the Business Roundtable together with Georgeson, a leading proxy solicitation firm, proposed returning primary voting responsibility to the beneficial owners.[121] The BRT/Georgeson proposal entails the following steps:

- On the record date, DTC would (as it does now) issue omnibus proxies to its members. These members would then (contrary to present practice) 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.
- The shareholder lists would be available to the issuer and to any dissidents running a solicitation, who would distribute the proxy materials would be distributed directly to the beneficial owners.
- Beneficial owners would return proxies directly to the tabulators.

There are several notable features of this proposal. It takes broker and bank custodians out of the process of collecting and processing voting instructions.[122] It increases ownership transparency. And it eliminates of the existing NOBO/OBO structure. Shareholders who wished to remain anonymous would have to establish nominee accounts with banks or brokers. See Figure 14.

[Figure 14 about here]

The proposed system would ameliorate several of the voting pathologies discussed above. By simplifying the system of distributing proxy materials and collecting votes, it would reduce the likelihood of materials not arriving or of votes not being counted. By requiring up-front attribution of shares to owners by intermediaries, it would eliminate overvoting. By increasing transparency, it would improve the ability to provide vote confirmation and an audit trail.

What are the difficulties in the way of such a reform? One key effect is to remove Broadridge from its position as the key, monopolistic actor at the center of the spider

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[121] 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. See also 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?).

[122] As a result, the proposal would eliminate "broker non-votes."

web. Under the current system, Broadridge 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 Broadridge and one would thus predict that Broadridge would oppose any substantial reform.

The reform also requires that custodians cooperate in the creation of a single list of shareholders entitled to vote as of the record date. Specifically, brokers would have to identify which shares have been lent out. This could lead margin account holders (which at present are blissfully unaware whether and how often their shares are lent out) to demand a share of the fees generated.[123] Indeed, the Securities Industry Association, the broker-dealers' trade association, opposed the BRT proposal arguing that no fundamental change was necessary.[124]

Finally, 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, this is more expensive than merely checking the OBO box and some holders may feel that taking that affirmative step will subject them to more criticism than under the existing NOBO/OBO system.

c. Redesigning the Architecture: Voting in a Direct Registration Clearing and Settlement System (the "Spanish" Model)

As our 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 depositary 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, or move completely to a book-entry system.

No one designing a system today from the ground up would (or, in fact, does) adopt this structure.[125] The necessity of immobilizing securities certificates yielded the cumbersome system of custody, clearance and settlement that complicates voting as well.

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[123] On the other hand, as noted above, tax considerations may force this identification in any event.

[124] The Securities Industry Association's June 24, 2004 letter in opposition, http://www.sia.com/2004_comment_letters/pdf/30454888.pdf.

[125] UNIDROIT (the International Institute for the Unification of Private Law) is currently developing a legal framework for the cross-border clearing and settlement of intermediated securities with the goal of producing a convention that will be adopted by states. http://www.unidroit.org/english/workprogramme/study078/item1/overview.htm. The working papers, available at the UNIDROIT Study 78 website, provide a wealth of information on the different systems of indirect ownership of securities in different countries. http://www.unidroit.org/english/workprogramme/study078/item1/main.htm.

The BRT/Georgeson proposal, taking this fundamental architecture of ownership as given, offers a change to the voting architecture that promises some improvements. A more fundamental reform would entail a "dematerialization", rather than a mere "immobilization," of securities. [126] This makes possible the creation of a share registry that can show all current holders and quickly reflect changes in securities positions.

Interestingly, the Spanish system of share holding took that route and thus offers an interesting alternative.[127] For listed shares, Spain has a pure book-entry system with share dematerialization mandatory for publicly traded firms.[128] The key player is IBERCLEAR, the Spanish equivalent to DTC. IBERCLEAR 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.[129] In order to issue securities that will be validly issued and tradable, the issuer must inform IBERCLEAR that the steps for listing a security have been completed and provide relevant details.[130] At this point, the securities are "deemed to be duly recorded in the accounts held by IBERCLEAR as CSD [Central Securities Depositary] and its participant entities"[131] and the investors have full property rights in the shares. The act of recording creates a direct legal relationship between the issuer and the investor.

Transfer of securities is by book entry, without any requirement of "delivery" of share certificates (which, in this system, do not exist).[132] This same principle applies to

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[126] In the SEC's 1976 report on nominee ownership, it recognized the trade off between incremental and fundamental reform. One potential reform considered was termed the "transfer agent depository concept" or which "would replace the certificate with computerized stockowner lists, maintained by the transfer agent, which would serve as both the issuer's stock records and the shareholder's evidence of ownership." SEC 1976 Final Report at 60. But the SEC did not embrace the proposal, noting that "The Commission has concluded that no alternative approach would facilitate shareowner communication without disrupting the current system of clearing and settlement, imposing significant costs and recordkeeping requirements on participants, or involving major computer development. . . The [transfer agent depository] concept exhibits promise as an important long-term alternative. It is not, however, a system for streamlining communications but rather an approach to a national clearance and settlement system which, as a by-product, would improve issuer-shareowner communications." Id. at 62.

[127] The description of the "Spanish" model in the text is somewhat simplified in order to focus attention on its role in simplifying corporate voting, and therefore ignores the important issues of clearing and settlement. For an overview and descriptions of different types of systems of indirect holding, see http://www.unidroit.org/english/publications/proceedings/2006/study/78/s-78-44-e.pdf and http://www.unidroit.org/english/publications/proceedings/2007/study/78/s-78-44add-e.pdf.

[128] 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. See, also, UNIDROIT Document 44 at pp. 6-7, available at: http://www.unidroit.org/english/publications/proceedings/2006/study/78/s-78-44-e.pdf.

[129] http://www.iberclear.com/Iberclear/home/home.htm

[130] Para. 2.7.2

[131] 2.7.2

[132] 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." 2.7.2

the creation of security interests in the shares.[133] 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.[134] Unlike in the US system, there is no netting of securities but only of cash.[135] In this system, transfers are irrevocable.[136] The buyer takes the shares subject to any recorded interests.[137]

In a book entry system, 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. In the top tier, IBERCLEAR maintains accounts for securities owned by its participants. In the lower tier, participants maintain accounts for other investors.[138] The introduction of a second tier complicates the voting process and is not an intrinsic part of the system. Indeed, one suspects that the reason for the two-tier system 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.

There are numerous advantages to a book-entry 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. Fourth, the system simplifies the payment of dividends and other cash distributions.[139] On the record date, IBERCLEAR certifies to the issuer the balance of securities that each participant has. The issuer then pays each participant an amount equal to the dividend per share times the number of shares evidenced in the IBERCLEAR certification.[140]

Most pertinently, from our perspective, the Spanish model simplifies voting. Consider Figures 15 and 16. With a book-entry system, whether one- or two-tier or a

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[133] 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". ")

[134] 17.7, 19.7, 20.7, 21.7 and 55.7

[135] 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.

[136] 21.7

[137] 11.7

[138] Para.5.7

[139] 34.7

[140] 34.7.1

one-tier, creation of a common comprehensive registry is straightforward.[141] Once this real-time registry exists, creating a record-date shareholder list is also straightforward. Indeed, in Spain, the record date is mere five days in advance of the meeting.[142] The processor, an agent of the issuer, would send out proxy materials according to a preliminary shareholder list, supplement with changes as of the record date, collect proxies, check the proxies against the record date list, tabulate the results and report them to the board of directors.

The Spanish model 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 percent of issued securities are recorded in the system,[143] solves the over-voting problem. 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. A shorter period between the record and the meeting date made possible by the Spansih model would reduce the degree of incidental discrepancies between voting rights and beneficial ownership. 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.[144] This would further reduce incidental discrepancies and foreclose some avenues to obtain "empty votes." Finally, a late record date would make it easier for investors to avoid the securities lending surprise.[145] 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.

There are few legal or practical obstacles to switching to a Spanish style system. UCC Article 8 already permits uncertificated securities and provides a legal structure for transfer. Under states' corporate laws, corporations may issue uncertificated equity securities.[146] Uncertificated bonds are already very common.

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[141] In Spain, IBERCLEAR certifies to the issuer how the securities are distributed among the participants in the system. 36.7. Then, for voting, the issuer sends an "attendance card" to the investor. Since 2003, issuers have been obliged to provide for "distance voting" through mail or electronic means. 34.7.1

[142] Art. 104 of the Public Companies Act: email 5/4/07 from Francisco Garcimartin.

[143] 36.7

[144] It thus could solve one version of empty voting (record date capture), but not other versions (e.g., hedging while retaining ownership).

[145] Note how securities "lending" occurs in this system. Because 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.

[146] Delaware, for example, provides that "t]he 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. Del. GCL §158.

As a practical matter, a move to uncertificated securities would also not pose many problems, even for existing companies with outstanding certificated shares. The board of directors of a company would 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 percent of the shares to book-entry. While other shareholders may not 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 their shares are eventually sold or transferred (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.

Of course, there are some downsides to a book-entry system. 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. But that seems like a small price to pay given the multiple advantages that a book-entry system offers.

The principal obstacles to reform are political. Broadridge, 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. Brokers may further oppose a change because it would eliminate their ability to lend out margin securities without telling the account holder.

Conclusion: Implications for Shareholders' Role

The existing system of shareholder voting is crude, imprecise and fragile. Gil Sparks, a leading Delaware lawyer, estimates that, in a contest that is closer than 55 to 45 percent, there is no verifiable answer to the question "who won?"[147] Suppose that Gil Sparks is right. Does it matter?

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. But that is hardly an adequate response to the challenge posed by that election -- or to a corporate vote with a close outcome. Whatever the overall distribution of errors, the participants in a specific vote have a large stake in the accuracy of the outcome. This is true regardless of whether the voting pathologies generate a bias or merely noise, whether they empower or disempower certain shareholder groups or merely fail to provide vote confirmation and an audit trail. Delaware's "not my problem"

[147] Personal communication.

establishment of legal presumptions cannot forever paper over the embarrassment of our present voting system.

One response, as we've discussed earlier, is to improve the technology so that it would function more reliably and accurately. Improvements are possible – and necessary -- but some problems are bound to persist. What one should strive for is a system that is adequate for the tasks given it.

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. Most importantly, shareholders vote for directors and have a veto over fundamental changes to the 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. 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 proponent of board centered corporate governance could argue that the result is acceptable: after all, the board did in fact recommend the merger and many (if not quite the requisite majority)of shareholders voted in favor. Similarly, when a merger is rejected even though an accurate count would have resulted in approval, one 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 percent of the shareholders, it is no tragedy that the deal fails, even if in fact more than 50 percent of the votes were cast in favor. Put differently, the veto role of shareholder voting in mergers or charter amendments may not really require complete accuracy.

But what about director elections? Here, complacency is harder to sustain, even from a board centered view. The board of directors have significant managerial powers and enjoy the protections of the business judgment rule. Elections to the board, as the sole governance check on the board, play a central ideological and monitoring role within corporate governance. An election system that generateS inaccurate results and fails to provide transparency and verifiability will eventually undermine its own legitimacy.

A recognition of the problems and limits of the corporate voting system has three implications for the current place of shareholder voting in the Delaware 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 of this shift.[148]

[148] Hu and Black (2006) likewise make this point.

Second, the traditional Delaware default rule, which 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.[149] By changing to a majority rule, the potential for uncertain outcomes increases. Under plurality voting, the number of votes received in director elections – and thus the need for accuracy and verifiability -- matters only in the relatively few contested election. With majority voting, the number of votes matters in every single election, and the number of close votes is bound to increase dramatically. This will greatly increase the pressure to find a better way to deal with the hanging chads of corporate voting.

Finally, given the problems with the existing system, one should not rush to expand the opportunities for shareholder voting in corporate governance. Rather than expand the number of issues on which shareholders have to vote on, perhaps we should channel our limited resources into ensuring accurate and verifiable results for the votes we already have.

[149] DGCL §216.

FIGURES 1 TO 16

Figure 1. Voting by Registered Owners

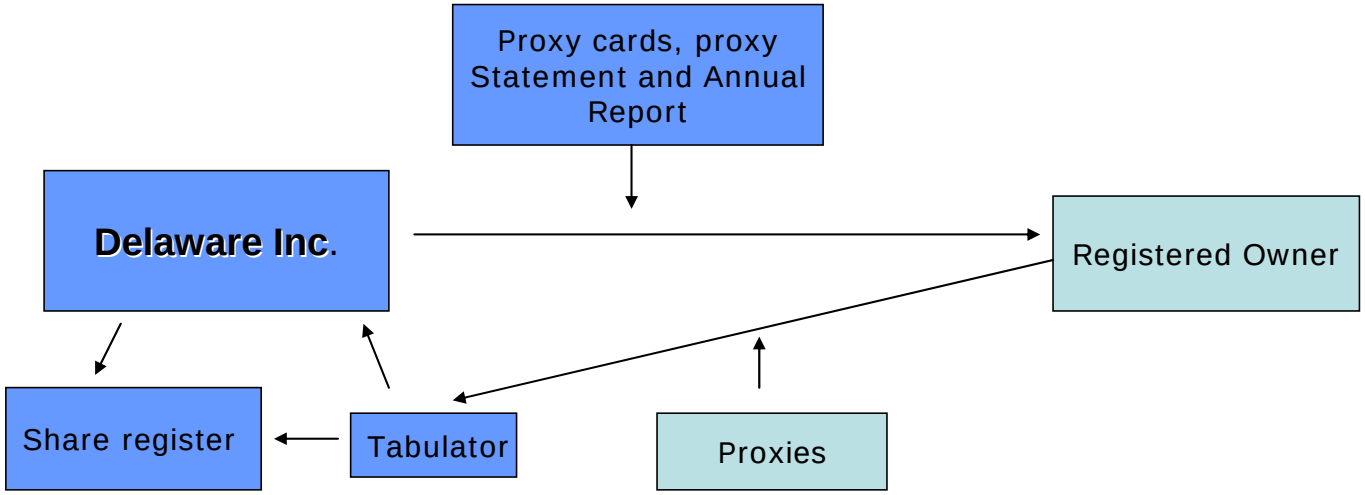
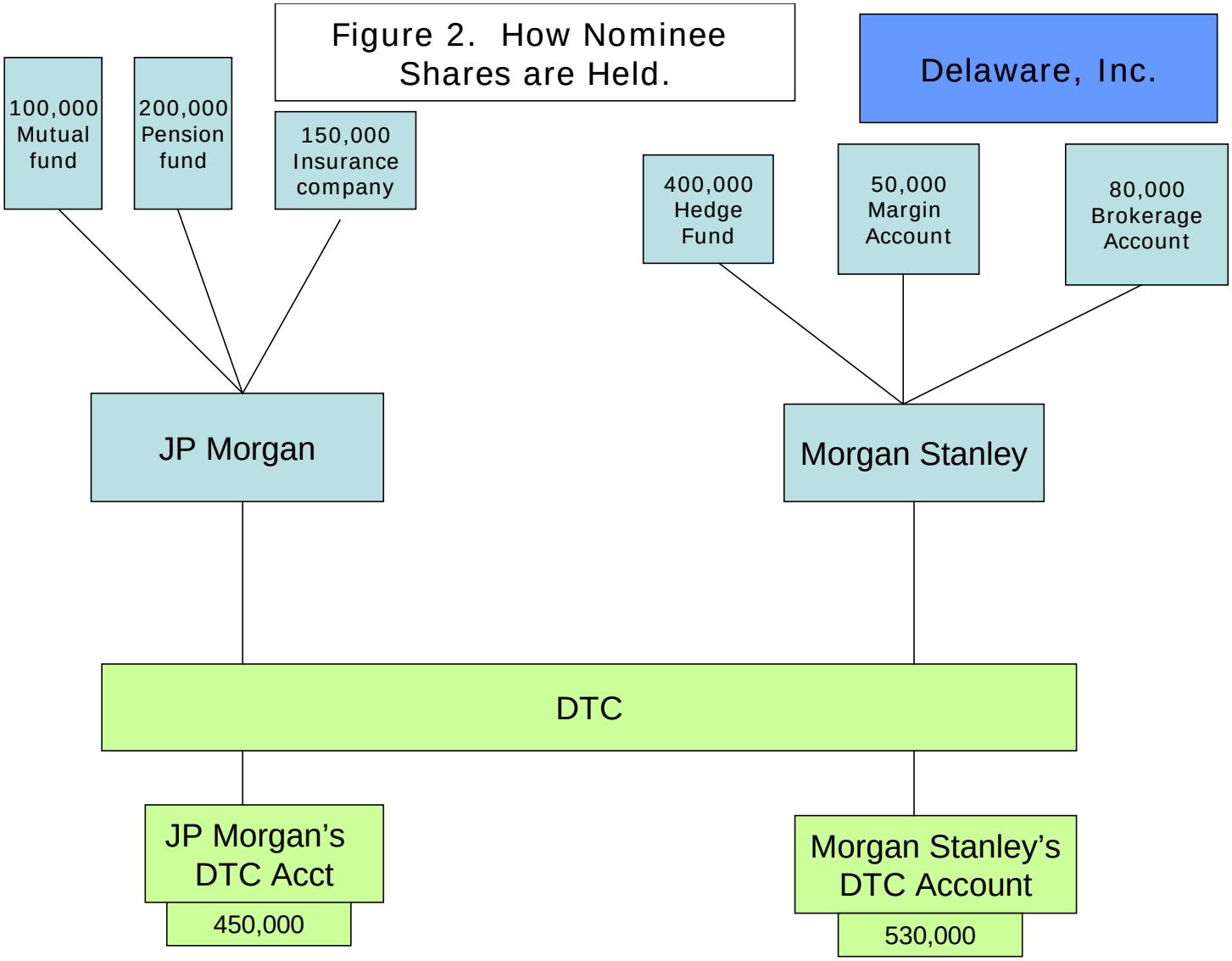


Figure 2. How Nominee Shares are Held.



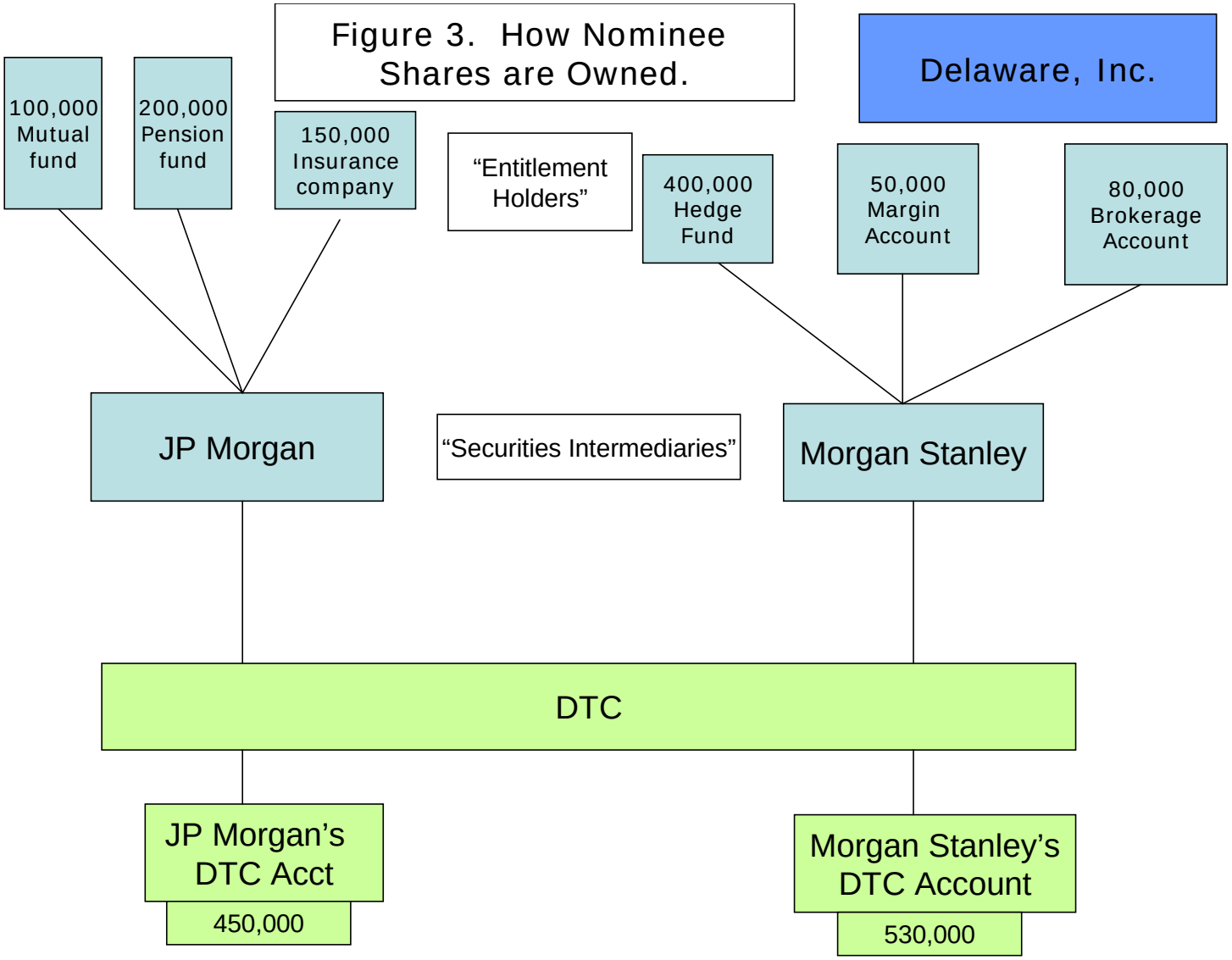


Figure 3. How Nominee Shares are Owned.
Delaware, Inc.
100,000 Mutual fund
200,000 Pension fund
150,000 Insurance company
"Entitlement Holders"
400,000 Hedge Fund
50,000 Margin Account
80,000 Brokerage Account
JP Morgan
"Securities Intermediaries"
Morgan Stanley
DTC
JP Morgan's DTC Acct
450,000
Morgan Stanley's DTC Account
530,000

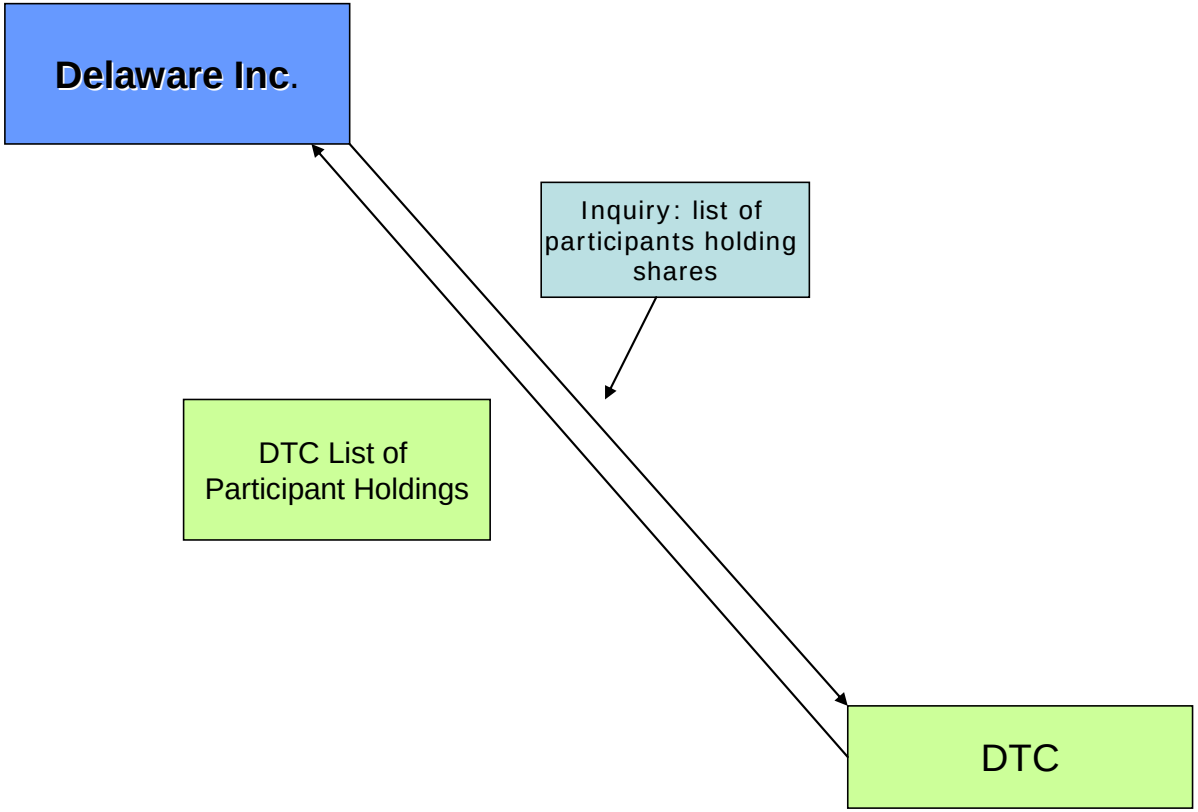


Figure 4. Finding the Beneficial Owners: issuer inquiry

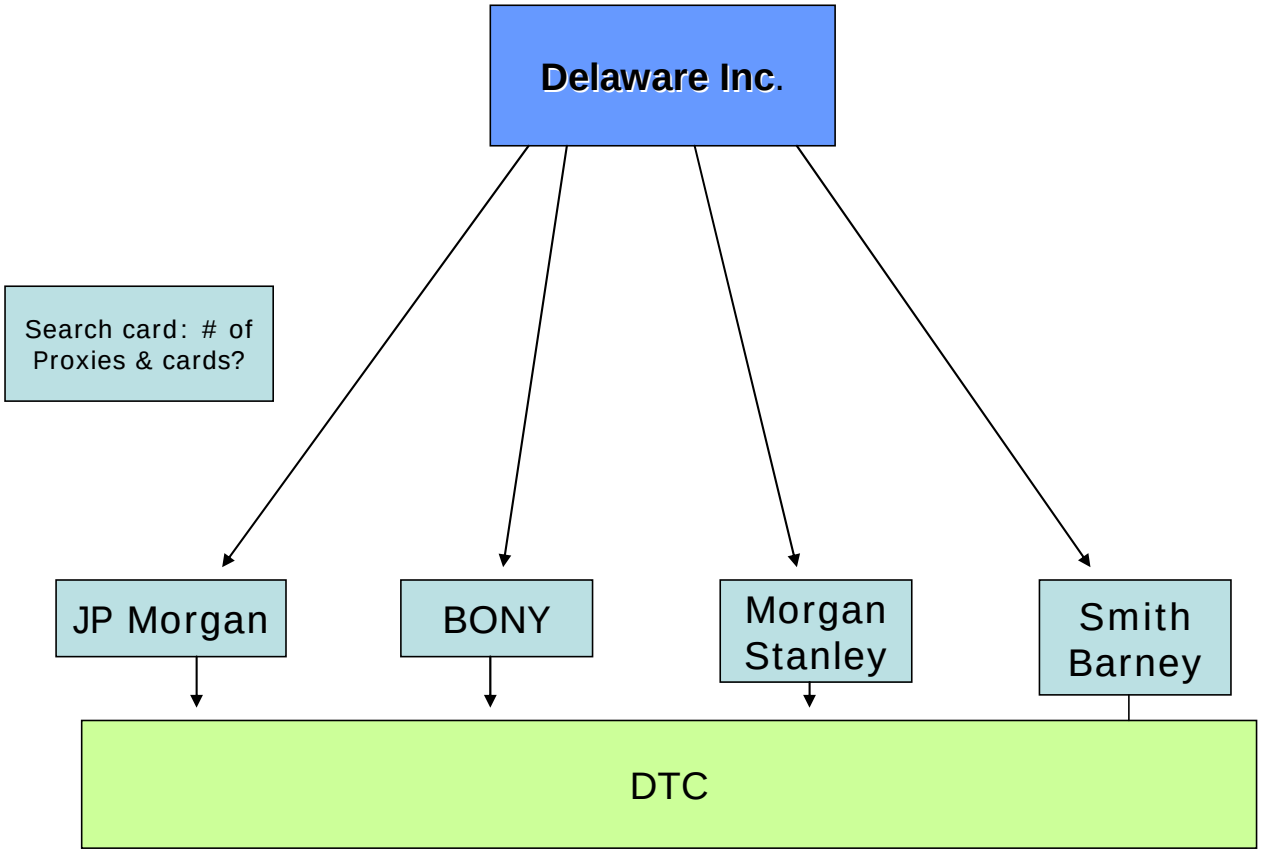


Figure 5a. Finding the Beneficial Owners: search cards

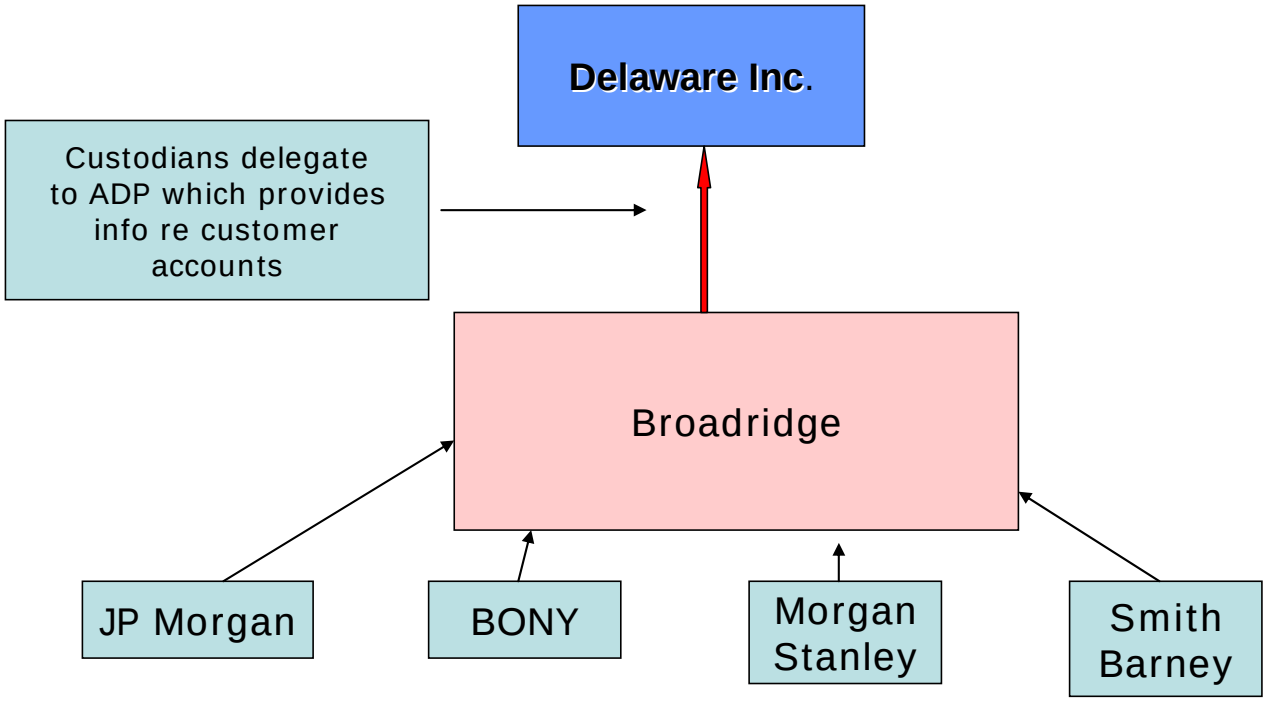


Figure 5b. Identifying the number of accounts and shares

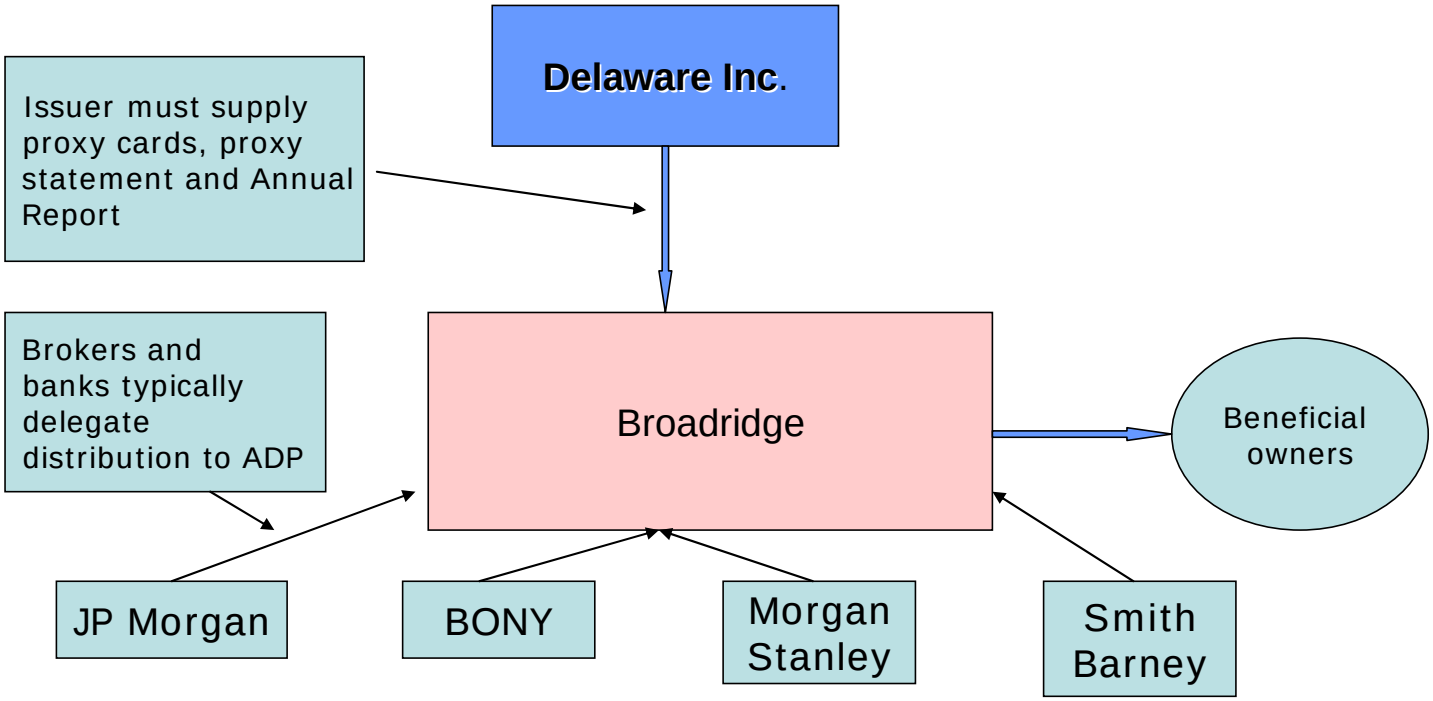


Figure 6. Distributing the materials

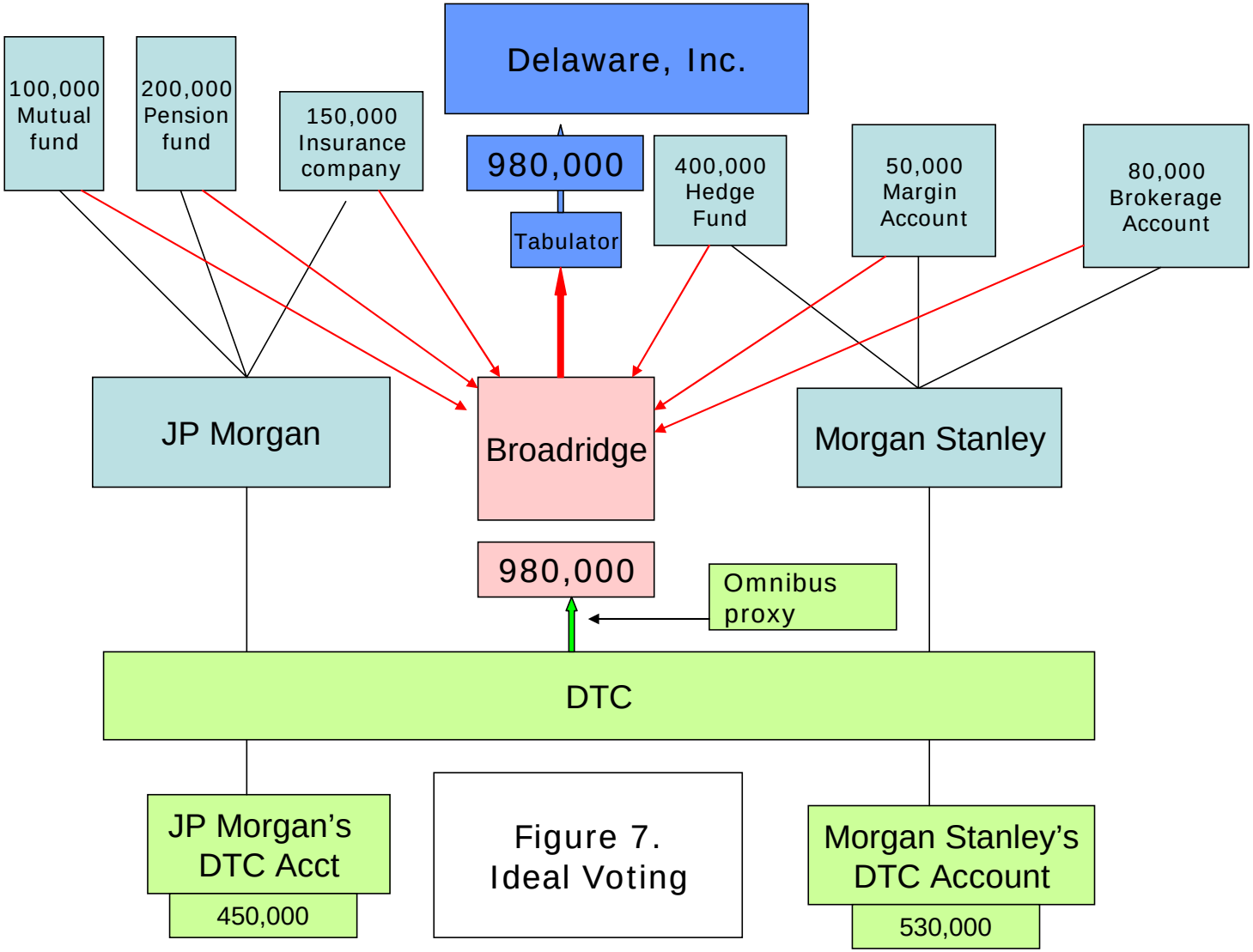


Figure 7.
Ideal Voting

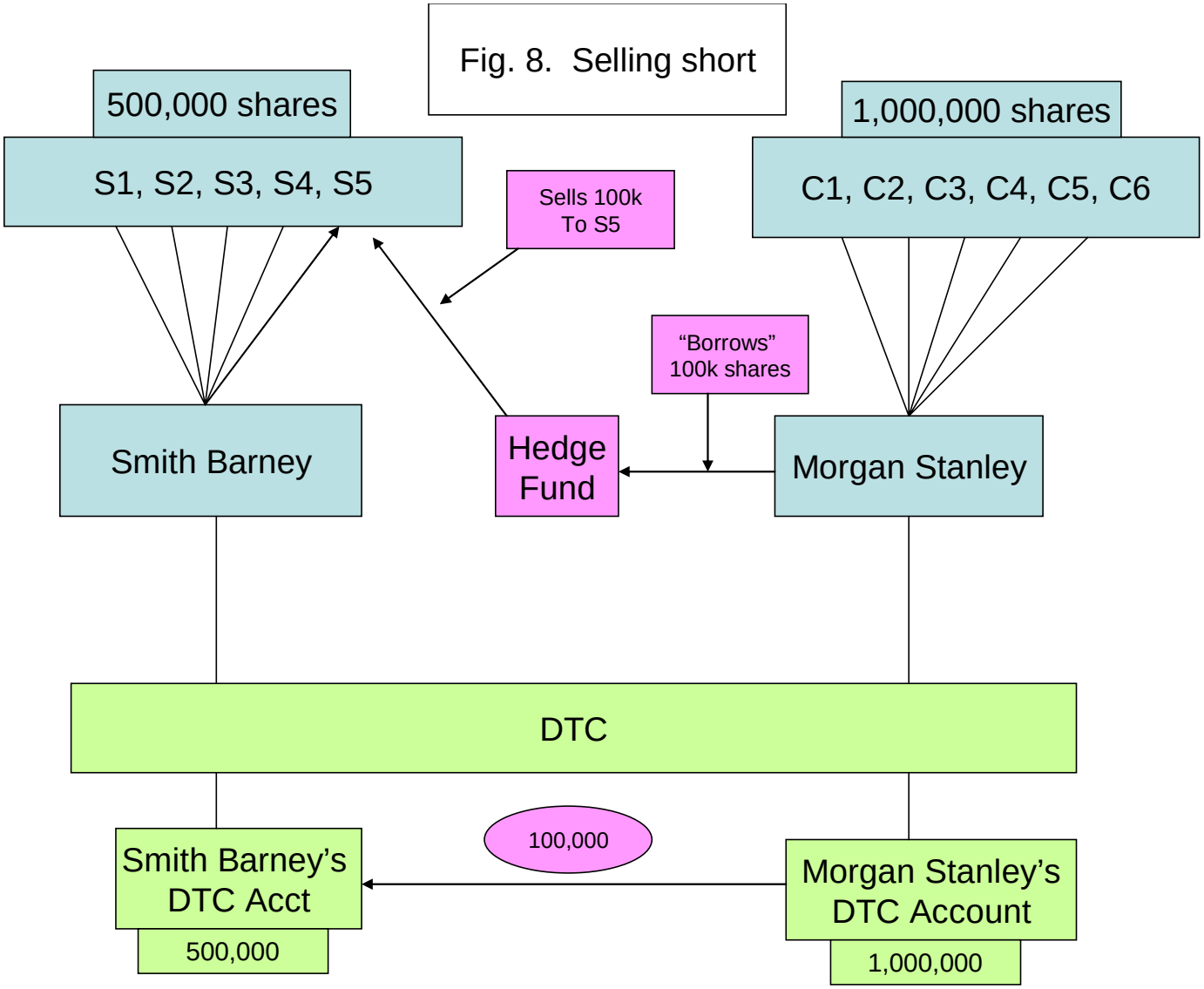
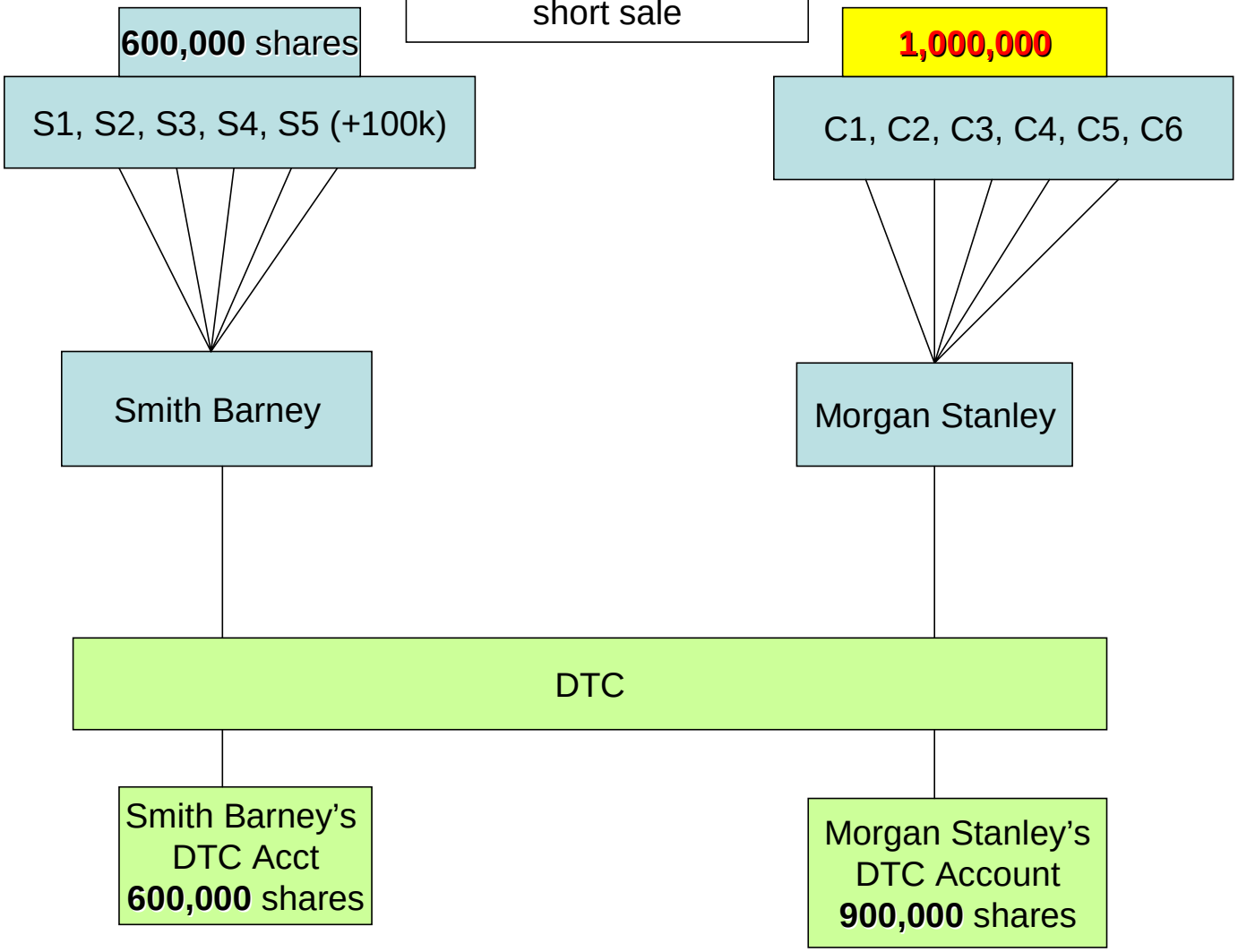


Fig. 8. Selling short
500,000 shares
S1, S2, S3, S4, S5
1,000,000 shares
C1, C2, C3, C4, C5, C6
Sells 100k
To S5
"Borrows"
100k shares
Smith Barney
Hedge
Fund
Morgan Stanley
DTC
100,000
Smith Barney's
DTC Acct
500,000
Morgan Stanley's
DTC Account
1,000,000

Fig. 9. Holdings after short sale



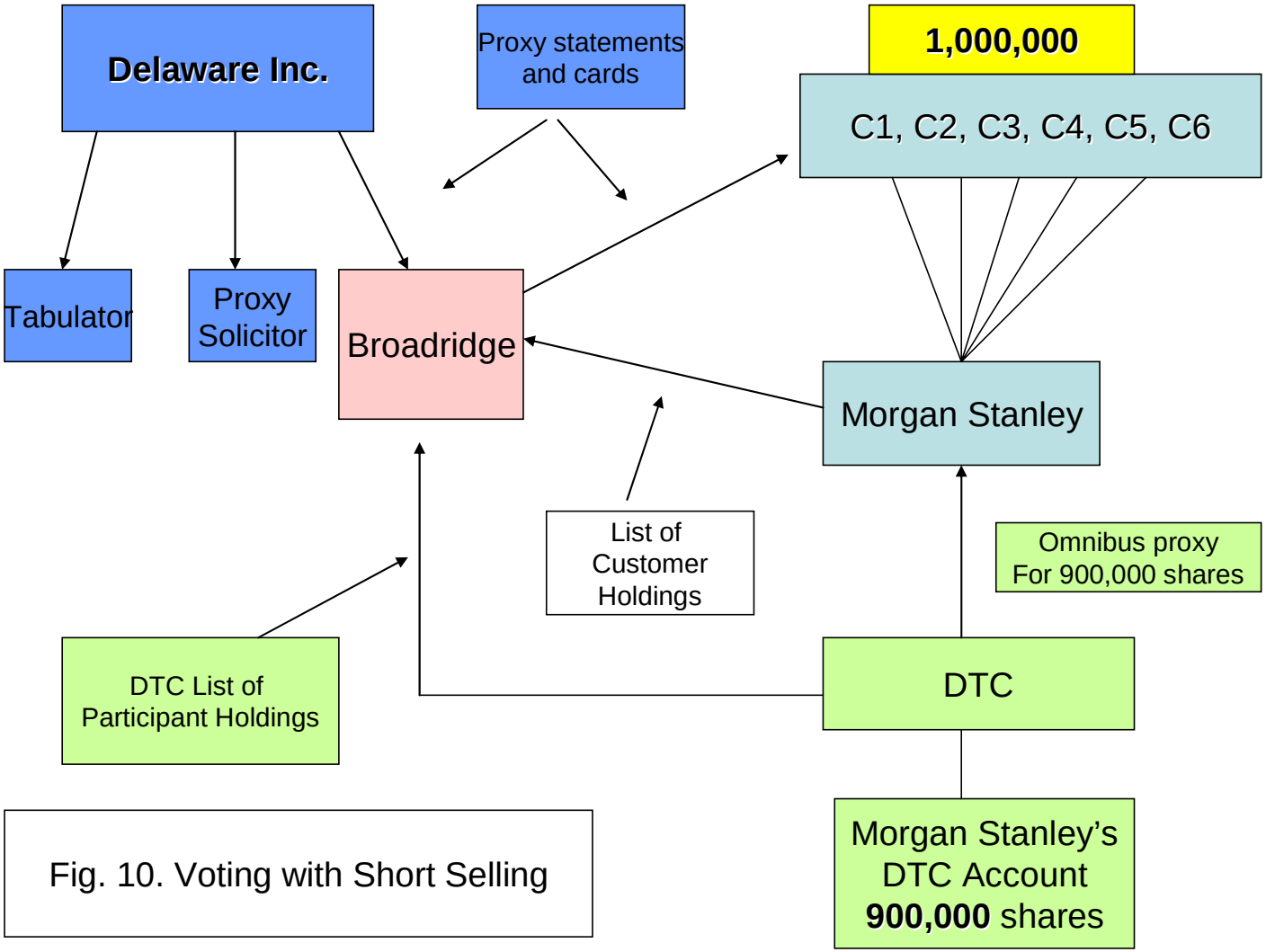


Fig. 10. Voting with Short Selling

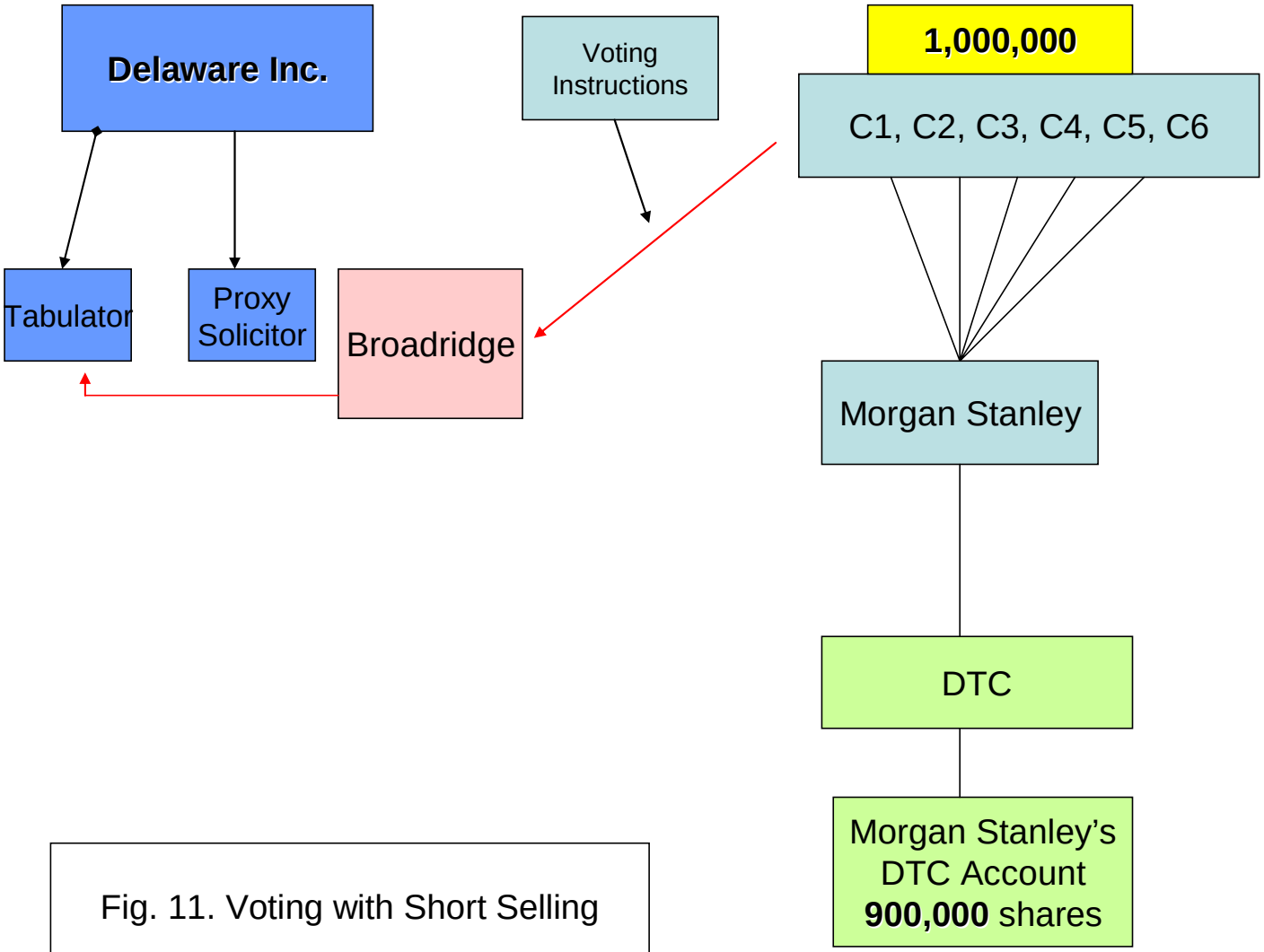


Fig. 11. Voting with Short Selling

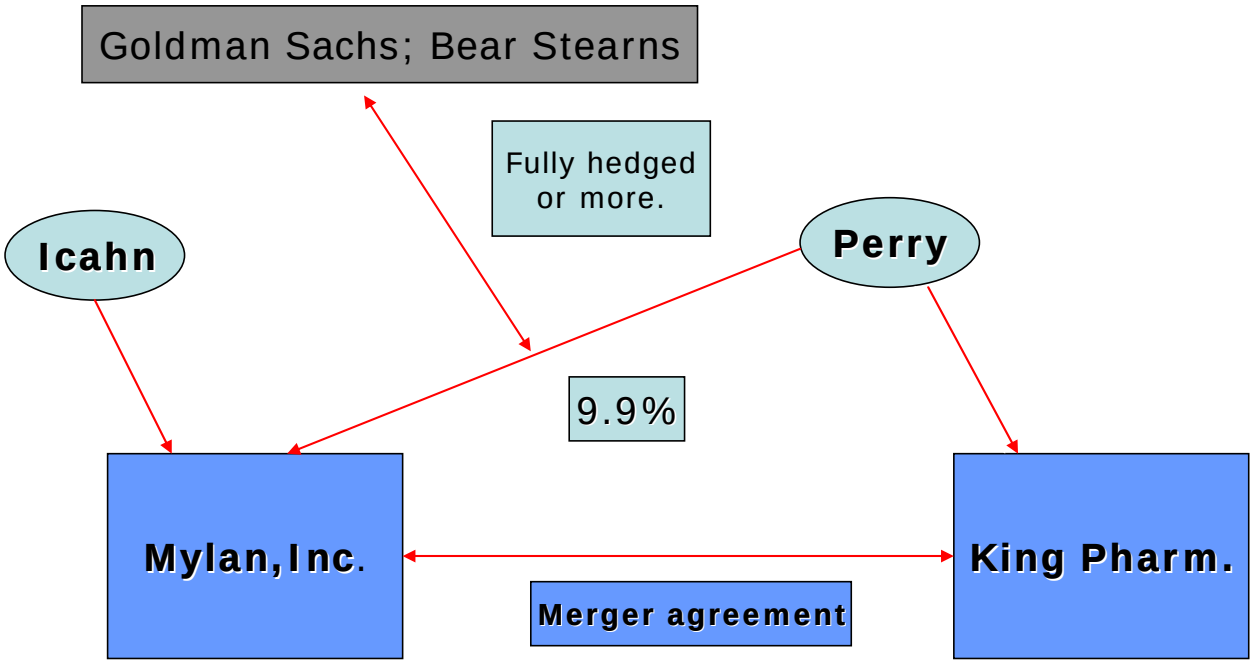


Figure 12. Empty Voting

Figure 13. The Effect of the Pathologies

	Pathology 1 Materials Don't Arrive	Pathology 2 Votes not counted - early closing	Pathology 2 Votes not counted - by mistake	Pathology 3 Verification	Pathology 4 Securities Lending Surprise	Pathology 5 Overvoting	Pathology 6 Incidental Discrepancies	Pathology 7 Empty Voting
Noise	Some	Symbolic	Some	Some	Some	Some	Some or more	Lots
Number of Shares	Fewer	Fewer	Fewer	No effect	No effect	More	Fewer	More
Shareholder Group Effect	Fewer votes for individual investors	Unclear	Unclear	No effect	Fewer votes for institutional investors Possibly more votes to short-sellers	Maybe fewer votes for individual investors	Fewer votes for institutional investors Votes to shareholders without beneficial interest	More votes for investors with bad incentives
Effect								
Discretionary Broker Voting	Pro-Management	n.a.	n.a.	n.a.	n.a.	Anti-management	n.a.	n.a.
Election of directors	Anti-Management	Symbolic	Neutral	Neutral	Neutral	Pro-Management	Anti-management or neutral	Strong but direction unpredictable
Mergers/Charter Amendments	Anti-Management	Symbolic	Anti-Management	Neutral	Neutral	Pro-Management	Anti-management	Strong but direction unpredictable
Shareholder Proposals	Pro-Management	Symbolic	Neutral	Neutral	Neutral	Anti-Management	Pro-management	Strong but direction unpredictable

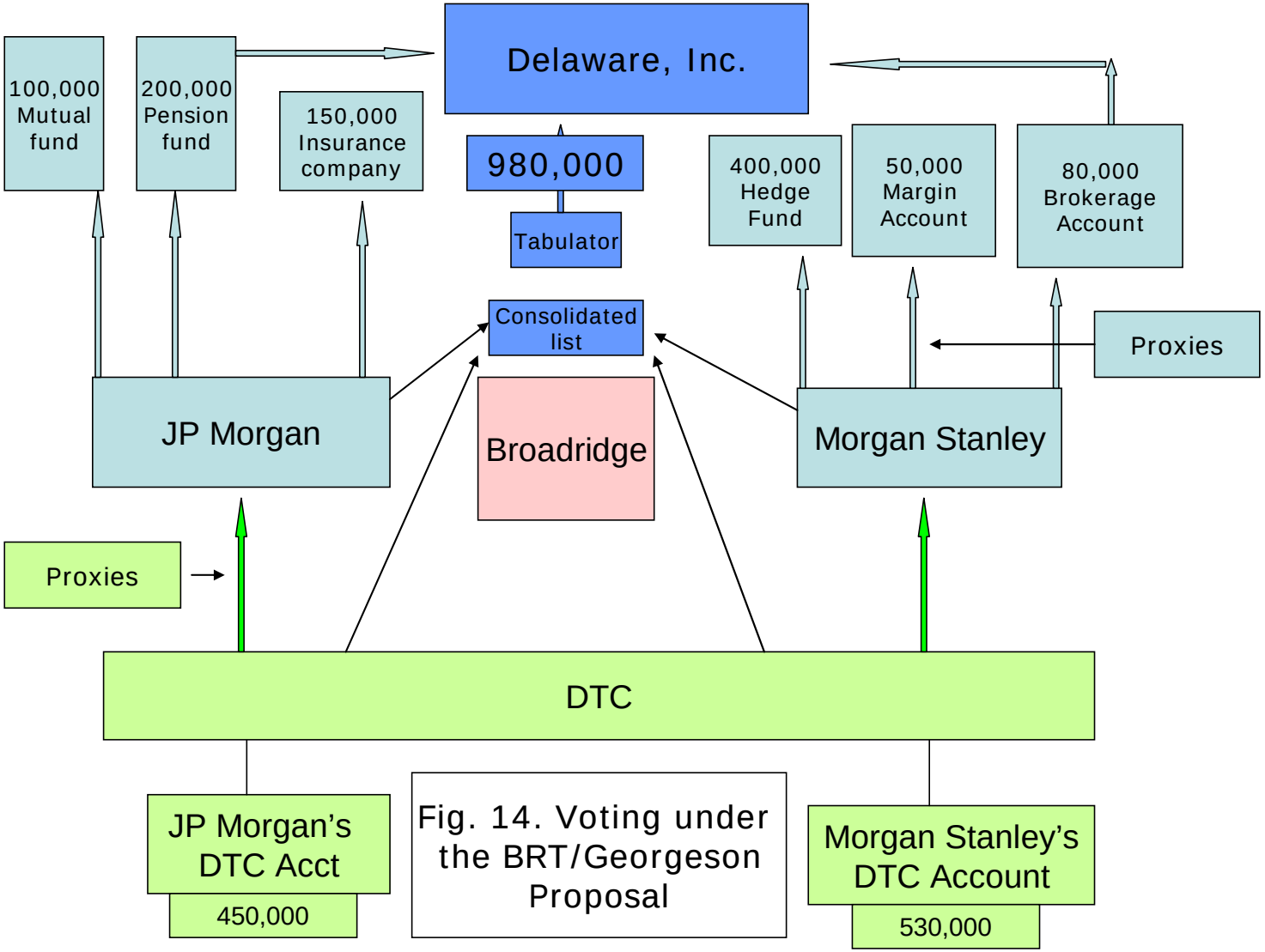


Fig. 14. Voting under the BRT/Georgeson Proposal

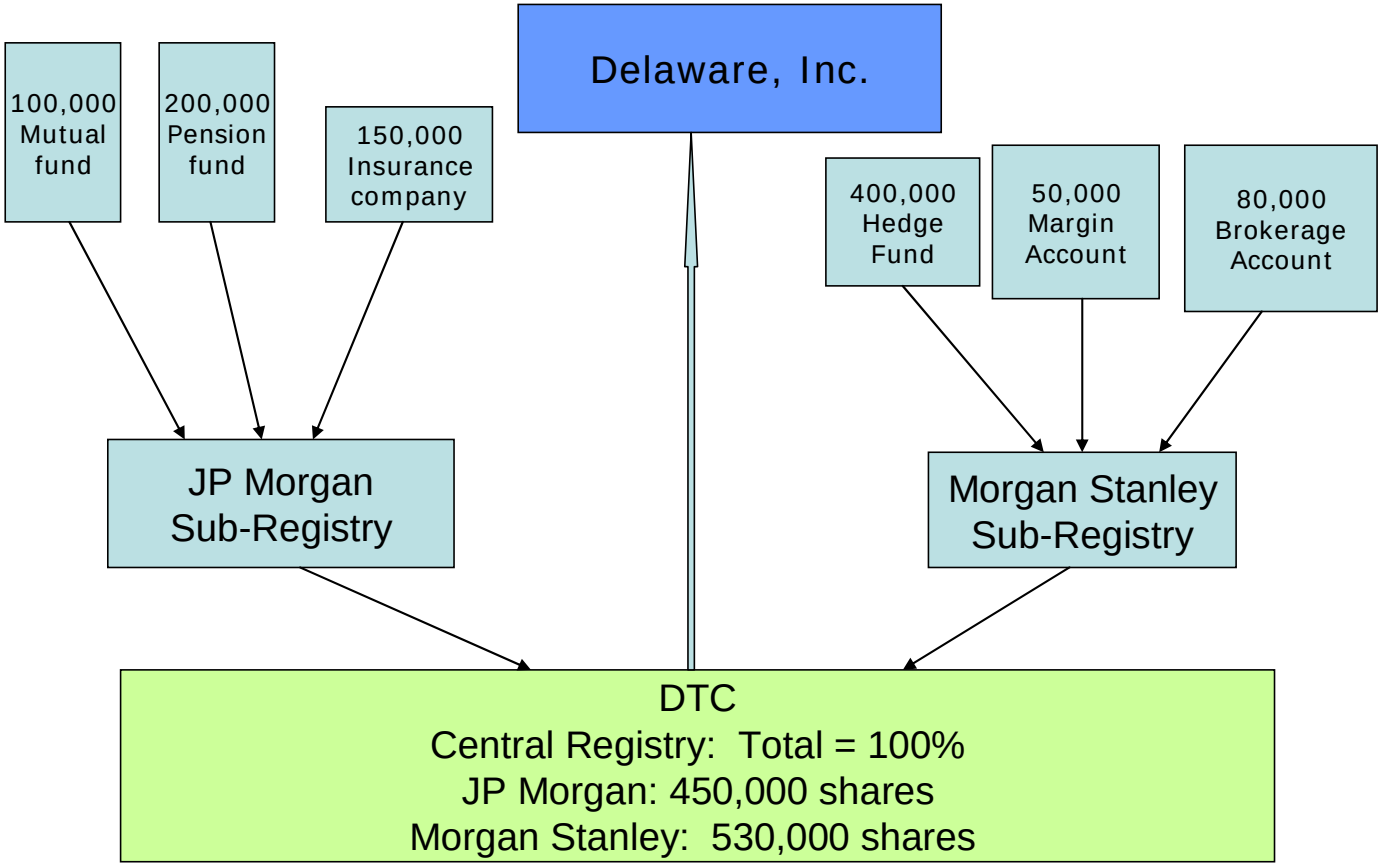


Fig. 15. Share holding in a pure book-entry system

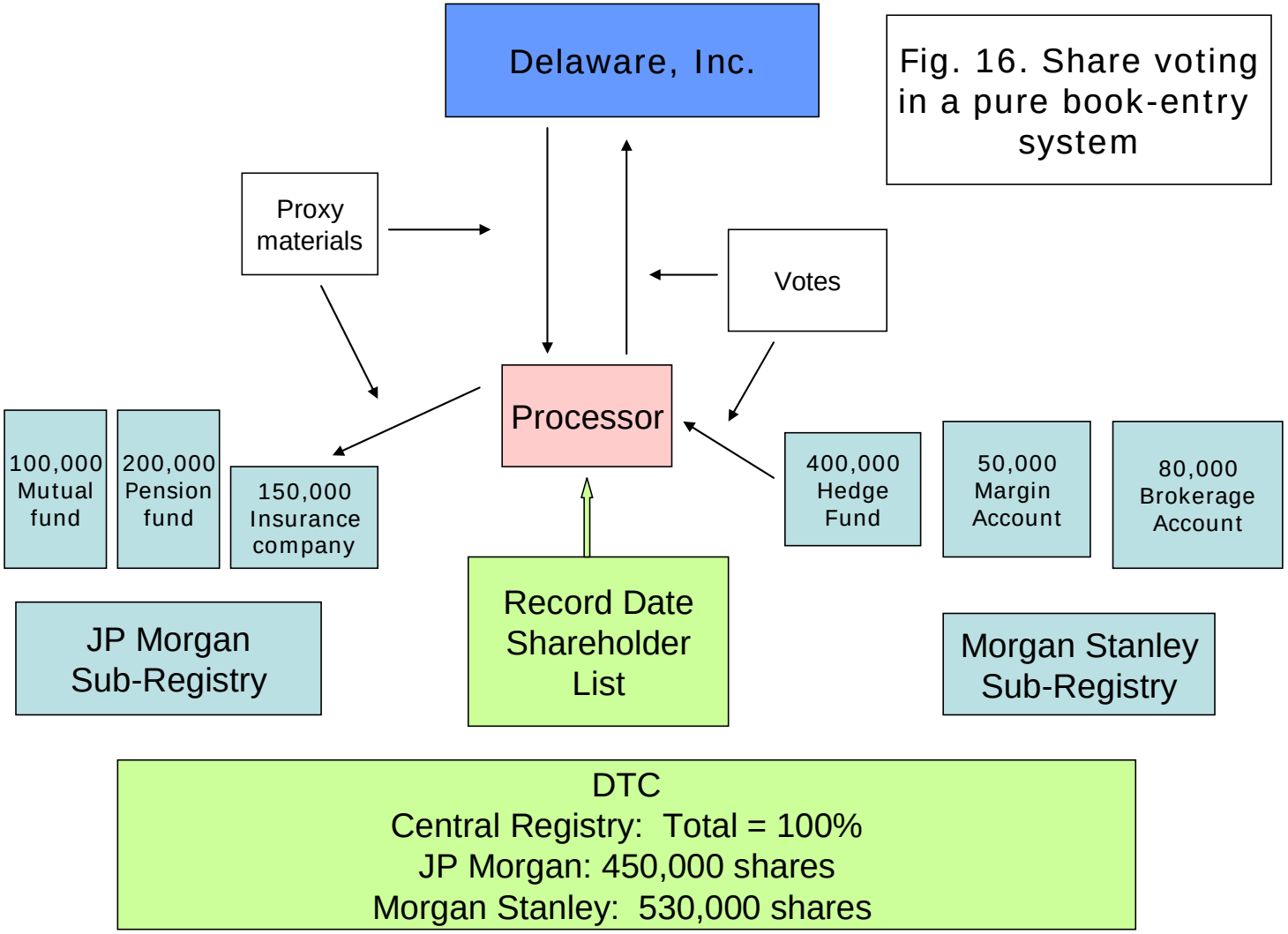


Fig. 16. Share voting in a pure book-entry system