



CENTER FOR THE STUDY OF FINANCIAL MARKET EVOLUTION

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November 28, 2012

Mr. David W. Blass, Chief Counsel  
Division of Trading and Markets  
U.S. Securities & Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: Lender-Directed Voting Initiative

Dear Mr. Blass:

The Center for the Study of Financial Market Evolution (CSFME) appreciates the opportunity to provide additional information regarding Lender-Directed Voting (LDV). As we have described to you previously, LDV would re-enfranchise long-term investors who have temporarily loaned their securities to brokers in return for additional portfolio yield, but as a result have lost their proxy voting rights.<sup>1</sup> Encouragement of the LDV initiative by the Commission and its staff would help U.S. broker-dealers to assign to their securities lenders, without fear of official censure, proxies that would otherwise go un-voted, thus providing numerous benefits to a wide range of market participants.

In response to your comments and questions, we have set forth below our views on several public policy issues raised by LDV, as well as the legal underpinnings that we believe will support Commission encouragement of LDV in broker proxy assignments. In summary, we believe that LDV will:

- A. Increase investment earnings, reduce operational risks, and improve corporate governance without impairing existing rights or responsibilities (see Annex A);
- B. Comply with current federal and state laws and regulations (see Annex B); and
- C. Reinforce existing market practices and the stated intent of Congress and the SEC to minimize the influence of broker votes (see Annex C).

To begin, we wish to associate our views with those of participants in earlier SEC inquiries into the corporate governance process. We agree that the U.S. proxy process, while complex, is also extraordinarily efficient. Virtually all participants in the 2007 SEC Proxy Voting Roundtable emphasized this point. Similarly, our 2010 Borrowed Proxy Abuse study<sup>2</sup> found that the infrastructure investments of financial firms and their service providers have made many proxy processes seamless. Nevertheless, there is still much that can be improved, such as providing a mechanism for securities lenders to maximize portfolio returns without surrendering their voting rights as beneficial owners.<sup>3</sup>

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<sup>1</sup> July 5, 2011 CSFME Comment Letter to SEC Re: Rulemaking for Dodd-Frank Act Section 984: Securities Lending and Proxy Voting 2011<http://www.sec.gov/comments/df-title-ix/lending-borrowing/lendingborrowing-22.pdf>

<sup>2</sup> <http://csfme.org/Portals/0/CSFME%20Research/BPA%20WP%20Final.pdf>

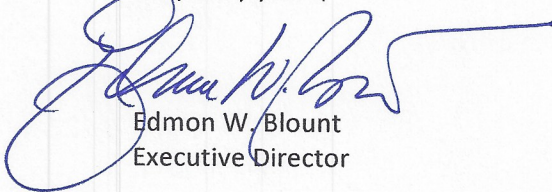
<sup>3</sup> LDV differentiates between securities lenders and other non-enfranchised beneficial owners (e.g., swap holders) by virtue of lenders' long-term ownership of the loaned securities, as well as the temporary nature of securities loans (i.e., lenders hold full legal title prior to securities loans and regain entitlement after loans close).

In 2010, investors earned over 40 basis points on loaned securities, enough to offset most if not all of their domestic custodial fees. Yet, these were not steady loans, nor was their income always reliable. A Georgetown University study found that lenders typically recalled or restricted almost 10 percent of U.S. equity lending supply to regain their voting rights.<sup>4</sup> Not only do such mass recalls cut into investor earnings, they are also a disruptive practice for settlement systems.<sup>5</sup> This is not a new insight. Ten years ago, global regulators said that securities lenders added so much to market efficiency that "[i]mpediments to the development and functioning of securities lending markets should, as far as possible, be removed."<sup>6</sup> Similarly, regulators have repeatedly stressed the need for "improvement[s] in transparency" in securities lending.<sup>7</sup> LDV would create a new conduit for lenders and their borrowers to share information, particularly with regard to loan supply and demand factors, thereby helping to advance another regulatory goal.

While stabilizing market efficiency, reducing recalls, and improving transparency, LDV would also help protect public finance. Early this year, the Senate Finance Committee warned, "[T]o the extent unfunded pension liabilities could contribute to a potential future downgrade they will contribute to increased borrowing costs for the Federal government."<sup>8</sup> By removing obstacles to stable securities lending markets, LDV would increase lending revenue for, among others, most large public pension systems. In turn, this would help fund pension liabilities and thereby control federal budget gaps.

For all these reasons, senior officials of the Florida State Board of Administration, California State Teachers Retirement System and other members of the International Corporate Governance Network have called for SEC support of the LDV initiative.<sup>9</sup> We thank you in advance for your consideration and look forward to continuing our discussions with you.

Very truly yours,



Edmon W. Blount  
Executive Director

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<sup>4</sup> <http://faculty.msb.edu/aggarwal/lending.pdf>

<sup>5</sup> This may be especially true if mutual fund NP-X reporting regulations are changed to require the number of proxies voted, which could cause mutual funds to recall many more shares before proxy record dates.

<sup>6</sup> CPSS-IOSCO, *Recommendations for Securities Settlement Systems* Recommendation 5, at 12 (Nov. 2001), at <http://www.bis.org/publ/cpps46.pdf>.

<sup>7</sup> See for example, [http://www.financialstabilityboard.org/publications/r\\_121118b.pdf](http://www.financialstabilityboard.org/publications/r_121118b.pdf)

<sup>8</sup> U.S. Senate Committee on Finance, *State and Local Government Defined Benefit Pension Plans: The Pension Debt Crisis that Threatens America*, A Report by Ranking Member Orrin G. Hatch, January 2012, pp. 3-4.

<sup>9</sup> Letters of support from these institutions are available at <https://www.icgn.org/component/k2/item/1024-lender-directed-voting> and <http://www.sec.gov/comments/df-title-ix/lending-borrowing/lending-borrowing.shtml>

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cc: Chairman Mary L. Schapiro  
Commissioner Luis A. Aguilar  
Commissioner Troy A. Paredes  
Commissioner Daniel M. Gallagher  
Commissioner Elisse B. Walter

Mr. Norm Champ, Director, Division Investment Management  
Mr. Robert W. Cook, Director, Division of Trading and Markets  
Ms. Meredith Cross, Director, Division of Corporation Finance  
Mr. Tom Kim, Associate Director, Division of Corporation Finance

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**PUBLIC POLICY ISSUES RELATED TO LENDER DIRECTED VOTING**

We believe Lender Directed Voting will provide substantial benefits to securities lending and corporate governance markets, as well as to participants in those markets. Moreover, we believe that no investor or issuer interests would be impaired by LDV's full implementation. Throughout this section, we discuss these benefits, as well as specific issues that you have raised in our discussions.

**SECURITIES LENDERS WOULD OVERCOME INCOME-VOTE TRADEOFFS AND INFORMATION ASYMMETRY**

Under present practices, lenders must choose between voting proxies and maximizing their securities lending revenues. This can be significant, as industry surveys indicated that securities lending in 2010 generated more than \$4 billion in additional portfolio revenue for investors and their beneficiaries, thereby helping to overcome funding and competitive pressures.<sup>10</sup> With LDV, investors would no longer have to choose between their corporate governance responsibilities and valuable fee income from securities lending. Those who currently prefer the income would no longer have to forgo their voting rights, while governance-oriented lenders could vote their proxies and still generate revenues from securities lending.

Even after implementation of LDV, securities lenders would continue to have the right to recall their securities for any reason, including for voting purposes. However, loan recalls may not be practical in many instances since proxy record dates are not always known in sufficient time, as explained in the Proxy Plumbing Release.<sup>11</sup> Even when proxy record dates are known, ballot items are generally not announced in advance, so securities lenders cannot make informed tradeoff decisions.<sup>12</sup> LDV would eliminate this need for lenders to know the record dates or ballot items in advance, since they would be able to cast votes on their loaned positions.

Panelists at the SEC's Selling and Securities Lending Roundtable (the "SL Roundtable") emphasized that lenders often lack knowledge of material events until after the record date. Major investors have endorsed the LDV solution for this problem. According to the Florida State Board of Administration, "[t]he implementation of LDV would address the issue of investors, with insufficient information as of the record date, having to identify situations where the value of voting a particularly important ballot item outweighs the potential income from lending a security."<sup>13</sup>

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<sup>10</sup> Data source: RMA Quarterly Composites. Analysis: CSFME.

<sup>11</sup> pp. 44-45, Proxy Plumbing Release

<sup>12</sup> This is especially true for special meetings, which are often the most important from a corporate governance perspective.

<sup>13</sup> Letter from Ashbel C. Williams, Executive Director & CIO, State Board of Administration of Florida, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (July 19, 2011), at <http://www.sec.gov/comments/df-title-ix/lending-borrowing/lendingborrowing-24.pdf>.



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**BROKERS AND BANKS WOULD HAVE HIGHER REVENUE, LOWER COSTS AND REDUCED RISKS**

As noted, some lenders recall borrowed shares to reacquire voting rights before proxy record dates. However, panelists at the SL Roundtable stated that, in many instances, recalling loans can have detrimental economic effects on both borrowers and lenders.<sup>14</sup> Indeed, academic research in 2010 found "evidence of a significant reduction in the supply of shares available to lend at the time of a proxy vote because institutions restrict and/or call back their loaned shares prior to a vote," concluding that proxy-related recall activity "corresponds to a 8.15 percent reduction in supply."<sup>15</sup> Accordingly, a reduction in these recalls would benefit the market, as well as banks, broker-dealers, and investors.

LDV would accomplish just such a reduction in loan recalls and, as a result, market participants would earn more revenue. Just as importantly, fewer recalls would reduce loan churn and associated operational, counterparty, and investment risks. For example, lending agents that receive loan recall orders are forced to reallocate loans to other lenders with available shares or, if reallocations are not possible, terminate loans to broker-dealers. Recalls can also require agents to return collateral to borrowers unexpectedly, which can then force the liquidation of collateral investments prematurely. With implementation of LDV, these steps would be reduced, or even eliminated for proxy-related recalls. In turn, LDV would directly contribute to a reduction of systemic risks in the critical securities finance markets, supporting the goals of the Financial Stability Oversight Board, the Federal Reserve System and other regulators.

LDV will be even more important in the future, as new capital rules motivate broker-borrowers to take a closer look at their principal lenders. Already, brokers are asking agents to retool the lending queues to allow them to manage their capital more efficiently. LDV would facilitate this, as well as allowing lenders the same privilege. Lenders and agents will be able to identify borrowers with more attractive qualities, including the willingness and capacity to vote on instructed shares, and more effectively direct their transactions to preferred counterparties.

**EXISTING CORPORATE GOVERNANCE CHALLENGES WOULD BE MITIGATED**

Corporate governance can be improved by LDV in many ways. For instance, surveys show that only 82.7 percent of shares were voted during the 2012 proxy season, implying that as many as 110 billion U.S. equity shares went un-voted throughout the year.<sup>16</sup> Using recent survey data, we estimate that only 15

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<sup>14</sup> Securities Lending and Short Sale Roundtable, at 56 – 57, 67, 107 – 15, 202 – 04 (Sept. 29, 2009), at <http://www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf>; see also Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 Geo. L.J. 1227, 1256 – 57 (2008).

<sup>15</sup> <http://faculty.msb.edu/aggarwal/lending.pdf>

<sup>16</sup> <http://www.broadridge.com/Content.aspx?DocID=1498>. If the voting percentage is applied to the total number of processed during the whole season (638.2 billion shares), 110.4 billion shares went un-voted. Notably, Broadridge statistics also show a declining percentage in the number of shares voted during the last few years, down from 86.4 percent in 2008 (see <http://www.broadridge-ir.com/main/2009ProxyStats.pdf>).

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billion U.S. equity shares are on loan to broker-dealers at any time. LDV could therefore close as much as 14 percent of the non-voting gap.

At the same time, we believe that allowing securities lenders to vote surely achieves a more appropriate reflection of the wishes of long-term beneficial owners than do current corporate governance processes. Lenders are typically knowledgeable, long-standing investors with positive economic interest, that is, exactly the investors whose interests are most closely aligned with the long-term health of their corporations. Moreover, they regain their direct ownership when their loans end, giving them further incentives to vote in ways that contribute to corporate well-being. Whereas today lenders' views are not fully incorporated into corporate governance processes, LDV would make proxy voting outcomes more representative of the overall shareholder base.

LDV would also help address concerns over "empty voting," or voting by investors with neutral or negative economic interests. Many panelists at the SL Roundtable expressed concern that such investors can interfere with the integrity of the corporate governance process by voting in ways that impair, rather than improve, long-term corporate health.<sup>18</sup> In support of their arguments, SL Roundtable panelists cited academic studies and anecdotal evidence claiming that proxy manipulations have been effected with the borrowing of shares across record date. Although the cited studies were inconclusive, a recent incident in Canada revealed "a precedent-setting transaction as it provided for the first time in Canada clear evidence of empty voting."<sup>19</sup> By having securities lenders instruct broker proxies through LDV, more votes would be cast by investors with positive economic interests, thereby reducing the relative voting power of potential "empty voters."<sup>20</sup>

**CORPORATE ISSUERS WOULD REACH QUORUM MORE OFTEN AND LESS EXPENSIVELY, WHILE GAINING MORE VOTES FROM LONG-TERM INVESTORS**

Corporate issuers would also benefit from LDV, in that they would receive more proxy votes, thus allowing them to reach quorum more often, more quickly, and at lower costs. During the 2012 proxy season, one fifth of all corporate elections did not reached quorum.<sup>21</sup> If LDV were implemented widely, so

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<sup>18</sup> One panelist said in her written statement, "It is our finding, based upon both our research and our own experience as investors, that stock lending, as it is presently conducted, has a significant detrimental impact upon share voting and upon the normal attributes of responsible ownership. We also believe that in a non-trivial number of cases, lending activity may have compromised the integrity of the shareholders' meeting." Letter from Christianna Wood, Chairman of the International Corporate Governance Network, and Andrew Clearfield Chairman, Securities Lending Task Force, International Corporate Governance Network, to Jeffrey Dinwoodie and David P. Bloom, Securities and Exchange Commission, at 12 (Sept. 24, 2009), at <http://www.sec.gov/comments/4-590/4590-10.pdf>.

<sup>19</sup> <http://www.osler.com/NewsResources/A-Call-to-Arms-on-Empty-Voting/>

<sup>20</sup> In addition, if "empty voters" accumulate their shares through margin accounts, LDV could reduce the number of proxies that brokers assign to such accounts, thereby directly reducing the likelihood of "empty voting." Finally, LDV would reduce the number of uninstructed shares that brokers vote proportionately to their customers' votes, thereby including those voted proportionately to "empty voter" instructions.

<sup>21</sup> <http://www.broadridge.com/default.aspx?DocID=1634>.

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as to close 14 percent of the non-voting gap, quorum levels could increase and thereby generate substantial savings to any issuers that would not have otherwise reached quorum.

Under LDV, issuers would also receive vote tallies more representative of their investor base. Investors whose interests were consistent with the long-term prospects of the enterprise would cast the votes, rather than broker-dealers who assign votes to uninstructed shares on a proportional basis. The SEC has noted the importance of long-tenured investors in its proxy rules, most recently during the proxy access initiative.<sup>22</sup> LDV would further these objectives by re-enfranchising securities lenders, which are generally long-term owners of the loaned securities. We believe that LDV will favor neither supportive nor activist investors. Some observers may suppose that activist-lenders would be most interested in LDV implementation. However, under existing market practices, these investors are more likely to recall loans before record date. Therefore, current practice may create a bias toward activist shareholders. Under LDV, that bias will be reduced, since pro-management investors who don't recall will still be able to cast votes.

The recent Wal-Mart proxy may illustrate a case in point. Prior to record date, activist investor-lenders would likely have recalled loaned shares to assure their right to vote, perhaps due to differing opinions on labor or competitive issues. Pro-management investors, on the other hand, would likely have left their shares on loan. Neither group could have been aware that allegations of improper board behavior would be publicized shortly after the 2012 proxy record date.<sup>23</sup> But because activists had recalled their loans, they could respond directly to these allegations of wrongdoing. Moreover, since pro-management investors could not vote proxies, brokers might inadvertently dilute their voting influence with a proportional vote based on executed proxies. In such a case, part of the supportive vote would have been cast pro-rata against the board, especially if headline-swayed investors joined anti-management investors. In this way, Wal-Mart's board was likely denied the support of non-recalling lenders at the annual meeting, while broker votes facilitated assembly of an even stronger voice against management. This example shows that LDV can enable both activist and supportive funds to make their voices heard during the annual meeting, to the benefit of issuers as well as investors.

**LDV WOULD NOT ENABLE LENDERS TO "LEVERAGE UP" THEIR VOTING POWER**

Some observers may also question whether, through LDV, lenders could obtain more proxy votes than the number of shares they own. For example, a lender could loan its shares to a collaborator who agrees to vote as the lender desires, then obtain an equivalent number of proxies through LDV. Although on the surface this could appear as if the lender has doubled its voting power, the collaborator could only borrow the shares by posting collateral totaling at least (and typically more than) the value of the borrowed shares. The collaborator is therefore entitled to the associated voting rights (just as if it had provided capital to purchase shares on the open market) and has the right to vote as it likes, includ-

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<sup>22</sup> <http://www.sec.gov/rules/final/2010/33-9136.pdf>

<sup>23</sup> See <http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?pagewanted=all>

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ing in line with the lender's wishes.<sup>24</sup> In the securities lending markets, nobody can acquire shares without posting capital to collateral their borrows, so there is no "free lunch." In turn, there is no mechanism for a lender to leverage up its voting power without a commensurate allocation of capital.<sup>25</sup>

**LDV WOULD NOT DISENFRANCHISE INTERESTED INVESTORS**

Among some observers, LDV may raise questions about whether allocating proxies to securities lenders would disenfranchise other investors. One example is an investor who specifically chooses not to cast a vote,<sup>26</sup> perhaps as an objection to the corporate issuer or as a means of forestalling quorum. It can be argued that assigning such an investor's proxies to a securities lender under LDV would be inappropriate, since the investor has made a conscious decision not to vote (in effect, the non-vote *is* the vote). However, as a practical matter, it is highly unlikely that LDV will offset the effect of such "voting non-votes."

As explained above, we estimate that LDV could fully satisfy the voting demand of securities lenders with only 14 percent of proxies that otherwise go uninstructed. Therefore, at the aggregate market level, the displacement of conscious decisions not to vote by LDV would only be relevant if greater than 86 percent of uncast votes belonged to investors who did not vote on principle. While some un-voted shares may represent specific investor decisions, the vast majority of un-voted shares are surely held by indifferent investors.<sup>27</sup> LDV can therefore be implemented without disenfranchising any interested investors.<sup>28</sup>

**LDV WOULD RESTORE INSTITUTIONAL INVESTOR VOTING RIGHTS WITHOUT IMPAIRING RETAIL INVESTOR INTERESTS**

Some may question whether LDV's assignment of proxies to institutional securities lenders would reduce the voting influence of individual investors. After all, institutions lend the majority of securities and therefore would receive most LDV proxy assignments. Notwithstanding that institutional investors generally represent individuals (e.g., mutual fund investors or pension plan beneficiaries), the simple example below shows that securities lending actually increases retail investor voting, while LDV restores the voting power of institutional investors without further reducing already-low voting by retail inves-

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<sup>24</sup> Indeed, the SEC's Proxy Plumbing Concept Release contains a discussion of advance voting instructions that would enable investors to "[v]ote shares related to particular types of proposals ... consistent with recommendations issued by specified interest groups, proxy advisory firms, investors, or voting policies; ..."

<sup>25</sup> A further constraint exists in that brokers cannot execute more proxies than authorized by their depository positions. As a practical matter, this constraint limits the ability of collaborators to leverage their votes even without LDV.

<sup>26</sup> Note that this is different voting "Abstain," which is still counted as a vote.

<sup>27</sup> Furthermore, LDV can be implemented so that, for each proxy event, a "buffer" is maintained so that not all proxies that would otherwise be uninstructed are allocated to securities lenders.

<sup>28</sup> For the avoidance of doubt, such a consideration can be eliminated after LDV implementation if brokers include adequate disclosure in their customer contracts.



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tors. Indeed, LDV minimizes, or even eliminates a voting penalty on those financial institutions that improve market efficiency by making their portfolio securities available to borrow.

To show how LDV returns voting power to normal levels, it is useful to proceed through an example without securities lending or LDV (Case 1 in the table below), another in which institutions lend securities (Case 2), and a final in which securities lenders receive proxy assignments through LDV (Case 3). In each case, assume that Company ABC issues 1,000 shares; that it has a typical ownership structure;<sup>29</sup> and that its shareholders exhibit normal proxy voting patterns.<sup>30</sup> Without securities lending or LDV (Case 1), retail investors cast only 9 percent of votes,<sup>31</sup> while 17.5 percent of shares go un-voted.<sup>32</sup>

**TABLE 1: COMPANY ABC VOTING POWER UNDER DIFFERING MARKET STRUCTURES**

	Case 1: No Securities Lending or LDV	Case 2: Securities Lending, but no LDV	Case 3: Securities Lending with LDV	
Shares Owned				
Retail	250	269	269	
Institutional	<u>750</u>	<u>731</u>	<u>731</u>	
	1,000	1,000	1,000	
Shares Voted				
Retail	75	81	81	
Institutional	<u>750</u>	<u>731</u>	<u>806</u>	
	825	812	887	
Un-Voted	175	188	113	
Percent of Voted Shares				
Retail	9%	10%	9%	
Institutional	91%	90%	91%	

- 75 (10%) institutional shares are loaned and sold short
- Retail investors purchase 19 (25%) of these short sales
- Institutional shares: 750 beginning - 75 on loan + 56 (75%) short sale shares = 731
- Institutional votes: 731 beginning + 75 from LDV = 806

In Case 2, we assume that institutional investors lend 10 percent of their shares, which are sold short.<sup>33</sup> We also assume investors purchase these shares sold short in the same proportion as their original purchases of Company ABC (*i.e.*, 25 percent retail). As a result of institutions facilitating short sales,

<sup>29</sup> We assume 25 percent retail and 75 percent institutional ownership. Brancato and Tonello (2010) reported that institutional investors held 73 percent of the top 1,000 U.S. companies in 2009 (see <http://tcbblogs.org/governance/2010/11/23/report-institutional-investors-owning-more-of-larger-companies/>). Institutional ownership of smaller companies is even greater (see for example [http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences\\_21Aug2012.pdf](http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf)).

<sup>30</sup> We assumed retail and institutional investors vote 30 percent and 100 percent of their shares, respectively. The SEC Proxy Plumbing Release stated that "some broker-dealers have estimated that only 20% to 30% of their retail customers usually vote." (see <http://www.sec.gov/rules/concept/2010/34-62495.pdf>). Broadridge also reported that that only 15.4 percent of retail accounts voted in 2010 (see <http://www.broadridge.com/Content.aspx?DocID=1440>) and that "retail accounts voted 27 percent of their shares in 2010." (see <http://www.securitiestechologymonitor.com/news/-27769-1.html>).

<sup>31</sup> 250 retail shares owned x 30 percent voted = 75 retail shares voted / 825 total shares voted = 9.1 percent

<sup>32</sup> According to Broadridge, 17.3 percent of shares went un-voted during the 2012 proxy season (see <http://www.broadridge.com/Content.aspx?DocID=1498>).

<sup>33</sup> This assumption is consistent with SEC Regulation T, which generally requires that "a creditor may borrow or lend securities for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations." (12 CFR §220.12)

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retail investor votes increase by 7.5 percent (from 75 to 81) and their portion of votes cast rises to 10 percent. Conversely, institutional investors cast 2.5 percent fewer votes. That is, institutions lose voting power by facilitating short sales and other transactions that improve market efficiency. Moreover, corporate governance processes are hampered and un-voted shares rise by 7.5 percent because retail investors, who vote less often, hold additional shares.

In Case 3, we assume that LDV is introduced fully into the market, so that lenders receive proxies for all loaned shares.<sup>34</sup> As a result, institutional investor votes increase by 10.3 percent (from 731 to 806) and total un-voted shares falls to 11.3 percent. Meanwhile, retail investor voting stays the same. Their share of votes cast declines somewhat, but only to the proportion they would have voted if institutions had never loaned their securities.<sup>35</sup> In other words, financial institutions' securities lending programs contribute not only to market efficiency and liquidity, but also provide more opportunities for retail investors to vote. By engaging in lending, however, these same institutions must forgo their own corporate governance interests. LDV would resolve this penalty, which in turn would encourage more lending and the commensurate increase in retail investor voting, all while maintaining the relative voting power of retail and institutional investors and providing additional proxy votes to corporate issuers.

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<sup>34</sup> Effects of LDV may be lower if brokers can't cover LDV proxy demand -- perhaps because retail investors vote more than 30 percent of their shares.

<sup>35</sup> Note that institutional investors can elect to recall all their loaned securities, which would reduce overall proxy voting, as well as retail investor proportional voting.

Annex B

## LEGAL ANALYSIS OF LENDER DIRECTED VOTING

We believe Lender Directed Voting may be implemented in compliance with current federal and state securities laws and regulations and under NYSE regulations. Under existing laws and regulations, brokers solicit proxy voting instructions from beneficial owners, and lenders are beneficial owners of loaned securities. Under LDV, brokers could therefore legally accept proxy voting instructions from securities lenders for shares they had borrowed from those lenders.

### SECURITIES LENDERS ARE BENEFICIAL OWNERS OF LOANED SHARES

The integral concepts of the term “beneficial owner” under the Securities Exchange Act of 1934 (“Exchange Act”)<sup>36</sup> and several different contexts under the U.S. securities laws flow from Rule 13d-3 under the Exchange Act. The definition of beneficial owner in Rule 13d-3 (a) applies to Section 13 of the Exchange Act, (b) is specifically incorporated by reference in Rule 16a-1 for purposes of Section 16 of the Exchange Act, and (c) is incorporated by reference in rule 14d-1(g), as the provisions of Rule 14d apply to tender offers. Rule 14a, which generally addresses information that is required to be furnished to security holders, also relies on the beneficial ownership definition in Rule 13d-3.<sup>37</sup> Because the Rule 13d-3 definition is the accepted touchstone for so many applications under the U.S. securities laws, it is appropriate to apply its principles in the context of LDV.

Under Rule 13d-3(a)<sup>38</sup> of the Exchange Act, voting and dispositive power are the hallmarks of beneficial ownership. The rule states that a beneficial owner includes “any person who directly or indirectly has or shares voting power and/or investment power over an equity security.” In addition, the Commission has consistently held that the right to acquire (or reacquire) a security imminently is comparable to direct ownership of the security because direct ownership is contingent, in some cases, only upon the exercise of that right.<sup>39</sup> Rule 13d-3(d) recognizes this potential for contingent ownership and provides that “a person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) (§ 240.13d-3(a)), within sixty days.”

Lenders of securities are contingent owners of those securities as contemplated by Rule 13d-3(d) because they may recall their lent shares at any time, and accordingly, recall voting and dispositive powers attendant to those shares. Indeed, standard securities lending agreements stipulate that lenders

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<sup>36</sup> 15 U.S.C. § 78a *et seq.*

<sup>37</sup> Securities Exchange Act of 1934 Rule 14a-1 -- Definitions -- states that “Unless the context otherwise requires, all terms used in this regulation have the same meanings as in the Act or elsewhere in the general rules and regulations thereunder.”

<sup>38</sup> Securities Exchange Act of 1934 Rule 13d-3 -- Determination of Beneficial Ownership, 17 CFR §240.13d-3.

<sup>39</sup> Beneficial Ownerships Reporting Requirements on Security-Based Swaps, Rel. No. 34-64087, Mar. 17, 2011 (76 FR 115874, 15881 [Mar. 22, 2011]).

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have the right to terminate loans at any time. For example, the Master Securities Lending Agreement, which generally controls securities loans in the United States, stipulates that "[u]nless otherwise agreed, either party may terminate a Loan on a termination date established by notice given to the other party prior to the Close of Business on a Business Day."<sup>40</sup> Similarly, the Global Master Securities Lending Agreement, which generally controls securities loans in overseas markets, states that the "... Lender shall be entitled to terminate a Loan and to call for the delivery of all or any Equivalent Securities at any time by giving notice on any Business Day ..." <sup>41</sup> By virtue of their ability to recall securities immediately, and thereby reacquire direct voting and investment power over loaned securities, lenders meet the criteria set forth in rules under the Exchange Act to be beneficial owners with respect to their loaned securities.

Importantly, these Rules explicitly provide that an investor may be a beneficial owner even if that investor shares voting or investment power with another person and/or is only able to exercise such power indirectly, or contingently, by directing the voting or disposition of such securities. That is, there can be more than one beneficial owner for each security, depending on the investors' control of (or ability to control) those securities. Indeed, the SEC has said that "[f]or certain purposes, a person may be deemed a beneficial owner if entitled to exercise any one of the foregoing rights with the result that there could be more than one beneficial owner of a single share."<sup>42</sup> In addition, with respect to lenders of securities specifically, Delaware courts have recognized that "With regard to the share borrowed, both the shareholder from whom it was borrowed and the third party to whom the share was sold are beneficial owners."<sup>43</sup>

**BENEFICIAL OWNERS CAN INSTRUCT PROXIES UNDER SEC AND NYSE RULES -- AS BENEFICIAL OWNERS, SECURITIES LENDERS FALL WITHIN THIS AUTHORITY**

At the federal level, proxy voting processes are regulated by SEC and NYSE rules, which stipulate that voting rights are vested with beneficial owners. Rule 14a-13 under the Exchange Act, for example, states that proxies must be distributed to beneficial owners<sup>44</sup> and, as described in more detail above, the definition of beneficial ownership under Rule 13d-3 is fairly implied with respect to the use of the term beneficial owner in Rule 14a. NYSE Rule 452 similarly states that "[a] member organization shall give or authorize the giving of a proxy for stock registered in its name, or in the name of its nominee, at

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<sup>40</sup> <http://www.sifma.org/services/standard-forms-and-documentation/mra,-gmra,-msla-and-msftas/>

<sup>41</sup> <http://www.isla.co.uk/images/PDF/MasterAgreements/gmsla%202010%20final3.pdf>

<sup>42</sup> "Preliminary Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner or Such Securities," December 4, 1975, at p. 10.

<sup>43</sup> *Deephaven Risk Arb Trading v. UnitedGlobalCom*, 2005 WL 1713067, \*7 n.34 (Del. Ch. July 13, 2005); *In re Digex, Inc. Shareholders Litigation*, 2002 WL 749184, \*2 (Del. Ch. Apr. 16, 2002).

<sup>44</sup> Securities Exchange Act of 1934 Rule 14a-13 -- Obligation of Registrants in Communicating with Beneficial Owners, 17 CFR 240.14a-13.

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the direction of the beneficial owner."<sup>45</sup> Rule 452 also regulates when brokers may cast votes for proxies that are not instructed by beneficial owners. For "routine" proposals, brokers may exercise their discretion to vote when beneficial owners fail to provide specific voting instructions within 10 days of the scheduled meeting (*i.e.*, when proxies are "uninstructed"). Brokers are prohibited, however, from voting such uninstructed proxies for "non-routine" matters, which comprises "certain types of corporate governance proxy proposals."<sup>46</sup> Importantly, proxies assigned to securities lenders under LDV would be instructed by beneficial owners, and thus would not be considered "uninstructed" as defined under Rule 452.

Consequently, we believe that assignment of proxies to securities lenders is consistent with federal proxy rules. Distribution of proxies to lenders complies with SEC Rule 14a and NYSE Rule 452, since securities lenders remain beneficial owners of loaned securities, and the proxies subsequently voted by securities lenders would never be "uninstructed" under Rule 452, since they would in fact be *instructed* by the lenders in their capacity as beneficial owners with secondary voting rights.<sup>47</sup>

**LDV WOULD NOT BE INCONSISTENT WITH STATE PROXY LAWS**

Under the Uniform Commercial Code (UCC), which has been adopted in some form by most states in the U.S.,<sup>48</sup> financial intermediaries have a duty to execute instructions, including proxy voting instructions, given by a security's "entitlement holder."<sup>49</sup> In effect, the entitlement holder is a special subset of beneficial owner, a concept that was developed to accommodate our indirect financial system and dematerialized market, as described in Annex C. Since transactions in physical objects, such as gold or stock certificates, are rarely traced through the hands of physical persons today, a "security entitlement" is not a claim to a specific identifiable asset. Rather, it is a package of rights and interests, which a person has against that person's security intermediary and its property.

Article 8 of the UCC defines entitlement holder as "a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary."<sup>50</sup> UCC Article 8 requires securities intermediaries to provide the entitlement holder with all of the economic and governance rights that comprise the financial asset and that the entitlement holder may look to

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<sup>45</sup> NYSE Rule 452 -- Giving Proxies by Member Organization. Also see NYSE Rule 450 -- Restriction on Giving of Proxies.

<sup>46</sup> [http://www.nyse.com/nyse/notices/nyse/information-memos/pdf;jsessionid=C3637E33901727CACF9AE3AD26F9A57A?memo\\_id=12-4](http://www.nyse.com/nyse/notices/nyse/information-memos/pdf;jsessionid=C3637E33901727CACF9AE3AD26F9A57A?memo_id=12-4)

<sup>47</sup> Given that the power to vote the proxy under LDV will always be arranged under the terms of a side letter between the lender and the broker, it can also be argued that the letter itself will re-affirm the lender's status as a beneficial owner.

<sup>48</sup> Currently, the UCC (in whole or in part) has been enacted, with some local variation, in all 50 states, the District of Columbia, and the Virgin Islands.

<sup>49</sup> See, Uniform Commercial Code Section 8-506 -- Duty of Securities Intermediary to Exercise Rights as Directed by Entitlement Holder; and Uniform Commercial Code Section 8-507 -- Duty of Securities Intermediary to Comply with Entitlement Order.

<sup>50</sup> UCC 8-503 (2004).



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them for performance of that intermediary's obligations.<sup>51</sup> The UCC is silent, however, with regard to a broker's duty when an entitlement holder fails to instruct an intermediary with regard to a proxy, although UCC Section 8-509(a) provides that "if the substance of a duty imposed upon a securities intermediary by Sections 8-504 through 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty."<sup>52</sup> For proxies uninstructed by entitlement holders, federal securities laws fill this gap, and brokers may therefore accept voting instructions from securities lenders as beneficial owners under the Exchange Act and NYSE Regulations, as explained above.

**LDV MAY BE IMPLEMENTED UNDER THE CURRENTLY-ACCEPTED SECURITIES LENDING AGREEMENTS.**

It is anticipated that LDV responsibilities would be documented in side letters<sup>53</sup> signed between lenders, lending agents, and broker-borrowers. These letters would merely supplement and not replace the existing agreements among LDV participants, and would specify that proxy assignments to securities lenders would be on a best-efforts basis.<sup>54</sup> Indeed, both the Master Securities Lending Agreement (United States) ("MSLA") and the Global Master Securities Lending Agreement (International) ("GMSLA") anticipate the assignment of proxies for loaned securities. Each agreement includes a provision that transfers the voting rights to the borrower *unless* other arrangements are made. The terms of LDV would embody such an alternative arrangement, so neither the MSLA nor the GMSLA would require amendment.

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<sup>51</sup> See generally UCC 8-501 et seq. (1994).

<sup>52</sup> UCC Article 8 is not intended to be a comprehensive body of private law governing the relationship between brokers and their customers, nor is it a body of regulatory law to police against improper conduct by brokers or other intermediaries. Many, if not most, aspects of the relationship between brokers and customers are governed by the common law of contract and agency, supplemented or supplanted by federal and state regulations.

<sup>53</sup> These letters would modify existing securities lending agreements to define the "best efforts" nature of LDV proxy assignments as well as any changes to the relationships among the participating lenders, agents and brokers. Side letters would also be desirable if special auditing, validation or other procedures were deemed appropriate by lenders, agents, or brokers, each of whom would be free to determine the form of such side letters, as well as whether the benefits of LDV would justify additional fees or associated expense reimbursements.

<sup>54</sup> Since brokers cannot know in advance how many of its shares will be instructed by entitlement holders, proxy assignments under LDV must be on a best-efforts basis.

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**EXISTING PRINCIPLES AND PRECEDENTS FOR LDV**

We believe that Lender Directed Voting is now possible as a result of four decades of technological progress in U.S. financial markets. The dematerialization of equity securities broke the link between ownership and possession of physical security certificates. Stocks became fungible, resulting in a virtual explosion of financial innovation, trading volume, and risk management techniques. As these markets evolved, so too did concepts of share ownership, rights, and responsibilities. Today, ownership rights are often treated with the same degree of fungibility as the equities from which they flow. Therefore, history and current market mechanics provide ample precedents for Lender-Directed Voting.

**TRANSITIVE FUNGIBILITY: THE ORGANIZING PRINCIPLE OF MODERN SECURITIES MARKETS**

Forty years ago, U.S. financial markets dematerialized equity securities, breaking the link between ownership and possession of physical security certificates. Stocks became fungible, resulting in a virtual explosion of financial innovation, trading volume, and risk management techniques. As these markets evolved, so too did concepts of share ownership, rights, and responsibilities. Today, ownership rights are often treated with the same degree of fungibility as the equities from which they flow. History and current market mechanics therefore provide ample precedents for Lender-Directed Voting.

The growth of block trading in stocks during the 1960s led to the Paperwork Crisis and the subsequent development of the CUSIP automated securities numbering system. During the early 1970s, trading automation and the immobilization of security certificates in securities depositories, such as the Depository Trust Company (DTC) in New York, improved the efficiency of market operations – just in time. After 1974, U.S. pension reform legislation greatly accelerated the growth of institutional markets and intermediation by their service providers.

As a result of these developments, security holdings by necessity became fungible, *i.e.*, substitutable freely at DTC and its member firms. It was no longer necessary to deliver particular certificates -- any stock or bond position could be used to deliver on a trade. Since stocks were fungible, operations managers controlled trade deliveries by tracking, not certificate numbers, but the number of shares held in their DTC accounts or in transit, using the same double-entry bookkeeping used to control cash ledgers. Certificate numbers became virtually irrelevant and certificates were long forgotten by everyone (except DTC and its participating transfer agents).

The same standard of fungibility also ruptured the linkage between a customer's proxy assignment and a particular stock certificate. The broker, as the DTC member, now assigned proxies to customers based

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on aggregate share positions.<sup>55</sup> In essence, the proxy inherited the fungibility of its associated securities issue. Proxies became *transitively fungible*.<sup>56</sup>

The immobilization of security certificates in DTC created a “balance sheet” in which a broker's assets, that is, its positions at DTC, are matched to its obligations to follow the voting instructions of beneficial owners. The referencing journal entries of buys, sells, fails, loans, and so on help to clarify and reconcile position differences, but they don't control the distribution of votes. That is done through the broker's proxy allocation system, using a fair and equitable algorithm.

**FUNGIBLE LATTICES OF SECURITIES LENDING: DERIVATIVES, HEDGING, AND CORPORATE GOVERNANCE**

Following the dematerialization and immobilization of security certificates in the 1970s, institutional securities lending grew rapidly. The operational efficiencies from lending gave rise to several financial innovations which, in turn, enabled new investment opportunities for institutional and individual investors, as well as improved risk management techniques. For example, development of option pricing models and increased emphasis on empirical research encouraged wider acceptance of derivatives. Securitization techniques allowed the separation of principal and interest payments, as well as the restructuring of secondary ownership rights to the underlying assets. Cash settlement of financial futures further separated the operational components of derivative trading. As a result of these developments, investors came to develop innovative portfolios with risk management and hedging strategies that could not have existed before the immobilization of security certificates and growth of securities lending.

Without securities lending, index funds could not have developed as quickly through the 1980s, such that individual investors would not have had access to low-cost vehicles through which they could benefit from advanced investment techniques. Fund managers began to rely on derivative exposures to market sectors, not just to individual corporate issuers, to reduce investment costs. They also discovered that revenues from lending their portfolio securities helped to reduce tracking errors, trade execution costs and custody fees. In turn, competition between index funds prompted their managers to push costs ever lower. These investment practices led to substantially higher demand for borrowed securities, as did the short sales that derivative dealers used to hedge their long positions.

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<sup>55</sup> Only brokerage member firms or custodial banks can belong to the securities depository.

<sup>56</sup> To illustrate, many brokers intentionally assign proxies to accounts with more shares in the aggregate than are held at DTC, so as to maximize the customer vote. Final reconciliation is made against the DTC position, but the proxies, like the shares, are fungible. The substitution of proxies takes place on the brokers' books, thereby making their operations more efficient while increasing the number of shares voted by customers.

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The rise of index funds and other financial innovations also led to increased focus on corporate governance. As index funds grew, so did their need to engage with issuers through proxy initiatives. Because these passive funds needed exposure to the companies in the index, they could not, like active managers, “vote with their feet” and sell their stocks when dissatisfied with management. The success of these funds attracted ever more investors through a process largely facilitated by securities lending.

Today, the vast majority of retail investors have entrusted their savings to institutions that, in turn, have entrusted operational support of their portfolios to intermediary broker-dealers and custodial banks. As a necessary consequence, individuals also entrust their corporate governance rights and responsibilities to their institutional managers. To deny securities lenders their voting rights is, in effect, to deny the rights of millions of individual investor-beneficiaries.

Index funds, hedging techniques, securitization, and derivatives all provide markets with efficient and effective means of tailoring investment profiles and managing risk. But by promoting these market innovations, the market community has implicitly accepted the notion that economic exposure and beneficial ownership are no longer linked directly to the equity certificates held on account at DTCC. Rather, the market accepts the notion that ownership rights can exist as fungible assets for issuers and investors, held on one side of the balance sheet, subject to the customer liabilities shown on the accounting systems of their intermediaries. For this reason, brokers are permitted to use a variety of proxy assignment algorithms so long as the results are fair and equitable.<sup>57</sup> The effect is to treat proxies as fungible; in that the assignment can be reallocated to another investor if available positions or customer instructions prove to be insufficient to optimize the vote. Yet despite the practical acceptance of proxy fungibility and clear evidence that individual and institutional investors have entrusted assets to brokers, just as have their margin customers,<sup>58</sup> securities lenders cannot exercise corporate governance rights over shares for which they remain beneficial owners.

**PERSPECTIVES ON LDV: TRADES VS BROKERS AND MARKETS**

It is reasonable to ask whether securities borrowed for settlement purposes can be included in LDV, since the shares have (presumably) been delivered out. One may also question whether institutions that

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<sup>57</sup> See, for example, the SEC’s Proxy Plumbing Release

<sup>58</sup> A contradictory notion persists that the brokers’ use of the borrowed securities to effect delivery (in compliance with FRB Regulation T) extinguishes the beneficial ownership status of the lenders. If such a notion were to be applied universally, then brokers’ margin customers could not be assigned proxy rights. Neither could hedge funds, since the equity finance desks of prime brokers frequently re-hypothecate shares in those portfolios. In both margin and hedge fund accounts, the equities have been delivered out in order to provide financing. However, Regulation T compliance doesn’t require returning borrowed securities to the original lenders, so brokers who manage their operations to maximum efficiency will return borrowed shares to those lenders with the least attractive rebates or most volatile recall policies. In the most logical construction, long share positions of brokers can no longer be associated directly with the original borrowing transaction.

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have made the decision to forgo the vote in favor of lending income should be entitled to recapture their votes. However, there is an invalid perspective assumed in both cases.

By following the delivered shares, the first questioner assumes the perspective of the trade. The more appropriate perspective is that of the broker. Indeed, the questioner assumes that the actual shares borrowed are being delivered out. In reality, and as described below, the shares are fully fungible, such that book-entry positions are "delivered" within the depository to settle an obligation of the broker. The borrowed shares replenish a deficient position, from which delivery is required. Furthermore, the proxies associated with the shares are also fungible, as evidenced by the brokers' ability to assign proxies to margin account despite the likelihood that the customer position is very likely to be delivered out for financing purposes.<sup>59</sup>

In the second instance, the questioner again takes the trade perspective, when the more accurate view is that of the market. Securities lenders gave up the right to vote in an older, less efficient market than that which exists today. Furthermore, any income to the lender fades in significance against the benefits to the marketplace that result from the lenders' contributions. As explained below, securities lenders contribute to the efficiency of the market by enabling the creation of index funds, as well as the use of derivative hedging and securitization techniques. In that context, it seems unreasonable to expect the practice of corporate governance to be impaired. Why deny securities lenders their votes, when precedents exist for proxy fungibility, as described below, and a remedy such as LDV is available?

**MANY REGULATORY AND OPERATIONAL PRECEDENTS EXIST FOR LDV**

The transitive fungibility of equities in our dematerialized market systems, along with the practical fungibility of their associated proxies, allows brokers to substitute the assignment of uninstructed proxies in one beneficial owner account to that of another beneficial owner. This principle is most clearly visible as the foundation of brokers' post-mailing and hybrid proxy reconciliation systems.<sup>60</sup> Under these reconciliation methods, margin customers are often entitled to vote their entire positions, including shares that have been delivered out for funding purposes. In concept and practice, LDV would be no different.<sup>61</sup> To the extent that a broker holds otherwise uninstructed proxies, it could assign those proxies to securities lenders to the limit of the number of shares each lender had loaned to the broker. As with margin investors, votes by securities lenders would not displace the votes of entitlement

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<sup>59</sup> Further evidence of the fungibility of borrowed shares can be seen by virtue of the fact that Regulation T doesn't require the broker to return shares to the original lender. A surplus position that is created when a short sale is closed out can be used to close out a loan from any lender, not just from the original lender.

<sup>60</sup> pp.33-35, SEC's Concept Release on the U.S. Proxy System, July 24, 2010

<sup>61</sup> However, the Commission may wish to impose a disclosure requirement for customer (fully-paid) cash accounts stating that their uninstructed proxies may be included in an aggregate reassignment regime consistent with accepted industry practices.



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holders, which would have first right to instruct proxies and, if an allocation of voting power was required, brokers would continue to use existing reconciliation procedures.<sup>62</sup>

Other operational precedents include instances in which, on authority from beneficial owners, lending agents have accepted executed vote instruction forms (VIFs) from brokers that are unable to comply with a loan recall notices.<sup>63</sup> Under standard securities lending contracts, failure to return recalled securities is an event of default, which can trigger a closeout of the entire securities lending relationship. To avoid such a disruptive incident, agents provided executed VIFs to their lenders to demonstrate borrower compliance with the lenders' voting instructions. This accommodation is consistent with the Best Practices of the International Corporate Governance Network,<sup>64</sup> as well as with the spirit of NYSE Rule 180 and DTCC procedures for insuring that counterparties remain responsible for the effects of a failure to deliver. LDV would improve on this practice by allowing the lender to vote the shares independently, avoiding the need for subsequent verification of the VIF.

As described in the Proxy Plumbing Release, the current practices of brokers also result in the assignment of their proprietary proxies to beneficial owners who desire the vote.<sup>65</sup> Brokers often hold equities to collateralize related trading positions and strategies, for which their corporate governance rights are relatively unimportant. The quality of corporate governance would be improved by assigning the proxies of broker proprietary positions to long-term investors under LDV.

Finally, we believe that existing systems and procedures will be capable of adapting to the support of proxy assignments among individual lenders and borrowing broker-dealers. Importantly, the total votes cast by a broker would continue to be limited by its position at DTCC, so LDV would not result in "over-voting." For support of large-scale LDV assignments and more complex arrangements among multiple brokers, agents and lenders, we believe that entities such as DTCC, Equilend, QuadriServe, Broadridge and others have the necessary systems and linkages. Moreover, securities lenders would instruct proxies assigned under LDV using their current service provider systems, such as those of Institutional Shareholder Services or Broadridge, thereby providing seamless operations and full transparency. However, we believe that infrastructure decisions should be left to the market, as informed by the outcome of an operational demonstration test.

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<sup>62</sup> If a participating broker-dealer found it necessary to allocate votes, it could use any system of allocation it currently believes to be permitted under applicable law, so long as the allocation system treated securities lenders no worse than margin customers whose securities are on loan.

<sup>63</sup> Although this practice is most prevalent in overseas markets, we reference it here because LDV would encompass proxies for non-U.S. shares owned by U.S. investors.

<sup>64</sup> "The borrower of a share, for whatever purpose, should not vote that share without the express permission of the lender, and in accordance with his instructions," International Corporate Governance Network, Securities Lending Code of Best Practice, at 9 – 10 (2007), at

[http://www.icgn.org/files/icgn\\_main/pdfs/best\\_practice/sec\\_lending/2007\\_securities\\_lending\\_code\\_of\\_best\\_practice.pdf](http://www.icgn.org/files/icgn_main/pdfs/best_practice/sec_lending/2007_securities_lending_code_of_best_practice.pdf).

<sup>65</sup> p.32, SEC's Concept Release on the U.S. Proxy System, July 24, 2010