Lender-Directed Voting (LDV)

Improving Investor Earnings and Corporate Governance for Institutional Securities Lenders

Special appreciation to:
California State Teachers' Retirement System
Colorado Public Employees' Retirement System
Florida State Board of Administration
State of Wisconsin Investment Board

and the
International Corporate Governance Network

The Center for the Study of Financial Market Evolution
1101 Pennsylvania Avenue, NW, Suite 600, Washington D.C. 20004
phone: 202 581 1188 • fax: 202 756 7323

Adoption of the LDV Initiative will …

- Increase portfolio earnings for institutional securities lenders, reduce operational risks for banks and brokers, and improve governance for corporations -- without impairing any existing rights or duties.
- Reinforce the stated intent of Congress and the SEC to minimize broker votes.
- Conform with existing market practices and current laws and regulations.
- Help meet public policy goals…

LDV will help meet Public Policy Goals

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- Corporations will achieve more representative governance profiles.
  - As many as 110 billion U.S. equities went un-voted in 2012.[2]
  - LDV would help close this non-voting gap, while votes would more appropriately reflect wishes of all long-term investors.
  - Almost 1/5th of corporate elections did not reach quorum in 2012,[3] even with additional and expensive investor outreach programs.
  - LDV would generate more votes, helping issuers reach quorum more quickly at lower cost.

- Institutions will recover voting rights and avoid income tradeoffs.
  - Lenders must choose between voting proxies and securities lending revenue, even though they often lack knowledge of material events until after the record date.
  - LDV would enable lenders to vote loaned shares, so they could continue to earn lending revenue while incorporating all market news into their votes.

- Brokers and banks will have higher profits and lower risks.
  - To retain voting rights, lenders restrict the supply of lendable shares by almost 10% over proxy record dates,[1] while recalls of loaned shares increase costs and operational risks.
  - LDV would reduce the need for lenders to restrict or recall loaned securities.

[1] http://faculty.msb.edu/aggarwal/lending.pdf
[2] http://www.broadridge.com/broadridge-insights/investor/presentations/Broadridge-2012-Proxy-Season-Key-Statistics-and-Performance-Ratings.html
[3] *ibid*

LDV: Operational Overview

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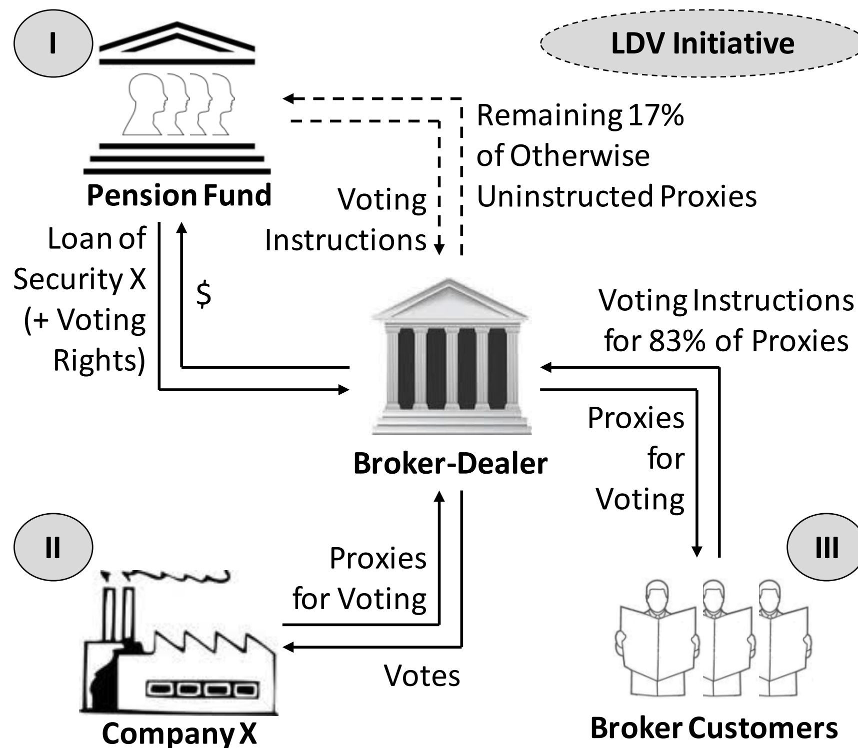
- LDV allows brokers to accept proxy voting instructions from their securities lenders, who remain the beneficial owners of loaned shares.



I. Funds earn almost $2B annually by lending 15B U.S. equity shares[4] to broker-dealers, but gave up voting rights to do so.

II. As registered owners, broker-dealers vote vast numbers of shares, mostly on instruction from their beneficial owner customers.

III. Only 83% of U.S. equities shares are instructed by beneficial owners -- 110B go un-voted.[5]

IV. Under LDV, lenders could provide voting instructions to their broker-dealer borrowers for some of the 17% of un-voted shares.

- If lenders can instruct proxies on loaned securities, current inefficiencies can be resolved without adversely affecting any market participants.

FAQ: Legal Analysis

- LDV may be managed with standard SL contracts.
  - The Master Securities Lending Agreement (U.S.) and the Global Master Securities Lending Agreement (international) both transfer voting rights to borrowers *unless* other arrangements are made.
  - LDV would embody such an alternative arrangement, so only a side letter among principals is needed. No amendments to either standard contract would be needed.
- Securities lenders may instruct proxies under SEC and NYSE rules.
  - With dispositive power, lenders are beneficial owners under SEC Rules 13d-3, 16a-1, and 14d-1.
  - The SEC has acknowledged there can be more than one beneficial owner for a single share.[4]
  - SEC Rule 14a-13 and NYSE Rule 452 both vest voting rights with beneficial owners.
  - Accordingly, lenders as beneficial owners can instruct proxies for loaned shares.
- LDV complies with state proxy laws.
  - The Uniform Commercial Code looks to federal law when proxies remain un-voted by entitlement holders, so lenders' beneficial ownership is the pertinent criteria.
  - Delaware state law also recognizes that lenders remain beneficial owners of loaned shares.[5]

[4] "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

[5] 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)

FAQ: Market Foundations and LDV Precedents

- Many regulatory and operational precedents exist for LDV.
  - LDV would be consistent with brokers' existing post-mailing and hybrid proxy reconciliation systems.
  - Other precedents include assignment of broker proprietary proxies to their customers, NYSE Rule 180 letters, safeguards against over-voting, and the limit to broker votes based on their DTCC positions.
- Proxy assignments are fungible, as are the underlying securities.
  - Dematerialization of securities greatly improved market efficiency and resulted in an explosion of financial innovation, trading volume, and risk management techniques.
  - The fungibility of dematerialized securities broke the link between proxies and physical stock certificates, leading in many cases to the fungibility of ownership rights.
- Fungibility is the lynchpin of modern securities lending.
  - Dematerialization promoted a rapid rise in institutional securities lending.
  - In turn, lending supported growth of derivatives markets, asset securitization, hedging techniques and corporate governance, all of which enabled innovations in investment and risk management.
  - Share fungibility makes it generally impossible to trace trades through brokers and financial markets.
  - Securities lenders generate far greater benefits to dematerialized markets than they themselves receive.

FAQ: Practical Constraints

- LDV cannot enable lenders to “leverage up” their voting power.
  - Under LDV, lenders would receive proxies only for shares on loan over the record date.
  - Borrowers post collateral totaling more than 100% of the value of borrowed securities, so there is no “free” way to leverage voting power through LDV.
- LDV cannot disenfranchise interested investors.
  - Only uninstructed proxies will be assigned by brokers to securities lenders.
  - Shares that investors purposefully choose to not vote logically represent only a small fraction of all 110 billion un-voted shares.
  - Therefore under LDV, lenders would only be assigned proxies abandoned by disinterested investors.
- LDV cannot impair retail interests. LDV *can* restore institutional rights.
  - Every entitled retail investor who wishes to vote will still vote.
  - Institutions will no longer have to forgo voting rights in favor of market efficiency and income.
  - LDV will retain the same retail-institutional voting proportions as if institutions had never loaned securities.

FAQ: Next Steps

- Lenders will identify a limited set of proxy issues of interest for their pre-approved borrowers who are willing to assign proxies.
- Lending agents will help negotiate side letters among their lenders and counterparties, enforcing fairness and validating assignments.
- Brokers will assign proxies for proprietary shares on a "best efforts" basis, receiving preferential access to lenders' supply.
- CSFME will help design operational system specifications for wider LDV implementation and continue to work with regulators on rules for assignment of other un-voted proxies.