



## Analysis of IAC Recommendations to Improve U.S. Proxy System

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**Editor's note:** Steve Wolosky, Andrew Freedman, and Ron Berenblat are partners at Olshan Frome Wolosky LLP. This post is based on their Olshan memorandum. Related research from the Program on Corporate Governance includes [Universal Proxies](#) by Scott Hirst (discussed on the Forum [here](#)).

On September 5, 2019, the SEC Investor Advisory Committee (“IAC”) issued a written statement (the “Statement”) to the Securities and Exchange Commission (“SEC”) making recommendations on steps the SEC should take to reform the “complex and multifaceted” U.S. proxy system. By way of background, the IAC is a committee of academics, investors, market participants and corporate and investor advocates established under the Dodd-Frank Act to advise the SEC on various regulatory priorities and to promote greater investor confidence and integrity in the securities markets. The Statement is actually a lightly modified version of a statement prepared in August by an IAC subcommittee consisting of an impressive cast of members, including a Director of CalPERS and the former General Counsel of Vanguard. The Statement was issued in response to consensus that widespread problems with the current “byzantine” proxy system relating to the accuracy, transparency, timeliness and cost-effectiveness of vote counts must be addressed in order to instill investor confidence in the system. These concerns were most recently brought front and center at the November 2018 SEC roundtable on “proxy plumbing.”

The complexity of the U.S. proxy system, according to this consensus, is a direct result of shares being predominantly owned through multiple “stacks” or chains of contracts through a complex web of intermediaries such as custodians, brokers, banks and transfer agents as well as the common practice of market participants outsourcing voting responsibilities to third parties. This has led to systemic technical problems with voting, including under-voting as a result of breaks in the chain of custody, over-voting stemming from share lending in the context of short selling, errors in reporting votes at meetings by the dominant proxy servicer (*i.e.*, Broadridge), and the “opacity” of the overall system, which makes it difficult for investors to verify that their shares were voted as intended or voted at all. The IAC provided the following unapologetic summary of the current system’s flaws and failures:

In sum, systematic and sometimes high-profile flaws in the current proxy system undermine confidence in the system generally. No one is satisfied with the current system. Shareholders cannot determine if their votes were cast as they intended; issuers cannot rapidly determine the outcome of close votes; and the legitimacy of corporate elections, which depend on accurate, reliable, and transparent vote counts, has been

called into doubt. Research has clearly established that investor confidence affects the cost of capital, so (while difficult to quantify precisely) the current proxy system almost certainly increases the difficulty of capital formation.

After discussing the feasibility of achieving comprehensive reform through a basic central book-entry ledger or more advanced technology (such as blockchain) and a review by the SEC and the stock exchanges of their own rules and policies that may be promoting aspects of the current proxy system that are conducive to Broadridge's monopoly on the voting regime, the IAC made four specific recommendations:

**End-to-End Vote Confirmations**—Recognizing that investors do not have the ability to determine whether their voting instructions are carried out by the various intermediaries and ultimately counted, the IAC recommended that the SEC require confirmations to be sent to the end-users with final voting authority over each given share. These confirmations should indicate that voting instructions have been received and implemented as instructed by the end-user. If voting instructions have not been properly implemented, a reason for such failure should be given to the end-user. These confirmations could take any reasonable form, including electronic delivery. Confirmations to shareholders who hold their shares in record name could be easily transmitted directly by the transfer agent. Confirmations to shareholders who hold their shares in "street name" could be transmitted through the Broadridge system the same way company annual reports and proxy statements are provided to them. The IAC suggested that if there are any concerns about any increase in marginal costs associated with end-to-end confirmations, the SEC could conduct a pilot program involving the largest companies.

**Duty to Cooperate in Regular Reconciliations**—Those involved in the voting system are required under various laws to maintain accurate books and records, which the IAC posited "encompass ownership and vote-relevant information necessary to make the current system work." However, the obligations of these market participants to cooperate with one another to resolve voting errors and irregularities pursuant to these rules vary and are not always enforced. In addition, the IAC observed that such reconciliation efforts are "often undertaken only in the heat of a proxy contest where allocation of voting entitlements could affect outcomes, raising the stakes for close examination of every proxy, [voting instruction form], and ownership chain." As a result, the IAC recommended that the SEC adopt rules requiring every proxy system participant, including custodians, banks, brokers, proxy servicers and proxy advisors, to routinely cooperate with one another to reconcile voting information.

**Studies of Investor Views on Anonymity and Share Lending**—Recognizing that investor anonymity and share lending are contributing factors to the proxy system's current complexity and problems, the IAC recommended that the SEC conduct two studies with the assistance of academics and other researchers. First, the IAC recommended that the SEC conduct a study on how identities of investors are kept from companies and the extent to which shareholders actually desire to remain anonymous to companies. Customers of intermediaries, or "beneficial owners," can elect to be identified to companies by choosing to be "non-objecting beneficial owners" or "NOBOs." The federal proxy rules effectively provide that beneficial owners are deemed to be NOBOs unless they "opt out" of such classification. However, intermediaries such as banks and brokers typically provide in their standard contracts with customers that they will be deemed to not be NOBOs, and hence their identities will be hidden from the companies in which they invest, unless they specifically elect to be NOBOs. The IAC recommended that these contracts should

be reviewed in order to determine the extent to which the statutory NOBO default has been “flipped” by intermediaries in their contracts. A survey of investors should then be taken in order to determine “whether such ‘flips’ were done without actual (as opposed to constructive) customer knowledge” and whether customers actually want their identities to be hidden from companies.

Second, the IAC recommended that the SEC conduct a study on the extent to which share lending contributes to issues relating to vote accuracy and entitlement under the current proxy system. It is common practice for brokers and banks to lend shares to third parties to facilitate short sales. If a loaned share is outstanding as of a record date for shareholders entitled to vote on a matter, the borrower of the loaned share has the power to vote the share. This often creates chaos and confusion as to voting of shares as of a specific record date as “more than one person may believe themselves to have ownership and voting power over the same share, resulting in attempted over-votes, and some shareholders may not be aware that they have vote entitlements, resulting in under-votes.” The IAC recommended that the SEC study the extent to which such voting errors and irregularities are caused by share lending and whether investors are adequately apprised of the effect of share lending on voting entitlement. Such a study could be conducted by reviewing contracts permitting share lending and learning from investors whether they actually realize that their shares can be loaned out and the impact this would have on their ability to vote the shares. The IAC also suggested that the study include a review of specific examples of how companies process votes represented by loaned shares and what verification measures are taken to ensure such shares are not over-voted or not voted at all.

**Universal Proxies**—In 2013, the IAC recommended that the SEC modify the proxy rules in order to provide proxy contestants with the option to use universal proxies, which would include the names of both the management and dissident slates, in connection with short slate election contests. In 2016, the SEC took the first step of making a universal proxy regime a reality when it issued a proposed rule that would make the use of universal proxies mandatory in contested elections. By way of background, proponents of universal proxies believe that under the current proxy regime where separate proxy cards are disseminated by management and the dissident listing their respective competing slates (referred to by the IAC as a “two-stream” system), it is too difficult for shareholders to mix and match their votes among all candidates, thereby disenfranchising shareholders and undermining corporate governance. Mainly due to concerns that universal proxies might favor dissidents, thereby increasing the number of proxy contests, the 2016 proposal failed to regain any traction.

From a proxy plumbing standpoint, the IAC discussed how the current two-stream regime “typically involves delivery of multiple (often duplicative) proxies throughout a contest” and “requires careful attention by the tabulator and others involved to make sure that the ‘last’ submitted proxy with respect to a given share is identified and counted as the valid vote.” The IAC stated that a universal, single-stream proxy regime would “reduce the confusion, costs and burden” on investors under the current system and “could help ‘clear the pipes’ in a system that is significantly clogged in the best of situations.” In light of studies that emerged after the 2016 rule proposal that universal proxies would not necessarily favor dissidents over management, the IAC stated that it is time for the SEC to work on a revised rule addressing a limited universe of remaining concerns with the original proposal. The IAC made specific recommendations as to how the SEC could address some of these concerns, including those relating to the percentage of shareholders a dissident should be required to solicit before it may use universal proxies and the

possibility that some incumbent directors may refuse to serve on a board if elected to a split slate as a result of a universal proxy solicitation.

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The IAC acted prudently by recommending an approach to kick-start improvements to the proxy system that focuses on just a few areas that it believes could “attract a consensus” relatively quickly and require immediate attention. Rather than advising the SEC to implement sweeping reform of the entire system, which we believe would be highly impractical, the IAC recognized that the complex and multi-tiered nature of the proxy system will require an “iterative, multi-step approach to improve it over a long period of time.” It remains to be seen whether the SEC will implement the IAC’s recommendations. We would not be surprised to see the SEC put a new universal proxy proposal on the fast track before addressing the other back-office “plumbing” fixes and studies recommended by the IAC.