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Re: Rule Proposal Comment Letter for Rule 206(4)-6

Dear Mr. Bottom,

I am excited to have the opportunity to comment on the topic of voting, which has been an area of research the past few years. I think it is one of the most overlooked topics in the US Capital markets and pleased to see the SEC asking for comments.

Executive Summary

One share, one vote.[1] A simple statement that is a core foundational part of how society works. That should be the end goal of voting - ensure every one share, gets one vote. Unfortunately, this can't be guaranteed in the US Capital Markets. We have the greatest capital markets in the world and can't guarantee One Share, One Vote.

This is unable to be guaranteed because shares that are held in a brokerage account are not legally owned by the customer. Record holders are the legal owner of those shares.[2] A share conceptually has both economic value and voting rights.[3]

- Beneficial owners have full economic value, but no guarantee of voting rights
- Record holders have full economic value and voting rights

The US Government, financial/financial related entities including the SEC, and academics acknowledge this as a fact. If we really want to show that the US Capital Markets are the

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[1]https://scholarlycommons.law.hofstra.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1166&context=faculty_scholarship The standard of "one share, one vote" was ensconced in American corporate practice by the New York Stock Exchange in 1926. For a discussion of the New York Stock Exchange rule, see Joel Seligman, Stock Exchange Rules Affecting Takeovers and Control Transactions, in KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 465, 468-73 (John C. Coffee, Jr., Louis Lowenstein & Susan Rose-Ackerman eds., 1988). More importantly (for our purposes), corporate scholars have argued that the "one share, one vote" corporate voting structure offers the best structure for maximizing social utility.

[2]https://courts.delaware.gov/opinions/download.aspx?ID=226510
Because of the federal policy of share immobilization, it is now Cede—not the ultimate beneficial owner and not the DTC-participant banks and brokers—that appears on the stock ledger of a Delaware corporation. Cede is typically the largest holder on the stock ledger of most publicly traded Delaware corporations.

[3] https://ccl.yale.edu/sites/default/files/files/PM-6-Bus-Law-Hu-Black.pdf

greatest in all the world, then One Share, One Vote needs to be the guiding principle for this policy.

Structure Of Letter

- Below is an illustrative example of what can happen regarding voting.
- Following the examples are strong quality citations with occasional setup. Direct quotes from the US Government and the SEC make up a majority of this letter.
- At the end are suggested remedies for improvement.

Illustrative Example

Assume Company1 issues 100 shares

- Example 1: Person1 buys 50 shares, Person2 buys 50 shares, and no shares are sold short
    - Person1 and Person2 each have 50 votes
    - Total shares owned by Person1 and Person2 equal total shares issued by the company
    - One share, one vote is honored
- Example 2: Person1 buys 50 shares, Person2 buys 50 shares, Person3 shorts 50 shares, and Person4 buys 50 shares
    - Person1, Person2, and Person4 each have 50 votes
    - Total shares owned by Person1, Person2, and Person4 is greater than total shares issued by the company
    - One share, one vote can not be honored

Citations

The US Government

In 1991, the following statements were made by a congressional subcommittee in relation to short selling[4]

Short sales of equity shares generally have the effect of increasing the total number of shares of that company's stock owned beneficially by investors.

As a consequence, the short sale creates a situation in which the total number of shares owned beneficially by investors exceeds the number of shares issued by the issuing corporation.

The result of such short selling and securities lending, in the aggregate, is that brokers as a group do not hold record ownership of as many shares of such a stock as they and their customers own beneficially. This may be described as a situation of fractional reserve brokerage, where the "reserves" of record shares, of issued shares shown on the records of the

[4] https://babel.hathitrust.org/cgi/pt?id=mdp.39015087623214&view=1up&seq=1249

issuing corporation, are only a fraction of the beneficially owned shares shown on the account statements of customers and in the brokers' own proprietary accounts.

As a consequence, it is not possible for all beneficial owners of such a stock to exercise a proxy vote in full proportion to their beneficial ownership.

Present practice in clearing and settlement leads to substantial and persistent delivery delays in certain equity issues, so that member firms do not necessarily have possession or control or record ownership of their customers' securities even when they do not engage in securities lending or hypothecation. This phenomenon is amply demonstrated by tabulations, prepared by this subcommittee from data supplied by the National Securities Clearing Corp. (NSCC), showing substantial and persistent receive fails (i.e., clearing longs) in many NASDAQ issues in December 1990. When such receive fails are outstanding on a proxy record date, then even cash customers may be deprived of their proxy voting rights if enough of the cash customers submit proxy instructions to a firm that has not reduced its shares receivable to possession or control. This buildup of substantial fails-to-receive in customer shares is apparently encouraged by the SEC. The NASD has reported that the SEC interprets Rule 15c3-3 in such a way that it is permissible for a member firm never to reduce to possession or control shares purchased for cash by cash customers, if the customer shares are receivable from (and guaranteed by) the National Securities Clearing Corporation. Paragraph (d) of Rule 15c3-3 requires that a broker must take steps to obtain cash and excess margin shares that are more than 30 days overdue, but apparently the SEC has determined not to enforce this requirement with regard to shares receivable from NSCC.

Proxy Voting Issues

Later in that same report, there was a section called ‘A Plausible Scenario.’ Below is a direct copy of that section in its entirety[5]

In fact, it is quite plausible that, contrary to the Exchange’s characterization, such proxy voting failures may occur with some regularity. The most plausible scenario would involve the equities of smaller companies that are not widely held but in which there is a substantial short interest on the record date for proxy voting.

If a particular stock is not widely held in the investment community generally, then a small brokerage firm could easily have just one or a very few customers who hold this stock in their accounts. If just one customer with a large and active account owns a major position in this particular stock on margin, if the firm has lent out most of all of the customer margin stock of this issue prior to the proxy record date, and if the firm’s other customers hold very little or none of this stock, then these circumstances make the situation very vulnerable to a proxy voting failure. If this one active customer should decide to return proxy voting instructions, the firm will clearly be unable to honor these instructions.

[5] Id

The Exchange and the SEC staff have both asserted that, on average, brokerage customers return only a small portion of the proxy voting instructions provided to them for company annual meetings and the committee has no basis for questioning this general characterization. The scenario of proxy failure suggested above is entirely compatible with this general statement, however, for it only requires one active margin customer with one small firm who decides to return proxy voting instructions.

The Exchange has also asserted that a firm that has lent out margin shares of an issue can recall the securities loans if needed to secure voting rights to honor customers' instructions. Additional votes can only be secured in this manner if the loans are recalled before the proxy record date, which is before the firm knows how many customers will return voting instructions. Moreover, there is absolutely no incentive for firms to recall loans for this reason. There is no penalty whatever for not having sufficient shares to honor customer voting instructions, and recalling the shares is costly. The loans are a source of income that would be cut off if they were recalled, and recalling stock loans may also generate ill will with the borrowing brokers, thereby impairing the firm's opportunity to derive stock loan income in the future. Thus, member firms has no incentive to recall loans purely to provide proxy votes for margin customers.

For these reasons, the scenario of scattered by regularly occurring incidents of proxy voting failure is entirely plausible, notwithstanding the low average general frequency of customer voting and notwithstanding the theoretical opportunity for firms to recall securities loans before the proxy record date

The subcommittee also rejected the idea that no complaints means there are no issues and said the following[6]

In its February 19 letter the Exchange cited the absence of customer, issuer, or member organization complaints as a reason for concluding that there have not actually been any instances where beneficial owners could not exercise their voting rights. The Exchange's later acknowledgment of occasional instances of voting denial, notwithstanding the absence of complaints, demonstrates that the absence of complaints per se does not prove that there are no problems, but it may still be construed by the Exchange as an indication that whatever denials of voting rights have occurred are not of importance to investors or issuers. Any such conclusion from the absence of complaints would not be justified. On the contrary, the absence of shareholder or issuer complaints that was cited by the Exchange might well not have any significance whatever. Brokerage customers do not have any way to learn that their voting instructions have not been executed according to their wishes, and so they have no basis upon which to make a complaint.

What Do Non Government Entities Say About Voting?

In 2019, Broadridge had a comment letter and said the following: "As we illustrate below, there can be isolated voting discrepancies when there is a disconnect between a stock record and a voting entitlement. The discrepancies often go unaddressed in uncontested meetings when

[6] Id

majorities of votes in favor of directors' recommendations are attained and there is no opposition party."[7]

BNY Mellon in 2010 discussed their approach and said "BNY Mellon endorses the adoption of a processing requirement that would make pre-reconciliation the industry standard. BNY Mellon believes that pre-reconciliation is the most effective means of addressing over-voting or under-voting."[8]

Katten lawfirm says the following[9]

A broker that follows a pre-reconciliation model will not in the first instance invite clients to vote shares that they technically are not entitled to vote. Referring to the example above, if the client holds 100 shares of ABC Company in a margin account and 50 of those shares have been re-hypothecated, the broker will invite the client to vote only 50 shares. Mr. Smith in the above example would not be able to vote more than 50 shares in the first instance.

Isn't the pre-reconciliation approach better because it prevents people from voting shares that they are not entitled to vote? Not necessarily. First, it depends on what you mean by "entitled" to vote. A client who seeks to vote 100 shares—even though 50 have been re-hypothecated—really has an economic interest in 100 shares. This means that he or she will benefit from any gains, and suffer any losses, on 100 shares, not 50 shares. When the broker's loans on the underlying shares expire, the client will hold those 100 shares both technically and substantively, so allowing that client to register 100 votes is arguably appropriate.

On the other hand: If the client above votes all 100 shares and a third party purchaser of the 50 "loaned" shares votes those shares, then 150 votes will have been offered based on the same 100 shares. So there is a legitimate debate about whether post-reconciliation is good or bad.

One other consideration: Overall, use of a pre-reconciliation model will inevitably result in lower levels of retail shareholder voting. That is because it effectively removes from the proxy voting system the types of votes described above—such that the shareholder in the example above will register only 50 votes when he or she wishes to vote all 100 votes in his or her account. An unintended consequence of pre-reconciliation is further erosion of retail voting, compounding declines that have already resulted from other factors such as the introduction of the Notice and Access model for the delivery or proxy materials and the elimination of broker discretionary voting in director elections.

Bob Drummand says the following[10]

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[7] https://www.sec.gov/comments/4-681/4681-6355043-196249.pdf
[8] https://www.sec.gov/comments/s7-14-10/s71410-178.pdf
[9] https://katten.com/files/21384_proxy-vote-processing-issues.pdf
[10] https://web.archive.org/web/20060421085925/http://www.rgm.com/articles/FalseProxies.pdf

Thomas Montrone, chief executive officer of Cranford, New Jersey–based Registrar & Transfer Co., which oversees shareholder elections. “It is an abomination,” Montrone, 58, says. “A lot of the time we have no idea who’s entitled to vote and who isn’t. It’s nothing short of criminal.”

The Hazlet, New Jersey–based Securities Transfer Association, a trade group for stock transfer agents, reviewed 341 shareholder votes in corporate contests in 2005. It found evidence of overvoting—the submission of too many ballots—in all 341 cases. As investors press for a bigger voice in corporate governance, more significant proxy fights will be decided by smaller margins, magnifying the potential for illegitimate votes to alter the result, Montrone says.

Rule 19-4c

Former commissioner Richard Y. Roberts said the following in a speech[11]

Rule 19c-4, as adopted, amended the rules of the national securities exchanges and national securities associations to prohibit the listing or quotation by a securities exchange or association, "if the issuer of such security issues any class of security or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer 7 registered pursuant to Section 12 of the Exchange Act

The rule also contained a list of presumptively permitted transactions that were deemed not to have a disenfranchising effect on the voting rights of existing shareholders, such as the issuance of low vote stock in a public offering. The Commission was of the opinion that Rule 19c-4 avoided burdening issuers and allowed companies flexibility in devising their capital structure, yet at the same time closed the window of opportunity for companies to rush to disenfranchise shareholders. Rule 19c-4 was short lived, however. Last June, in Business Roundtable v. SEC,6 a federal circuit court Invalidated the Commission's shareholder disenfranchisement rule

During the two years that Rule 19c-4 was In effect for the major securities markets, it is my view that It worked well and that it served its purpose of prohibiting shareholder disenfranchising transactions while permitting companies flexibility in devising their capital formation, Moreover, through interpretations published by the SROs, companies were becoming more familiar and comfortable with the rule. More importantly, the historical right of common stock holders to vote their shares was to some extent preserved.

I consider it ironic that Amex, which has represented itself as the only major securities market that Is still predominantly used by individuals, may implement a listing standard that, in a relative manner, discourages corporate accountability to the individual shareholder. I also note with considerable Irony that as a historical matter, I can recall when the Amex enthusiastically, in a legislative context, supported the potential adoption by the Senate of a shareholder voting rights listing standard remarkably similar to Rule 19c-4.

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[11] https://www.sec.gov/news/speech/1991/030191roberts.pdf

What Is A Share?

A share conceptually has both economic value and voting rights. It’s really easy to decouple those.[12] Saying this differently, go long 100 shares, short a call at strike k, and go long a put at strike k (same expiration). That’s the cost to buy 100 shares, 100 votes, and shed some or all economic risk.

In the same paper from Hu & Black, they say the following[13]

We refer to empty voting and hidden ownership together as "the new vote buying" or simply as "decoupling." In the past several years, this decoupling has affected takeover battles and control of public companies in (at least) the U.S., the U.K., Germany, Japan, Australia, and New Zealand. Its full extent is unknown. Policymakers abroad are beginning to confront the new vote buying, and requiring additional disclosure. Policymakers in the U.S. have barely begun to address it, but will soon need to.

Surprising results can flow from empty voting. A recent public U.S. instance illustrates the potential risks. Perry Corp., a hedge fund, owned seven million shares of King Pharmaceuticals. Mylan Laboratories agreed in late 2004 to buy King in a stock-for-stock merger at a substantial premium. However, Mylan's shares dropped sharply when the deal was announced. To help Mylan obtain shareholder approval for the merger, Perry bought 9.9% of Mylan – becoming Mylan’s largest shareholder -- but fully hedged the market risk associated with the Mylan shares. Perry thus had 9.9% voting ownership of Mylan but zero economic ownership. Including its position in King, Perry's overall economic interest in Mylan was negative. The more Mylan (over)paid for King, the more Perry stood to profit.

A second, potentially beneficial use of empty voting involves outside shareholders magnifying an existing long ownership position. Other things equal, this can reduce shareholder collective action problems. For example, an activist hedge fund can borrow shares just before the record date for a shareholder vote, then reverse the transaction afterwards. The first publicly reported instance of this "record date capture" strategy occurred in the U.K. in 2002. Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a major U.K. property company. At the annual general meeting, Laxey emerged with voting power over 9% of British Land's shares, the better to support a proposal to dismember British Land. Just before the record date, Laxey had borrowed 42 million shares.

Empty voting by institutions is a close cousin to hedging techniques widely used by insiders (zero-cost collars, variable prepaid forward contracts, and the like) by which managers and controlling shareholders retain formal ownership of shares, while shedding some or most of their economic ownership. In the U.S., these strategies have typically been driven by managers' desire to shed risk while deferring taxes, rather than by vote buying motives. But insiders can

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[12] https://ccl.yale.edu/sites/default/files/files/PM-6-Bus-Law-Hu-Black.pdf

[13] Id

easily also use empty voting techniques to cement their control. As we discuss in Part II, they are doing so in other countries[14]

Other Comments From The SEC[15]

Consequently, there are no specific shares directly owned by either the broker participants of DTC or the underlying beneficial owner. As a result, a beneficial owner's ownership cannot be tracked to specific shares but rather its ownership interest is represented as a securities entitlement at his or her broker-dealer. Each of those beneficial owners don't own the actual shares credited to their account but rather they own a bundle of rights defined by federal and state law and by contract with their broker. Consequently, a beneficial owner may not have the "right" to vote the securities credited to his or her account. It depends on what the beneficial owner's contract says. That's news to a lot of people.

When an imbalance occurs between the number of securities on deposit in the broker's DTC account and the number of securities credited on its records to its customer accounts, the broker can either (1) allocate to each of its customers one vote for each share credited to the customer's account and if too many votes are submitted, the broker will have to decide which votes will count, or (2) decide which customers (or itself as a holder of securities) will get to vote and how many shares they get to vote.

Reconciliation and allocation methodologies vary significantly among brokers, with some fairly complex schemes. We also discovered that in many cases, the reconciliation and allocation methods selected by the firm were based on the firm's business model and customer base. Some brokers reconcile and adjust their stock records on an aggregate basis, making sure that the total number votes allocated to customers is not more than the number of shares on deposit at DTC, before mailing out the proxy materials — a process known as pre-reconciliation. When following the pre-mailing reconciliation process (pre-reconciliation), the broker-dealer determines which investors are entitled to vote and adjust their stock records prior to sending the proxies to their customers. Although firms use various criteria to make these adjustments as to which customers are entitled to vote, firms typically adjust their records to reflect securities on loan. Customers with fully-paid securities usually are given first priority and allocated a vote. To allocate any remaining votes among their margin account customers, the firms generally use a lottery or pro rata method.

In another process, data is reconciled to accommodate an over-vote situation after the broker-dealer's customers have submitted their votes — a process called post-mailing reconciliation. If the broker-dealer votes in excess of its position at DTC, the broker-dealer will reconcile or adjust the number of votes to correspond to its DTC position. The manner in which the adjustment is made varies among firms. Some simply reduce the number of votes cast by the firm's proprietary position. Others use formulas whereby they may allocate only a certain

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[14] There are tax minimization strategies that can be employed with these tactics too by taking advantage of put-call parity and other complex financial instruments. The focus on this comment letter is around voting.

[15] https://www.sec.gov/news/speech/2007/spch101607ers.htm

number of votes or a certain percentage of the broker-dealer's overall position to customers with securities purchased on margin. Others use a lottery system.

The methods by which brokers allocate votes to their specific customers also vary significantly. There are too many permutations to go into here, but some of the differences involve whether the broker first allocates imbalances to their own proprietary accounts, whether brokers allocate imbalances on a lottery or a pro rata basis, and whether brokers prioritize between margin account customers who specifically request a vote. Clearly, whether a customer is capable of casting a vote is determined in part by the reconciliation and allocation methodologies used by its broker.

Brokers decide upon their particular reconciliation and allocation methodologies based on the firm's business model and its customer base. I believe that, some firms allocate to its customers a vote for the shares credited to the customer's account, while other firms appear to give priority to customers with fully-paid positions over customers in a margin account (who may not have fully paid securities). Most firms appear not to vote their proprietary positions if there is an imbalance.

Given the number of variables that influence the choice of reconciliation and allocation methodologies that may be appropriate, I do not believe it best to mandate any particular methodology. In fact, it may be optimal for brokers to use one methodology if its customer base is largely retail and another methodology if its customer base is largely institutional. I believe that many of the concerns about the proxy distribution and voting process can be addressed effectively by setting forth principles that would apply in every voting situation and by requiring brokers to adequately disclose their voting policies.

<u>Remedies & What's Needed</u>

I'd like the SEC to move forward with their proposal, but want them to move forward with these specific elements

- First and foremost, the SEC needs to have an official policy regarding shareholder rights.
- As congress once said, "The SEC should therefore promptly establish a policy concerning the proxy voting rights of the customers of securities brokers and dealers when short selling has expanded the beneficial ownership of individual stocks, and should then utilize its broad authority under Section 14(b)(1) of the Securities Exchange Act of 1934 to implement this policy"[16]
- Transparency, transparency, transparency. The more transparent the markets are, the better informed household investors can be
    - Any limits to the proxy voting rights of customers should be clearly documented and communicated
    - Pre-reconciliation/post reconciliation transparency by broker to allow customers to make informed decisions

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[16] https://babel.hathitrust.org/cgi/pt?id=mdp.39015087623214&view=1up&seq=1249

  - Votes not able to be honored after the fact for whatever reason and any amount should be clearly documented and communicated to the customer. In addition, this should be documented and reported annually to the general public/SEC. The reporting should be clear to identify causes for not being able to honor votes (ie FTD, FTR, on loan, etc).
  - As congress suggested earlier[17]

    Brokers and dealers should be required at all times to promptly secure and to maintain record ownership of the number of shares of each equity security that their customers own beneficially in cash accounts.

    Brokers and dealers should be prohibited from transferring customer security positions from customer cash accounts into any other status in order to evade the requirements set up for protecting the proxy voting rights associated with cash account shares.

- Have set rules for how to allocate votes
- The SEC should uphold One Share, One Vote and use that to guide the policy

Shareholders must reliably be able to have their democratic rights honored and executed.

Sincerely,

J

[17] Id