

## SPECIAL REPORT

# Over-voting or Over-reporting: 'Tempest in a Teapot'?

BY CHRIS KENTOURIS

**B**roker-dealers call it over-reporting; transfer agents call it over-voting. Broker-dealers say it's a nonissue. But a group representing some transfer agents and issuers says it's a flawed part of voting by shareholders, which needs to be fixed.

What is it? The potential for a corporation to receive more votes from beneficial shareholders during its annual meeting than actually can be cast.

The over-voting could occur when a broker-dealer or a bank makes a recordkeeping mistake on the number of shares that can be voted at an annual meeting. This can take place for a variety of reasons, but the most typical miscue is failing to keep track of shares when they are out on loan. That is because the lender of the securities has lost its right to vote to the holder of the securities on record date. That right goes to another borrower or another investor, further down the line.

Such recordkeeping errors can and will be caught by financial intermediaries prior to an annual meeting. But the Shareholder Communications Coalition (SCC) is asking the Securities and Exchange Commission to mandate even more operational improvements on the part of broker-dealers. The SCC, an umbrella organization for the transfer agent trade group Securities Transfer Association and several issuer organizations, wants the regulator to require brokerage firms holding shares for beneficial shareholders to always adjust their records in advance of each annual meeting. That will allow them to ensure they know who is eligible to vote—and how many shares they are entitled to vote—before they mail out proxy materials and ballots to investors.



"Broker-dealers should reconcile account holders' long positions with share-lending positions prior to distributing voting instruction forms and mailing out proxy materials," said Niels Holch, a partner at Holch & Erickson, the Washington, D.C. lobbying firm representing the SCC.

Such a process of prereconciliation is often done, by institutional brokerages. Retail brokerages often use a process called postreconciliation.

The SCC's request comes in the midst of a far-reaching analysis by the SEC on how to improve the current proxy voting system. The SCC also wants the SEC to allow corporations to send proxy materials directly to their beneficial shareholders rather than through banks and brokerages, entities which hold shares on their behalf.

"Over-voting is sort of a misnomer because the issuer doesn't get the extra votes, but there is still an operational glitch involved," conceded Rob Folinus, product manager for proxy services at BNY Mellon Shareowner Services, the Jersey

City, N.J. stock transfer arm of Bank of New York Mellon. The unit tabulates votes for about 1,000 annual meetings.

Regardless of how one identifies the hiccup, here is how the voting process works:

- Broker-dealers now send contact information on a company's beneficial shareholders and their holdings to Broadridge Financial Solutions, the world's largest distributor of proxy materials.

- Broadridge then distributes voting instruction forms to the beneficial shareholders, so they can vote.

- Broadridge tabulates the votes

from the beneficial shareholders and provides the vote totals to a company's transfer agent.

- That agent acts as the vote tabulator for an annual meeting, adding in the votes from registered shareholders who vote in their own names.

- Broadridge, in some cases, can serve as the tabulator, as well.

Transfer agents typically provide corporations with administrative services for registered shareholders, those who hold accounts in their own name. Broker-dealers administer accounts on behalf of beneficial shareholders—those who hold shares in the name of their financial intermediary—but typically outsource the proxy mailing and voting process to Broadridge.

In prereconciliation, the broker-dealer will reduce the number of votable shares to what they actually are. That means the broker-dealer will adjust the shares out on loan to match the correct number of shares held by the broker in securities depositories such as Depository Trust Company on the record date prior to Broadridge mailing the voting instructions and proxy materials. That means customers with fully paid-up securities are given first priority and allocated a vote. To allocate any remaining votes among margin-account holders, firms use a prorated method.

In postreconciliation, the broker-dealer sends out voting instruction forms to clients based on the long positions on their accounts, regardless of the inventory of shares held by the broker on record date. If the number of votes returned exceeds the voting position on record, the broker-dealer will then have

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to reduce the number of shares to match the inventory of shares held on the record date at securities depositories. This can mean eliminating shares from the broker-dealer's own proprietary position and then allocating a certain number of votes to margin-account holders.

A free service offered by Broadridge also notifies about 300 brokers of any "over-reporting conditions"—if they have exceeded the allowable number of votes on record date so they can adjust their books quickly. Those 300 brokers account for about 95 percent of the U.S. beneficial shareholder accounts, says Broadridge.

Just how serious is the problem of over-voting or over-reporting? No one is willing to specify but broker-dealers, transfer agents, issuers and even Holch agree its been on the decline ever since the New York Stock Exchange fined five large brokerages for what it called over-reporting in 2005. In that case, Deutsche Bank Securities had to pay \$1 million, UBS Securities \$600,000, Goldman Sachs Execution & Clearing \$500,000, Credit Suisse Securities \$350,000 and RBC Capital Markets Corp. \$80,000. The NYSE's investigation into the five brokerages and the subsequent uncovering of widespread recordkeeping problems followed complaints from the STA.

"It was taking place at every annual meeting we were tabulating back then, but it's now become a rarity," says BNY Mellon's Folinus. Donald Kittell, Broadridge's managing director for regulatory affairs, calls over-reporting "a tempest in a teapot."

Holch acknowledges that the problem he defines as over-voting is eventually fixed—before an annual meeting takes place—but that is only on a macro level. "It's a mathematical number-crunching exercise and has nothing to do with ensuring that the right investor is casting its vote," he asserted. "It's a matter of corporate governance."

Granted, issuers are not getting more votes than they should for proposals during annual meetings be-

## PREVENTING 'OVER-VOTING'

Broker-dealers must ensure that issuers do not receive more votes than they should from beneficial shareholders for a corporate agenda. Here are two ways they can prevent it:

### Prereconciliation

1. **Compare tallies.** Total up the number of long positions and match this to the number of votable positions recorded at Depository Trust Company and other securities depositories.

2. **Adjust.** If the number of shares in long positions exceeds the number of shares held at the securities depositories, reduce the number of shares held in margin accounts. And do so on a pro-rata basis.

3. **Send list.** Send Broadridge a list of eligible beneficial shareholders and the number of shares they can vote.

4. **Send instructions to voters.** Distribute vote instruction forms to client accounts, and Broadridge will receive and count up the vote instructions.

5. **Issue final report.** Broadridge will send the list of beneficial shareholder votes to the vote tabulator which could be a transfer agent or do the tabulation itself. In either case, it will issue a final vote report.

### Postreconciliation

1. **Send list.** Send Broadridge a list of eligible beneficial shareholders and the number of shares they can vote.

2. **Distribute instructions.** Distribute vote instructions to client accounts, and Broadridge will receive and count up the vote instructions.

3. **Reconcile.** If the number of vote instructions exceeds the votable positions held in securities depositories, reconcile the number by reducing the shares held in margin accounts.

4. **Issue final report.** Broadridge will send a list of beneficial shareholder votes to the vote tabulator, which could be a transfer agent, or do the tabulation itself. In either case, it will issue a final vote report.

cause broker-dealers are eventually adjusting their records. But issuers still don't know if the ultimate investor who is entitled to vote is the one who actually cast the vote, Holch said.

Meanwhile, broker-dealers, he asserted, shouldn't be sending contact information to Broadridge for beneficial shareholders who are not eligible to vote the shares of an issuer on record date.

"If a broker-dealer engages in securities lending it should reconcile its long and short positions to ensure that only eligible voters are involved in the proxy voting process," Holch said. "If it doesn't, then too many voting ballots are being mailed out to ineligible investors."

## 'OVER-VOTING' EVENTUALLY GETS FIXED. IT'S A NUMBER-CRUNCHING EXERCISE.

Not all transfer agents think that issuers really care that much about whether pre- or postreconciliation is used. "The approach is less important than the outcome. Their first priority is getting the total number of votes right whether through pre- or postreconciliation," says BNY Mellon's Folinus. "But issuers do want transparency in the process, and that means knowing who their investors are and having the opportunity to send them proxy materials directly [rather than through their financial intermediaries]."

Yet for Holch, getting proxy materials and assigning the right vote to the right shareholder is paramount. "Ineligible voters should not be getting proxy materials because when they receive such materials and return a proxy voting instruction form, over-voting does occur at the beneficial shareholder level," he says.

So far, neither the Securities Industry and Financial Markets Association (SIFMA) nor the SEC has been willing to take a stance on whether prereconciliation or postreconciliation should take place on

the grounds that vote outcomes are accurate under both.

In 2006, SIFMA, then known as the Securities Industry Association, said broker-dealers could rely on either methodology. The following year, the SEC also said that it could not dictate how broker-dealers reconcile the votes they are entitled to cast with the correct number of shares held on record date. Still, it said that beneficial shareholders should understand their voting rights when it comes to lent shares or shares bought on margin.

No official statistics are kept on what percentage of brokerage firms favor one type of reconciliation versus another. However, two proxy executives say all of the five brokerage firms fined by the NYSE in 2005 have since implemented prereconciliation procedures.

Operations executives familiar with the prereconciliation process told *Securities Industry News* that it requires more work up front—and higher programming costs—but it will reduce the amount of last-minute scrambling a broker-dealer will have to do to ensure it can adjust its records before a company's annual meeting.

The prereconciliation process also has its shortcomings. The process does take into account shares on loan and other adjustments prior to sending out voting instruction forms to clients. Retail investors holding margin accounts are affected a lot more than they would be under postreconciliation. That is because in the case of postreconciliation, the votes of margin account holders are counted in full when other shareholders don't vote. That's not so in prereconciliation.

"The votes of margin account holders [in prereconciliation] might be reduced even though there are no corresponding instructions received from the other long position holders," Kittell said. "That means margin account holders could lose their right to vote and it doesn't seem right to some issuers that investors should get penalized for buying shares on margin." ■