CENTER FOR THE STUDY OF FINANCIAL MARKET EVOLUTION
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Washington, D.C. 20004
202-581-1188

July 5, 2011

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Rulemaking for Dodd-Frank Act Section 984: Securities Lending and Proxy Voting

Dear Ms. Murphy:

The Center for the Study of Financial Market Evolution[1] appreciates the opportunity to respond to the Commission's request for comment on current practices and the need for new regulations in securities lending markets.[2] In this letter and the accompanying exhibits, we present our latest findings as a follow-up to our testimony, as well as to issues raised by other witnesses, at the Securities Lending and Short Selling Roundtable in September 2009.[3] In particular, we find that recent systemic and technological advances have enabled modifications to existing practices, which could permit broker-dealers to vote proxies at the direction of currently disenfranchised, institutional, beneficial owners of lent securities. Furthermore, we find that lender-directed voting would provide numerous benefits to a wide range of market participants, including:

- Institutional investors would no longer have to choose between their corporate governance responsibilities and important fee income from securities lending. Those who currently prioritize income would no longer have to forgo voting rights, while others could continue to vote proxies while generating more revenue from securities lending.

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[1] The Center for the Study of Financial Market Evolution (CSFME) is an expert, independent, nonprofit organization whose mission is to improve transparency, reduce risks, support research, and promote sound regulation of financial markets. It does so by conducting data-driven analysis, providing investor education, and supporting regulatory reviews in otherwise opaque markets.

[2] Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act, *at* http://www.sec.gov/spotlight/regreformcomments.shtml. Specifically, the Commission requests comments on rulemaking initiatives under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) relating to the loan or borrowing of securities or securities lending activities. Section 984(a) of the Dodd-Frank Act makes it unlawful to effect, accept, or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. In addition, Section 984(b) requires the Commission, by July 21, 2012, to promulgate rules that are designed to increase the transparency of information available to brokers, dealers, and investors, with respect to the loan or borrowing of securities.

[3] *See* Securities Lending and Short Sale Roundtable (Sept. 29 – 30, 2009), *at* http://www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf *and* http://www.sec.gov/news/openmeetings/2009/roundtable-transcript-093009.pdf; *see also* Comments on Securities Lending and Short Sale Roundtable, File No. 4-590, *at* http://www.sec.gov/comments/4-590/4-590.shtml.

- Corporate issuers would receive many more proxy votes from long-term investors with positive economic interests, reducing time and costs of reaching quorum in corporate elections and better aligning votes cast with beneficial ownership.

- Securities lending agents and broker-dealers would gain more stable loan and borrow portfolios, which in turn would decrease investment, operational, and systemic risks.

The Commission should therefore, in crafting whatever rules it may choose to adopt concerning securities lending and corporate governance, take care to avoid promulgating rules that could interfere with lender-directed voting of lent securities.

<u>The Income – Vote Tradeoff in Securities Lending</u>

Under present practices, institutional investors must choose between voting proxies and maximizing their securities lending revenues. Securities lending has consistently been shown to be essential for improving price discovery and maintaining liquidity in the global capital markets. Broker-dealers' ability to borrow securities improves their functioning in many ways, according to a report of the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions (IOSCO), which recommended that securities lending and borrowing should be encouraged as a method for expediting the settlement of securities transactions and that "[i]mpediments to the development and functioning of securities lending markets should, as far as possible, be removed."[4] Beyond these market benefits, securities lending adds significant value to the portfolios of investors. According to industry surveys, securities lending in 2010 generated more than $4 billion in additional portfolio revenue for institutional investors and their beneficiaries, thereby helping to overcome funding and competitive pressures.[5] However, these revenues have not come without costs and controversy.

Proxy voting rights transfer with loaned shares,[6] forcing securities lenders to weigh lending revenue against their fiduciary duty to monitor corporate events and vote proxies.[7] Since institutions take their

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[4] CPSS-IOSCO, *Recommendations for Securities Settlement Systems* Recommendation 5, at 12 (Nov. 2001), *at* http://www.bis.org/publ/cpss46.pdf. As the Commission recently noted, Section 805(a) of the Dodd-Frank Act directs the Commission to take into consideration relevant international standards and existing prudential requirements for clearing agencies that are designated as financial market utilities, and this report is one of the most relevant international standards. Clearing Agency Standards for Operation and Governance, Release No. 34–64017 (Mar. 3, 2011), 76 Fed. Reg. 14472, 14476 (Mar. 16, 2011).

[5] Data sourced by the Risk Management Association, which reports securities lending returns gross of agent fees for a large sample of the U.S. lending market. Lender revenue estimates by CSFME account for agent fee splits and market universe.

[6] Under the Federal Reserve Board's Regulation T, the only purpose for which securities may be lent to a borrower in the United States by a lender other than a broker-dealer is to make delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations. 12 C.F.R. § 220.10(a). Virtually all borrowed securities are therefore transferred upon receipt to another party, who expects full ownership rights of the securities, including voting rights.

[7] *See, e.g.,* 29 C.F.R. § 2509.08-2(1) (employee benefit plan fiduciary has fiduciary obligation to vote proxies on issues that may affect the economic value of the plan's investment, but should take costs of voting into account); Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003), 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003) (fiduciary duty of investment advisers to vote proxies for clients); *State Street Bank & Trust Co.*, SEC No-Action Letter (Sept. 29, 1972) (if management of a registered

responsibility to vote seriously, their portfolio managers frequently give up revenue from lending securities, and either avoid lending or recall already-lent securities when they see benefits from voting.[8] However, the decision to lend or to recall may be quite difficult. Panelists at the Securities Lending and Short Selling Roundtable pointed out that lenders often lack knowledge of material events until after the record date. In many instances, they said, recalling loans may have detrimental economic effects on both borrower and lender.[9] Panelists also expressed concern that this income versus voting tradeoff interferes at times with the integrity of the corporate governance process.[10] In support of their arguments, these witnesses cited academic studies and anecdotal evidence claiming that proxy manipulations have been effected with the borrowing of shares across record date.

Although more robust independent[11] and academic studies[12] have called these allegations of manipulation into question, it is nevertheless true that securities lenders must weigh their expected lending revenue against perceived voting values, as they cannot gain both under current market practices. In addition, from the broader perspective of preserving the functionality of securities settlement, periodic market-wide recalls of securities on loan must be seen as unhelpful.

Disparate Treatment of Institutional and Margin Lenders

Broker-dealers who borrow securities, either for their own or for customer accounts, generally do so either from institutional lenders seeking to increase portfolio returns or from margin customers who have agreed, as part of their margin account agreement, that their securities may be lent. In practice, the voting rights of these two groups are treated quite differently. Institutions lending to broker-dealers under master securities lending agreements typically do not have any voting rights, other than the right to recall the loaned securities (so that they may be voted). In contrast, if the carrying broker-dealer uses post-reconciliation or hybrid reconciliation,[13] or if it finds it unnecessary to apply a reconciliation

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investment company has knowledge that a material event will occur affecting an investment on loan, the directors would be obligated to call such loan in time to vote the proxies).

[8] Reena Aggarwal, Pedro A.C. Saffi & Jason Sturgess, *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, at 34 – 35 (May 2011), *at* http://ssrn.com/abstract=1688993 (Aggarwal, Saffi & Sturgess).

[9] 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).

[10] 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.

[11] CSFME Comments on Securities and Exchange Commission's Concept Release on the U.S. Proxy System, File No. S7-14-101, Washington, DC, October 20, 2010, *at* http://www.sec.gov/comments/s7-14-10/s71410-202.pdf

[12] Aggarwal, Saffi & Sturgess, at 35 – 36.

[13] Because of the effects of securities lending and fails to deliver in the clearance and settlement system, broker-dealers may receive more voting instructions than they hold securities to vote, making it necessary to use a reconciliation process to avoid over-voting. Brokers use methods known as pre-reconciliation, post-reconciliation, or hybrid reconciliation to avoid over-votes, which are described in Concept Release on the U.S. Proxy System, Release Nos. 34-62495, IA-3052, IC-29340 (July 14, 2010), 75 Fed. Reg. 42982, 42990 – 91 (July 22, 2010) (Proxy Concept Release). A broker-dealer using the *post-reconciliation* method requests voting instructions from its customers with respect to all shares credited to customer accounts, including for those

procedure,[14] then margin lenders are able to vote securities that are on loan. However, in practice, the broker-dealer's reconciliation procedure may reduce or eliminate the margin lender's votes in the unusual case where the broker-dealer has insufficient holdings to accept all voting instructions.

Broker-dealers have broad discretion in choosing reconciliation procedures, which are not currently governed by Commission or securities exchange rules, and a variety of methods are in use.[15] Under these procedures, lenders are considered "beneficial owners" under New York Stock Exchange Rule 452, which restricts the ability of member organizations to vote stock for which voting instructions have not been received from the beneficial owner.[16]

Recent Advances in Securities Lending and Proxy Voting Systems

We believe that the disparate treatment of institutional lenders may be resolved by capitalizing on the substantial investments in securities operations made by banks and brokers since 2000. It is well known to practitioners that the securities lending industry has made great improvements in financial data formats, messaging systems, and information transfers, all of which have generated systemic efficiencies and reduced operational risks.

In 2000, a group of 10 global financial institutions began investing in EquiLend Holdings LLC, in order to create a standards-based, open, and secure global securities lending platform that would "avoid the time consuming and labor-intensive process of matching borrowers and lenders."[17] This "central hub [was created] through which interested parties can easily locate suitable counterparties and book transactions." Partly as a result of market improvements such as this, it is believed that most if not all securities lenders avoided losses due to operational failures during the recent credit crisis, even in the immediate aftermath of the Lehman Brothers default.

Lending agents and broker-dealers have also invested in systems designed to increase securities lending transparency and improve counterparty risk management. In 2003, Commission staff began a dialogue

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shares that may have been purchased on margin, loaned to another entity, or not received because of a fail to deliver. In the event that it receives voting instructions from its customers in excess of its aggregate securities position, the broker-dealer adjusts its vote count prior to casting its vote with the issuer, allocating voting rights to the extent necessary. *Hybrid reconciliation* uses elements of *pre-reconciliation*, in which shares that are on loan are not given a vote, but typically allows margin account customers who wish to vote to do so.

14 Some broker-dealers have not developed policies and procedures to address the reconciliation and allocation of votes among their customers because historically they have usually held enough shares to provide a vote to all customers wanting to vote. Proxy Concept Release, 75 Fed. Reg. at 42991 n.80.

15 Proxy Concept Release, 75 Fed. Reg. at 42990, 42991; H.R. Rep. No. 102-414, at 24, 28 – 29 (1991), *at* http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1990/1991_1206_ShortRegulation.pdf (H.R. Rep. No. 102-414).

16 H.R. Rep. No. 102-414, at 25 – 26 (citing New York Stock Exchange correspondence). Lenders are also "customers" of the broker-dealer under Rule 15c3-3, although securities lending arrangements meeting the requirements of Rule 15c3-3(b)(3) are exempt from the physical possession or control requirement of the rule. Net Capital Requirements for Brokers and Dealers, Release No. 34-18737, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,220 (May 13, 1982).

17 Martinez, John, et al, "System and Method for Securities Borrowing and Lending," The EquiLend Patent, U.S. Provisional Patent Application Ser. No. 60/389,556, filed June 17, 2002, as updated February 28, 2008. Today, EquiLend's investors include BlackRock; Credit Suisse; Goldman Sachs; J.P. Morgan Clearing; J.P. Morgan Strategic; Merrill Lynch; Morgan Stanley; Northern Trust; State Street; and UBS. About EquiLend, http://www.equilend.com/about.html (viewed July 1, 2011).

with their industry counterparts about the Commission's net capital rule for registered broker-dealers engaged in agency securities lending transactions (Rule 15c3-1). These discussions, known as the "Agency Lending Disclosure Initiative" (ALDI), led to the formation of a taskforce, which defined a uniform set of processes, procedures, and related infrastructure to permit disclosure by agent lenders of data regarding the principals in each securities lending transaction. Broker-dealers, as a result of ALDI, began in October 2006 to receive daily reports from lending agents on the specifics of their credit exposure to each lending principal, who are generally institutional investors.

Daily loan pricing and performance measurement systems provide further evidence of recent improvements in securities lending market transparency. Starting in 2004, the Lending Pit systems of ASTEC Consulting enabled securities lenders to identify mispriced loans, monitor trends in loan demand and evaluate the risk-adjusted performance of their lending programs.

As a complement to these advances in securities lending, service providers have invested in proxy systems technology to distribute, collect, compile, and transmit proxy voting documents and records. Broadridge Financial Solutions created a system to reduce the operational risks in proxy, from both over-voting and arbitrary rejection of votes, which "compares a subscriber's daily vote update report with its DTCC participant position report – and identifies vote instructions that would otherwise create an over-reporting condition."[18] As of last year, "more than 300 nominees, representing more than 95% of all beneficial account holders, subscribe to this service," which has helped to largely eliminate the effects of proxy over-reporting, a long-standing source of friction between the corporate governance and securities lending processes.

Lender-Directed Voting

According to our research, existing practices could be further improved by technology investments, with reliance on current regulations, to ameliorate some or all of the remaining securities lending - corporate governance tradeoffs. Our concept, as well as processes by which the interests of corporate stakeholders could be aligned with those of securities lenders and their intermediaries, are presented in an attachment to this letter.

Essentially, participating borrowing broker-dealers could agree to give institutional securities lenders voting rights comparable to those currently provided to margin lenders, and to use post-reconciliation or hybrid reconciliation if an allocation of voting power is required. 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 institutional lenders no worse than margin customers whose securities are on loan. In effect, participating institutional lenders would be able to vote lent securities to the extent that the borrowing broker-dealer holds otherwise uninstructed securities. As under current practices for broker-dealers using post-reconciliation,[19] broker-dealers could use their proprietary positions to redress any imbalances. Of course, institutional securities lenders would continue to have the right to recall their securities for any reason, including for voting purposes.

[18] Letter from Charles V. Callan, SVP Regulatory Affairs, Broadridge Financial Solutions, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 7 n.8 (Oct. 6, 2010), *at* http://www.sec.gov/comments/s7-14-10/s71410-62.pdf.

[19] Proxy Concept Release, 75 Fed. Reg. at 42991.

In addition to the existing ability of many margin account lenders to vote lent securities, it is our understanding that sound precedents exist for the practice of directed voting, both in the United States and abroad. Specifically, broker-dealers and custodians have voted proxies at the direction of institutional accounts, using title to shares held in the firm's proprietary accounts. These instances have usually involved important ballots when the institution's loaned shares could not be recalled from borrowers in time to be re-registered (as of proxy record date) on the corporate issuer's books.

Investors and issuers have singled out the practice of voting upon the instructions of lenders as the only permitted instance in which either a borrower or the holder of collateral in a secured borrowing can instruct a proxy.[20] The Commission has also treated the voting of loaned shares as a positive attribute of a securities lending program for registered investment companies. We now believe that enabling technologies and practices have evolved to a point where the Commission's wishes may be implemented for all institutional lenders. In the specific case of registered investment companies, lender-directed voting would appear to be responsive to the staff's view that it would not object to the use of any practicable and legally enforceable arrangement to ensure that fund directors are able to fulfill their fiduciary duty to vote proxies with respect to loaned portfolio securities.[21]

In earlier years, lender-directed voting would have been impractical because of the increased risk of over-voting. Under current practices, however, the risk of over-voting is minimal, and appropriate reconciliation and allocation procedures will prevent adverse effects on other shareholders. The Suggested Practice Guidelines for Proxy Processing, now followed by most broker-dealers, acknowledge that both pre-reconciliation and post-reconciliation are suitable methods as long as there is correct supervision, and impartial allocation methods that are fair and equitable among all clients in the event that the amount of shares the holder is entitled to vote needs to be adjusted.[22]

Advantages of Lender-Directed Voting

If lender-directed voting were to be adopted by institutional lenders and their borrowing broker-dealers, long-term investors could instruct proxies for as many as one quarter of all unvoted shares in the United States. Broker-dealers would allocate vote instruction forms to, and then submit votes at the direction of, those beneficial owners from whom they had borrowed stock. The fact that lenders may not know the specifics of upcoming ballot items would become irrelevant in most cases, since their decision and

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[20] "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. … Similarly, the holder of a share as collateral should not vote that share, unless specifically given the exclusive right to do so by private treaty with the borrower who provided the collateral. … The lender's Master Lending Agreement should specify that shares are not being lent for the principal purpose of voting those shares, and should provide clear guidance as to what circumstances might permit a borrower to vote borrowed shares as well as what the responsibilities of any lending agents might be in those circumstances." 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.

[21] *Salomon Brothers*, SEC No-Action Letter (May 4, 1975). Lender-directed voting would not alter the duty of fund management in the rare instance in which management is aware of an upcoming material event and the borrowing broker-dealer is not expected to have sufficient uninstructed shares to give effect to lender-directed votes.

[22] Suggested Practice Guidelines for Proxy Processing, at 3 n.7 (Sept. 2006), *at* http://www.sifma.org/uploadedFiles/Issues/Capital_Markets/Technology_and_Operations/Proxy/Issues_Technology%20and%20Operations_Suggested%20Practice%20Guidelines%20for%20Proxy%20Processing.pdf.

choice of vote could be deferred until after the record date. Not only would lender-directed voting accommodate the institutional account holder, but it would also allow the lending agent to avoid declaring a technical “event of default” if borrowers could not obtain recalled securities. Although unlikely, a default declaration involving a large borrower could add to systemic risk by forcing termination of the relationship and cancellation of all loans with that borrower, leading to precipitous liquidation of related cash collateral reinvestments. If institutions could vote their shares on loan, the decline in recalls to vote would enhance stability in the securities lending market, as well as in the operations of clearing and settlement systems.

Lender-directed voting would also bring improvements to the corporate governance process. The broker-dealer, who lacks economic interest in the issuer, either votes uninstructed shares or they are not voted at all.[23] In either case, voting by lenders would increase the number of shares voted by beneficial owners of the issuer’s shares. In addition, to the extent that broker-dealers are unable to vote uninstructed shares because the matter affects substantially the rights or privileges of the stock, lender-directed voting would make it easier for issuers to achieve a quorum.

Practical Considerations of Lender-Directed Voting

Under current practices, lenders who wish to vote proxies of their loaned shares must, prior to the record date, recall and re-register the securities in their names. To make informed recall decisions, lenders and their lending agents would wish to forecast the proxy capacity that their approved borrowers would have on the date of the corporate meeting. Many factors may be included in that forecast, such as broker-dealer share and security borrowing positions; historical voting and loan recall patterns; the materiality of the proxy election; and broker-dealer proxy allocation routines. To develop robust forecasts, data would need to be integrated and analyzed from several sources, including broker and securities lender recordkeeping systems; central lending hubs; and proxy service providers. As stated above, recent information system improvements enable these data to be pooled in an efficient and timely manner to support recall decision-making by securities lenders.

Lenders, agents, and broker-dealers would also want to allocate loans and assign proxies according to informed algorithms. Allocating loans may require matching among lenders who wish to vote proxies and those broker-dealers with forecasted proxy capacity. In turn, broker-dealer proxy assignments should provide for equitable distribution among all lending counterparties, as mentioned above. When allocating loans, lenders and their agents may wish to consider the scope of the existing relationship among the lender, agent and borrower, to include credit and operational risk exposures. Broker-dealers may also wish to consider similar risk factors, while taking full advantage of the new ALDI transparency in deciding whether to make additional proxy capacity available to institutional lenders. Integration of the pricing and over-reporting services in these algorithms would enable confirmation of proxy votes, while avoiding any over-voting problems.

[23] For broker-dealer nominees that are member organizations of the New York Stock Exchange, the determination whether the broker-dealer can vote uninstructed shares is governed by the exchange’s Rule 452. In general, Rule 452 allows the member organization to vote uninstructed shares on matters that do not affect substantially the rights or privileges of the stock. Votes for directors, other than directors of registered investment companies, and votes relating to executive compensation are among those which member organizations cannot vote. New York Stock Exchange Rule 452.11.

Conclusion

Historically, institutional securities lenders have had to choose between earning income on securities lending programs and voting their proxies. Today, a series of technological and systemic advances have enabled securities lenders to vote their loaned shares and avoid making that trade-off decision. Lender-directed voting could also have significant benefits for corporate governance in the United States. For example, if securities lenders had voted in 2010, as much as 25% of the 60 billion unvoted shares could have been included in the corporate governance process (please see attached exhibit). The interests of corporate issuers would be more directly aligned with those of their long-term investors, many of whose beneficiaries would regain the inherent privileges of their voting franchise. Benefits would also accrue to financial intermediaries and the market system through a reduction in the volume of loan recalls, and a consequential reduction in the volatility of lending activity on proxy record dates.

Lender-directed voting is entirely consistent with existing federal laws and regulations and should not require any rulemaking actions, whether by the Commission or by others. Of course, lenders, banks and broker-dealers act globally, so we plan to approach domestic and global regulators to address any issues they may identify.

We respectfully request that the Commission take notice of the favorable opportunities presented by lender-directed voting and avoid rulemaking that could interfere with it in the future.

Very truly yours,

Edmon W. Blount
Executive Director

cc: Mary L. Schapiro
Chairman

Meredith Cross
Director, Division of Corporation Finance

Eileen Rominger
Director, Division of Investment Management

Robert W. Cook
Director, Division of Trading & Markets

www.csfme.org

Lender-Directed Voting (LDV)

Improving Corporate Governance while Aiding Securities Lenders

May, 2011 Presentation to:

The U.S. Securities and Exchange Commission

Divisions of Corporate Finance, Investment Management, and Trading and Markets

Special appreciation to:

California State Teachers' Retirement System

Colorado Public Employees' Retirement System

Florida State Board of Administration

State of Wisconsin Investment Board

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Agenda

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5. … while 15 billion U.S. equities were on loan
6. Funding pressures disenfranchise public funds…
7. … but LDV could have re-enfranchised lenders
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10. Case Study: Goldman Sachs
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LDV could have "resolved" ¼ of uncast votes while re-enfranchising millions of beneficiaries

CSFME Mandate and Institutional Support

www.csfme.org

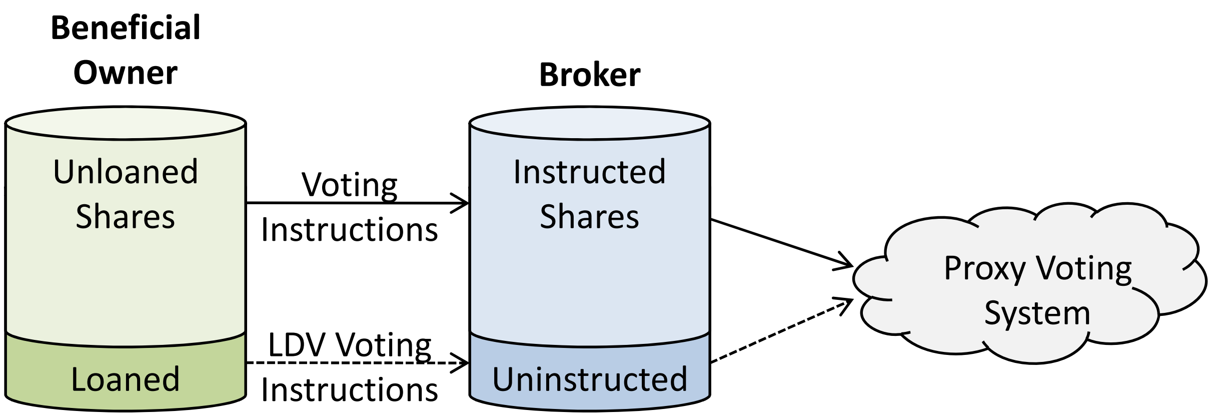
- The Center for the Study of Financial Market Evolution (CSFME) is an independent, nonprofit organization whose mission is to improve transparency, reduce risks, support research, and promote sound regulation of financial markets. It does so by conducting data-driven analysis, providing investor education, and supporting regulatory reviews in otherwise opaque markets. It serves individual and institutional investors, banks, brokers, other financial market participants, academic institutions, and government regulatory agencies.

- LDV research has been supported by:

  - Three of the ten largest public pension funds. Combined, the four participating funds hold $390 billion in assets and represent 2.7 million beneficiaries.
  - Three of the four largest securities lending agents/custodians
  - Numerous large brokers (data and logic contributors)
  - Many of the same institutions that supported CSFME's research on Empty Voting and the Broadridge Institutional Task Force

LDV Overview

- Lender-Directed Voting allows securities lenders to vote proxies by matching loan positions to brokers’ uninstructed shares

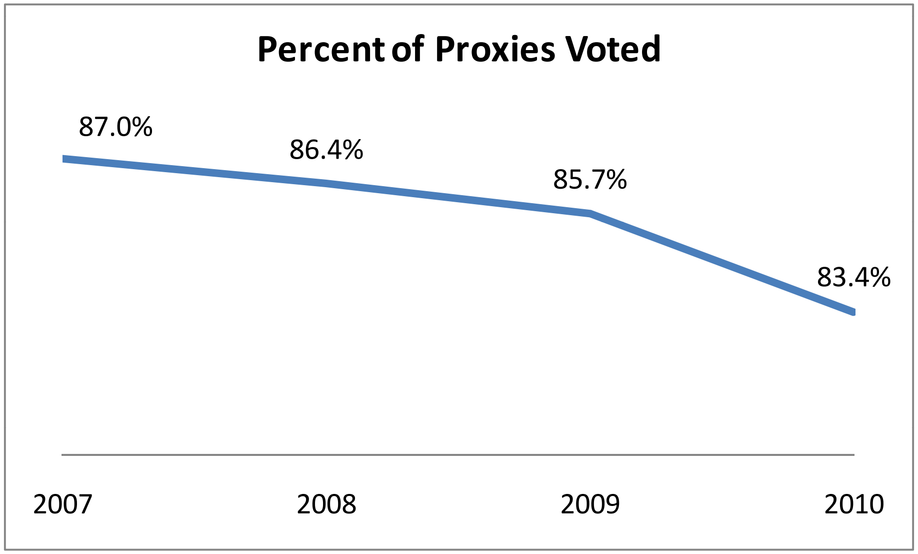


- Benefits:
  - Securities lenders can vote while earning lending income (i.e., avoid income-vote tradeoff)
  - Corporate issuers receive more votes from investors with positive economic interest (and are more likely to reach proxy quorum faster)
  - Brokers get more stable loan supply because there are fewer recalls
  - Lending agents get more stable loan portfolios and cash pools

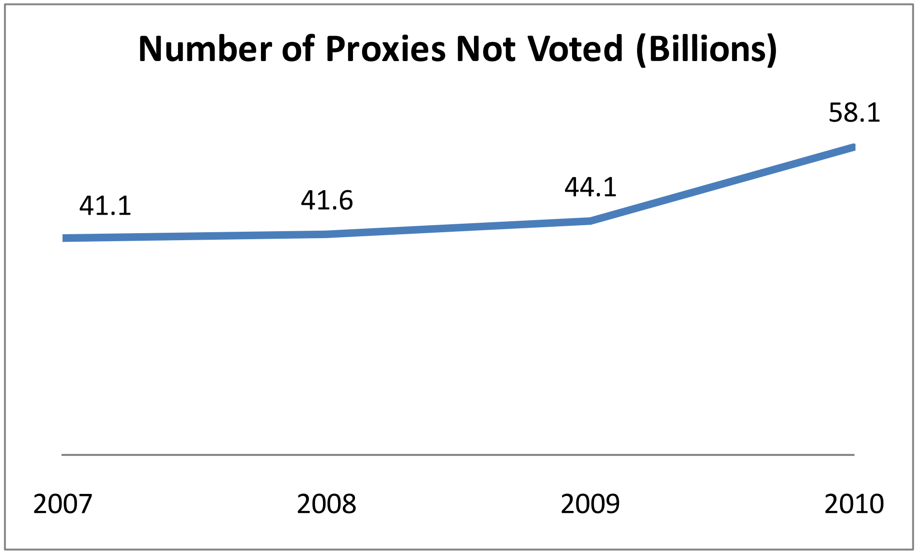
Almost 60 billion shares were not voted in 2010 …

www.csfme.org

- Proxy voting has declined in recent years …
  - Changes to NYSE Rule 452 limited brokers' ability to cast discretionary votes (although impact seems limited)
  - E-proxy implementation led to reduced proxy voting by retail investors



- … raising challenges for corporate issuers
  - Longer timelines to reach quorum in corporate elections (and some cases of difficulty reaching quorum)
  - Higher proxy solicitation costs (2nd mailings, investor outreach and phone calls, etc.)



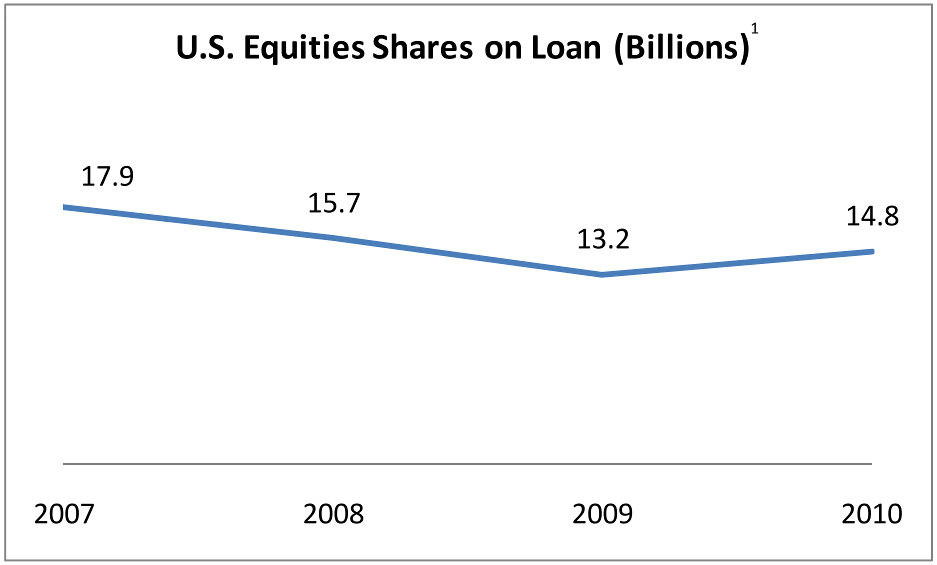
Vote data from Broadridge www.broadridge.com/investor-communications/us/Broadridge_Proxy_Stats_2010.pdf

… while ~15 billion U.S. equities were on loan

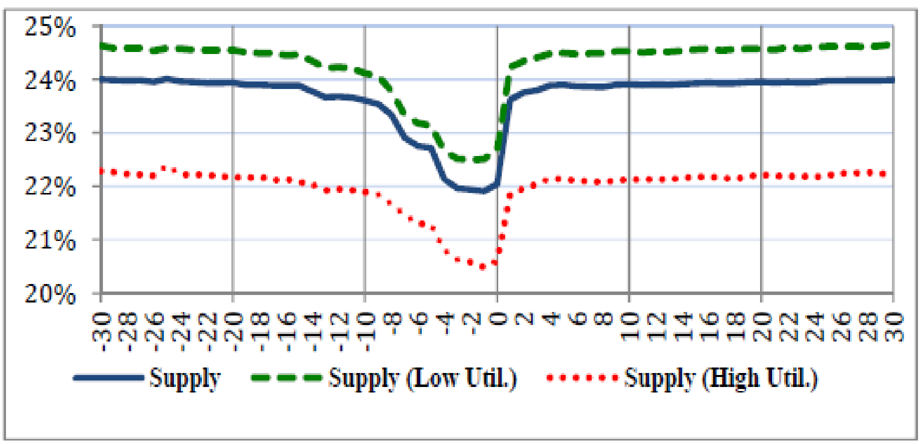
- U.S. equity lending rebounded in 2010, despite (because of?) losses incurred during the credit crisis

- Some lenders restrict or recall shares to reacquire voting rights, but over one-fifth of U.S. equities are made available to borrowers over proxy record dates

- Through LDV, lenders could have submitted votes for 25% of the shares that otherwise go unvoted, giving corporate issuers another 15 billion votes from investors with positive economic interest



Loan Supply around Proxy Record Dates (% of market cap)[2]



1. Assumes an average stock price of $20 applied to average annual loan volume reported by RMA (http://www.rmahq.org/RMA/SecuritiesLending/DataDecisionSupportCenter/SecuritiesLendingQuarterlyAggregateComposite)
2. http://faculty.msb.edu/aggarwal/lending.pdf

Funding pressures disenfranchise public funds…

- Traditionally, securities lenders have had to choose between lending income and voting rights
- Public pension systems face funding shortfalls, so many regularly forgo voting to earn lending income
- Competitive pressures lead many retail and institutional funds to make a similar tradeoff

"Recalling loaned securities for proxy voting purposes is expected to represent the exception rather than the general rule."
- Teacher Retirement System of Texas[1]

"Restricting or recalling shares will be made on a case-by-case basis considering the following factors: income vs. value to vote, ..."
- State of Michigan Retirement Systems[2]

"… the ratio of pension assets-to-liabilities, or funding ratio, for all 126 state pension plans was 69% in 2010 …"
- Wilshire Consulting[3]

"… the present value of the already-promised pension liabilities of the 50 U.S. states amount to $5.17 trillion … Net of the $1.94 trillion in assets, these pensions are underfunded by $3.23 trillion. This "pension debt" dwarfs the states' publicly traded debt of $0.94 trillion."
- Novy-Marx and Rauh[4]

1. www.trs.state.tx.us/investments/documents/proxy_voting_policy.pdf
2. www.michigan.gov/documents/treasury/SMRSProxyVotingPolicy_290368_7.pdf
3. www.scribd.com/doc/50219014/2011-Wilshire-Report-on-State-Retirement-Systems-Funding-Levels-and-Asset-Allocation
4. Novy-Marx, Robert, and Joshua D. Rauh. 2009. "The Liabilities and Risks of State-Sponsored Pension Plans." *Journal of Economic Perspectives*, 23(4): 191–210.

… but LDV could have re-enfranchised lenders

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To test this concept, we:

- Collected confidential loan and uninstructed share data from beneficial owners and brokers
- Selected 25 sample CUSIPs that had highest overall loan volume or loan utilization rates (most stressing cases)
- Found that:
  - Sample brokers had 10x the number of discretionary shares as our sample lenders would have voted.
  - LDV lenders would have been able to fully participate in 20 of 25 proxy events.
  - Issuers would have received another 38 million votes.

CUSIP	Firm	Record Date	Coverage
054937107	BB&T CORP	2/24/2010	745%
060505104	Bank of America	1/7/2010	248%
112900105	Brookfield Properties Corp	3/8/2010	255%
150934503	Cell Therapeutics Inc	2/19/2010	486%
171779309	CIENA Corp	2/16/2010	198%
172967101	Citigroup Inc	2/25/2010	5873%
247916208	Denbury Resources	2/3/2010	133%
345370860	Ford Motor Co	3/17/2010	1604%
628530107	MYLAN, Inc	3/25/2010	94%
696643105	PALM Inc.	5/24/2010	1253%
742352107	Princeton Review	2/22/2010	163%
767754104	Rite Aid Corp	4/26/2010	499%
854616109	Stanley Black & Decker	1/11/2010	46%
984249102	YRC Worldwide Inc	1/4/2010	259%
984332106	Yahoo! Inc	4/27/2010	301%
01903Q108	Allied Capital Corp	2/2/2010	534%
25811P886	Doral Financial Corp	6/1/2010	838%
27579R104	East West Bankcorp	2/12/2010	64%
55261F104	M & T Bank Corp	2/26/2010	254%
62856H107	MYREXIS, Inc	3/8/2010	796%
71343P200	PepsiAmericas, Inc	1/4/2010	54%
71654V408	Petroleo Brasileiro SA	5/28/2010	1164%
87161C105	SYNOVUS Financial Corp	2/12/2010	799%
Y1505D102	China Telecom CP H	4/23/2010	1%
Y3990B112	Industrial & Commer	4/16/2010	257%
Overall			**1026%**

How would LDV work?

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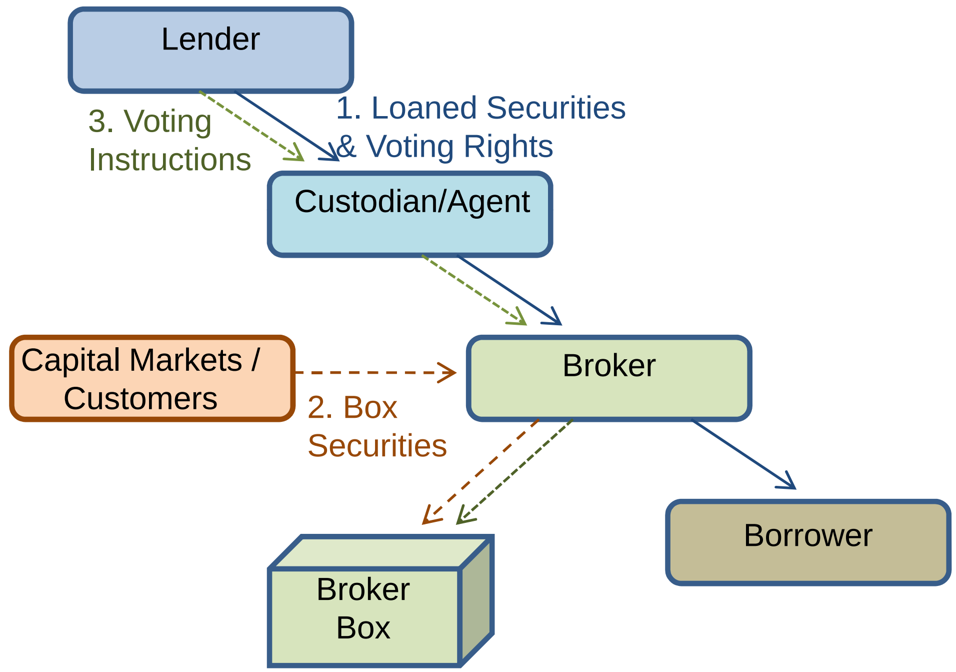
1. Currently, voting rights transfer with stocks in loan transactions. Lenders can only reacquire voting rights by recalling loaned shares.

2. Brokers acquire large quantities of stocks through various business lines, some of which are not voted (e.g., proprietary or customer uninstructed shares).

3. Through LDV, lenders would maintain existing loans and pass voting instructions to brokers, who would apply them to otherwise non-voted shares.

- Lenders would participate in more proxy votes while earning income, brokers and agents would have more stable loan and collateral portfolios, and issuers would receive more proxy votes at a lower cost



Case Study: Verizon

Case Study Findings:

- 65% of sample brokers’ shares went unvoted
- In our sample, brokers had 16X the voteable shares as demanded by lenders
- Issuers would have received an additional 1.8 million votes

Proxy Stats:

- Record date: March 7, 2011
- Meeting date: May 5, 2011
- Total float: 2.82 billion shares

Key Proxy Items:

- Proxy resolution to deny payment of certain bonuses unless Verizon’s stock performance was at least equal to the median of its peer companies.
- Tender for Terremark, which had announced the settlement of a potential class action litigation regarding the proposed merger.

Case Study: Goldman Sachs

Case Study Findings:

- 76% of sample brokers’ shares went unvoted
- In our sample, brokers had 29X the voteable shares as demanded by lenders
- Issuers would have received an additional 121K votes

Proxy Stats:

- Record date: March 7, 2011
- Meeting date: May 6, 2011
- Total float: 455 million shares

Key Proxy Items:

- Proxy resolution by The National Center for Public Policy Research, which holds 23 shares of GS common stock, that GS prepare “a report disclosing the business risk related to developments in the political, legislative, regulatory and scientific landscape regarding climate change." According to the Center’s resolution proposal, “Goldman Sachs will be materially affected by developments concerning climate change. The Company's Environmental Markets Group has $3 billion of investments in renewable energy.” Goldman’s board petitioned the SEC to exclude the resolution from its proxy materials. The SEC denied the request.

Considerations

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- Basic proxy timeline (calendar days)[1]

A. LDV Projection (MD-70)

B. Record Date (MD-60)

C. Discretionary (MD-20)

D. Discretionary (MD-10)

E. Meeting Date (MD)

  - Need to project before record date how many votes will eventually be uninstructed so lenders can make loan recall decisions. LDV will always be "best effort" due to changes in broker share inventory.

- Equitable access to voting opportunities
  - Maintain vote allocation algorithm (similar to a securities lending queue)

- Constraints on lender voting
  - The limit on the votes they can acquire through LDV is the number of shares they had on loan as of record date
  - Controls can be implemented to preclude inappropriately increasing lender voting power

1. https://materials.proxyvote.com/Approved/EPLST1/20100210/OTHER_52009/PDF/broadridge-cis2010_0009.pdf

Next steps

- Seek regulatory approval (as necessary)

- Conduct a live pilot with a small set of issues

  - Beneficial owners have expressed interest in:

	Record Date	Meeting Date
Yahoo	4/26/11	6/23/11
Bed Bath & Beyond	5/6/11	6/23/11