One share does not always equal one vote in the crazy math of proxy contests. When short sellers borrow stock, investor democracy can be a sham.

# Corporate Voting Charade

By Bob Drummond

Mony Group Inc.'s future was on the line in May 2004, when shareholders cast ballots on whether to sell the New York life insurer to France's Axa SA for $1.5 billion. Facing opposition from three of Mony's biggest investors, who considered the price too low, the U.S. company figured the outcome to be close. It was. Needing a majority of Mony's 50.1 million shares, the buyout was approved by a margin of just 1.7 million votes.

Mony's referendum, after an eight-month takeover battle, shows how small numbers of shareholders can determine the fates of major companies and the fortunes of investors. Cliffhanger contests at Mony and other companies also point to hidden shortcomings in shareholder election practices that threaten to undermine investor confidence in the results.

In a little-known quirk of Wall Street bookkeeping, when brokerages loan out a customer's stock to short sellers and those traders sell the stock to someone else, both investors are often able to vote in corporate elections. With the growth of short sales, which involve the resale of borrowed securities, stocks can be lent repeatedly, allowing three or four owners to cast votes based on holdings of the same shares. As Mony's merger showdown neared, 6.2 million Mony shares were loaned to short sellers and resold, creating the potential for extra votes amounting to more than three times the margin of victory.

In close contests with little room for error, the

**Thomas Montrone,** CEO of a company that oversees shareholder elections, says overvoting is 'nothing short of criminal.'

PHOTOGRAPHS BY JONATHAN SAUNDERS

results of high-stakes company decisions may hinge on the invisible influence of millions of votes that shouldn't be counted, says 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.

"Increasingly, there's big, big money riding on the outcomes of these corporate elections," says Carl Hagberg, a shareholder services consultant in Jackson, New Jersey, who has supervised more than 300 stockholder votes. "As votes get closer and the number of sophisticated investors grows, this is going to be a bigger and bigger issue."

Company executives aren't happy with overvoting, either. Cary Klafter, vice president of legal and government affairs at Santa Clara, California–based Intel Corp., the world's biggest semiconductor maker, says investors and management can be hurt by having the wrong people vote in company elections. "It appears to be the case where there are opportunities to game the system," Klafter says. "From the point of view of the issuers, we'd like to have a very high degree of accuracy and transparency."

A robust market for stock loans puts into circulation billions of borrowed shares that can create multiple votes that corrupt corporate elections. Many loans go to short sellers, who borrow stock from stockbrokers and then sell the shares. They're betting that the stock price will drop and, as a result, that they'll profit by paying a lower price for the shares before returning them to the lender. In one measure of potential overvoting, 15.2 billion New York Stock Exchange, Nasdaq Stock Market and American Stock Exchange shares were loaned out to short sellers as of Jan. 13, an 81 percent increase from 8.4 billion shares five years earlier.

"There are votes cast twice on almost every matter of substance," Hagberg, 63, says. "It definitely can and does, in my experience, affect the outcome of corporate elections and proposals."

Wall Street securities firms such as Goldman Sachs Group Inc., Merrill Lynch & Co. and Morgan Stanley lend shares from a central pool, and the brokerages don't attribute loans to the accounts of particular clients. While the small print in a typical brokerage contract says a customer's voting rights may be affected if the firm loans out stock, most brokerage customers likely don't even notice when short sellers borrow stock because their accounts typically list the same number of shares as before.

"Everybody's reaction when they find out about this is that they can't believe it happens," says Anne Faulk, chairwoman of Swingvote LLC in Atlanta, which manages proxy voting for institutional investors who may own stock in thousands of companies.

**Donald Kittell** of the Securities Industry Association says overvoting shouldn't be a big concern.

These overvoting concerns come at a time when there's pressure from investors and the Securities and Exchange Commission for greater shareholder say in corporate affairs through proxy votes.

The advent of spring in the U.S. heralds the arrival of proxy season, when many public companies hold annual meetings at which shareholders can exercise their rights as owners to vote on company matters. They can elect directors, appoint auditors, approve executive stock option plans and cast ballots on corporate governance policies. Before a meeting, companies must provide shareholders with information about issues to be decided, along with voting instructions. Most votes are cast by proxy through brokers or other intermediaries.

The SEC in 2003 proposed a rule to make it easier for stockholders to nominate their own candidates to corporate boards. That policy died under corporate opposition. Since then, activist shareholders have pushed through bylaw amendments requiring that directors be elected by at least a majority of votes.

The Washington-based Business Roundtable, a group representing company chief executives, has petitioned the SEC to let companies get the names of investors who hold stocks in the names of their brokerages or banks. That would allow companies to find out who owns their shares, and then corporations could lobby investors directly during proxy battles.

There hasn't been more attention to correcting rampant double or triple voting in part because brokerages would have to spend time and money on something most clients don't even know exists, says Susanne Trimbath, CEO of STP Advisory Services LLC, an economics consulting firm in Santa

Monica, California. “It’s a big, messy, complicated problem; the solutions are not easy; and other problems have higher priority,” Trimbath says. If clients were told they could vote only some of their shares because of stock borrowing, customers might be reluctant to let brokers loan out their securities, she says. “Stock lending is a revenue-generating service, and people don’t want to do anything to disrupt their income from that. To admit there’s a problem is to admit that, for years, they’ve been looking the other way.”

Since 2003, U.S. tax law has forced brokerages to tell customers whether dividends come from shares that are loaned out. Congress that year cut the federal tax on most dividends to 15 percent. The lower rate usually doesn’t apply when shares have been loaned because, in most cases, investors don’t get dividends from those shares directly from companies. Instead, the stock borrower pays the original owner cash equal to a company’s dividend.

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“They can do that accounting for dividends, but they say they can’t do it for voting rights,” Montrone says. “They have a parochial interest in not telling shareholders they can’t vote because their shares have been loaned out.”

The causes and effects of overvoting are hidden in the nuts-and-bolts recordkeeping behind corporate democracy. To make it easier to buy and sell securities, most people own stocks in their broker’s name, under a system called street-name registration. Because of that, companies typically don’t know which individuals own most of their shares. Companies must rely on Wall Street securities firms to act as clearinghouses, sending proxy ballots to customers who own a particular stock and gathering votes they then forward as a group to the companies.

At the same time, many investors use margin accounts, which let them buy securities with money they borrow from brokers, pledging their shares as collateral. The typical margin account contract allows the broker to loan out clients’ stocks without informing the investors. When company elections come around, brokers often let clients cast votes for the shares that have been loaned out without their knowledge—even though the stock may have been resold to other investors who will turn in ballots for the same shares, Hagberg says.

In November 2004, the NYSE sent a notice to members alerting them to the overvoting phenomenon. “Several recent special examinations of member organizations’ proxy departments have discovered significant areas of concern involving an apparent systemic overvoting of proxies,” the exchange wrote. Voting inaccuracies stemmed primarily from a failure to properly account for stock loans and short positions, the exchange said.

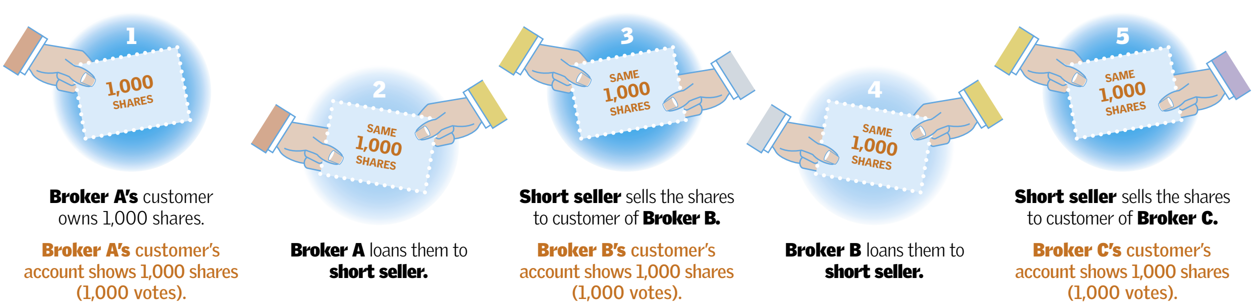
On Feb. 15, the NYSE fined New York–based Deutsche Bank Securities Inc. $1 million. The exchange said Frankfurt-based Deutsche Bank AG’s investment banking arm had sent companies duplicate votes for the same shares in numerous instances from March 1998 through November 2003. The NYSE said the bank submitted more than the eligible number of votes in 23 of 27 corporate elections in 2002 and 2003. “Proxy overvoting creates a serious risk that shareholders’ votes will not be counted,” says Susan Merrill, chief of enforcement at the NYSE’s regulation division. “Shareholders are entitled to expect that even in routine matters, the proxy process has been properly supervised by their broker-dealer.”

Deutsche Bank spokesman Ted Meyer says, “We are pleased to have reached a voluntary resolution to correct the issues that were identified.”

Stock loans by brokerages often are made to hedge funds—which are loosely regulated groups of wealthy investors who use risky strategies to try to earn high returns—

## Multiple votes

The same 1,000 shares can be voted three times for a total of 3,000 votes because short sales create potential records for shares on loan.




Source: Bloomberg

and other groups of investors who use short sales and other maneuvers. Those investors, who may sometimes borrow stock just to get votes in a proxy contest, may have different interests in an election's outcome than a company's long-term shareholders, Hagberg says. Wall Street's failure to keep adequate tabs on voting of shares that may be loaned out repeatedly creates the potential for mischief in a high-stakes election. "The system could be manipulated," Hagberg says. "I really believe I could vote my shares 10 times without there being any red flags."

University of Pennsylvania finance professor David Musto and colleagues are studying whether traders are borrowing shares in order to obtain votes to help influence corporate elections. When planning an election, companies try to make sure only one investor can vote each share by limiting voting rights to investors who own stock on a specific day, known as a "record date." Looking at stock loans from one bank's client accounts in the period between November 1998 and October 1999, Musto's group found that borrowing on companies' record dates jumped an average of 24 percent over lending volume during the surrounding 20 days.

"We thought we would see a dip in lending on that day because people would want to hold on to their votes, but, instead, there was a spike," Musto says.

**'If a company took away your rights as a voter, you'd be outraged,' a state official says. 'It's an affront to the public trust.'**

Hong Kong's Securities and Futures Commission is reviewing whether voting of borrowed stock may have made the difference in a Jan. 20 vote, when shareholders of Hong Kong–based Henderson Investment Ltd. narrowly rejected a buyout by its parent company, Henderson Land Development Co. About 10.9 percent of Henderson Investment's shares were voted against the takeover, which required 90 percent approval.

When brokerages' customers turn in more ballots than they're eligible for, the firms typically have procedures to reduce vote totals before the ballot results are sent to a company. If a broker gets 10 percent more votes than the number of shares held by clients after stock loans, for example, the yes and no totals may each be reduced by 10 percent. That system was outlined by the Securities Industry Association, a New York–based trade group for securities firms, in an April 2005 letter to the NYSE. "As long as they do it consistently, in my view, it's a tempest in a teapot," says Donald Kittell, executive vice president of the SIA. "We get criticized for not having a picture-perfect way of allocating votes. As a practical matter, half of those shares don't vote anyway."

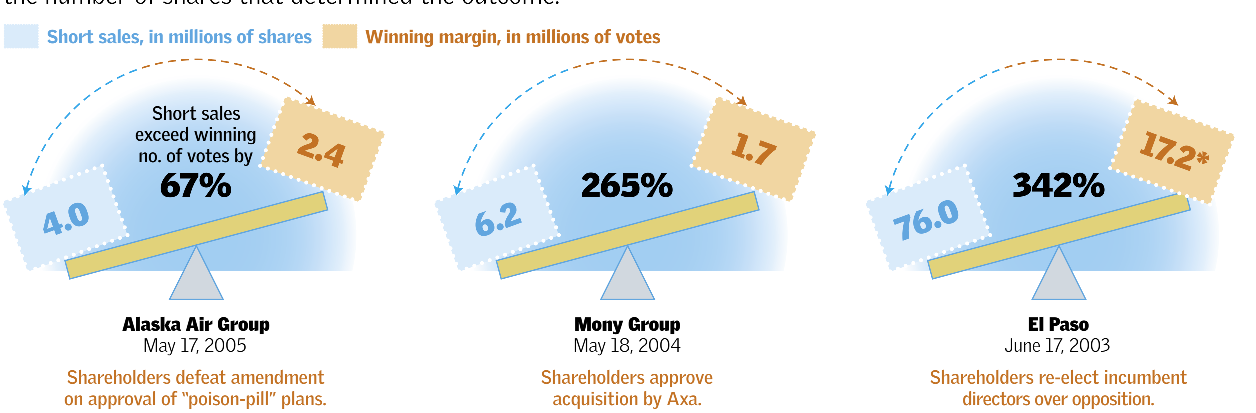
By failing to track down which clients weren't technically eligible to vote in the first place, such a proportional adjustment threatens to throw out some valid ballots to make room for ineligible votes, Registrar & Transfer's Montrone says. "They lop off votes they want to lop off without any consideration of whose votes are being cut out."

Ralph Lambiase, director of the Connecticut Division of Securities in Hartford, says shareholder voting rights shouldn't depend on the luck of a draw. "If a company took away your rights as a shareholder, you'd be outraged, but when a broker just reduces your vote, they get away with it," he says. If political elections were run like corporate votes, people would be allowed to cast as many ballots as they could, as long as the total didn't exceed the number of registered voters, Lambiase says. "It's an affront to the public trust," he says.

At most companies, the principle underlying stockholder elections is straightforward: One share equals one vote. In practice, the potential for one share to produce more than

## Tipping the balance

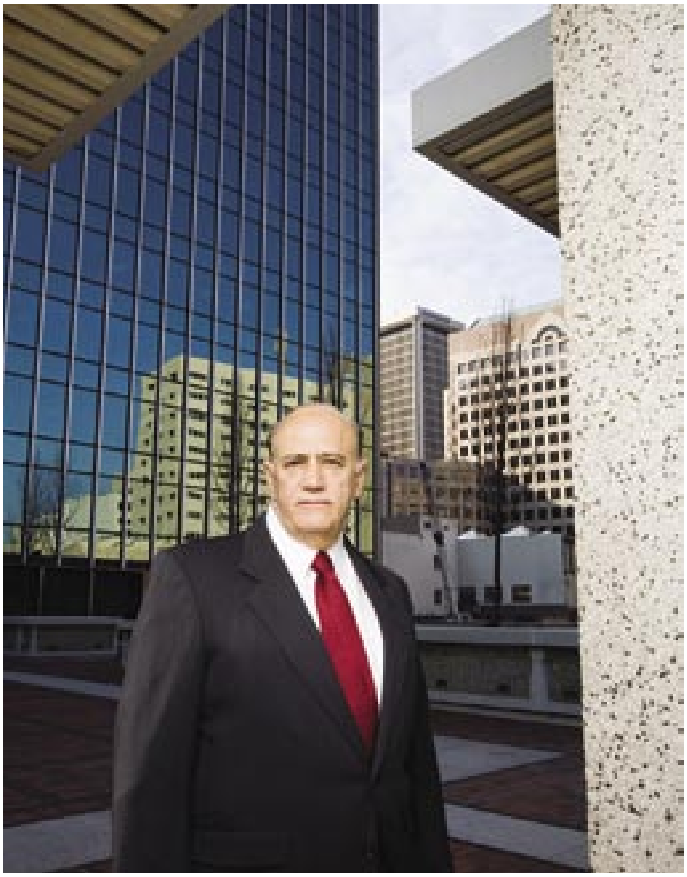
In each proxy contest below, the number of potential extra votes, estimated on the basis of short sales, exceeded the number of shares that determined the outcome.




*Winning votes in closest race. Source: Bloomberg one vote creates, at the least, uncertainty about the validity of close contests and, at worst, the potential to manipulate the outcome, says Trimbath, the California economist. "There are opportunities out there for abuse," she says. "There is no one share, one vote."

It's impossible to precisely gauge stock lending's potential impact on proxy votes because statistics are scarce. The only published figures that permit estimates of lending activity for any individual stock are contained in monthly short-interest disclosures by the NYSE, Nasdaq and American Stock Exchange. Those reports show how many of a company's shares are out on loan to short sellers as of a single day in the middle of each month. Short-sale levels aren't made public for other times, such as a record date.

Before Mony's shareholder meeting on the Axa merger, the company announced, on Feb. 23, 2004, that investors who owned stock on April 8 of that year would be eligible to vote. The most current short-selling data near Mony's record date were in the NYSE's report on short interest as of March 15. The 6.2 million Mony shares on loan to short sellers on that day represented a 64 percent jump from 3.8 million shares a month earlier. Average daily trading of Mony stock by short sellers rocketed almost 140 percent during the same period. The reasons for short selling are never publicly posted. Given there was an eight-month fight in progress, with nobody certain whether the deal would go through, there was a rationale for some investors to bet against the stock.



Connecticut official **Ralph Lambiase** says overvoting undermines trust.

Short-interest statistics show the potential damage stock loans can cause to the concept of one share, one vote. At El Paso Corp., a Houston-based energy company, incumbent directors survived a challenge at the 2003 annual meeting from a slate of nine dissident nominees fielded by the company's biggest individual shareholder, former Zilkha Energy Co. CEO Selim Zilkha. The incumbent board members won reelection by as few as 17.2 million votes, at a time when the latest statistics showed active short sales of almost 76 million borrowed shares. There were 600 million outstanding shares of El Paso at the time of the vote.

At Alaska Air Group Inc.'s meeting last May, a bylaw amendment requiring shareholder approval of antitakeover plans within four months after their adoption by the board fell 2.4 million votes short of the required 75 percent approval required. At the time, almost 4 million shares were sold short. At the same meeting, a nonbinding resolution calling for annual elections of all directors at the Seattle-based company passed, over management opposition, by fewer than 250,000 votes.

The arrival of millions of duplicate ballots in a corporate election would be more obvious if not for one fact: In many elections, up to half of all stockholders don't participate, leaving plenty of leeway for brokerages to permit voting of borrowed shares without going over the maximum number of eligible votes. "It's invisible," says Paul Schulman, executive managing director of Altman Group Inc., a proxy solicitor based in Lyndhurst, New Jersey. "Most of the time you don't get overvotes because so many shareholders don't vote."

Many investors ignore even crucial votes. In December, Houston-based BindView Development Corp.'s acquisition by Cupertino, California–based Symantec Corp. barely squeaked by because only about 69 percent of shares were voted on an issue that needed approval by a two-thirds majority. Ninety-nine percent of the shareholders voting approved the acquisition of the Internet security company. Fewer than 62 percent of eligible votes were turned in last May when investors in Chicago-based USF Corp. approved the trucking company's acquisition by Overland Park, Kansas–based YRC Worldwide Inc., formerly called Yellow Roadway Corp.

It's rare, then, for enough votes to be submitted to create glaring overvoting. In one case, Toronto-based Iamgold Corp., which produces gold in West Africa, had to delay announcing the results of a July 2004 referendum on its proposed $1.7 billion purchase of Vancouver-based Wheaton River Minerals Ltd. after some brokers sent 25 million more votes than their clients were entitled to cast. After questionable ballots were weeded out, the acquisition was rejected by a margin of about 16 million votes.

Just a few decades ago, it was easier to keep tabs on who had proper claim on a particular share's voting rights. Stocks came in the form of paper certificates registered to a specific owner. To sell or loan shares, stockbrokers had to bundle up a client's certificates and arrange delivery to the new owner's brokerage. As stock investing gained popularity in the 1960s—the NYSE's 1963 trading volume broke a record that had stood since the 1929 stock market crash—such painstaking paperwork threatened to bury Wall Street. By 1968, after the exchange's volume almost tripled in just five years, stock markets closed every Wednesday for more than six months so brokerages could catch up on their bookkeeping.

The paperwork crisis led, in 1973, to creation of a central securities storage and record management institution now known as Depository Trust & Clearing Corp. Instead of ferrying reams of paper all over lower Manhattan, Wall Street brokerages deposited their clients' shares at Depository Trust, which is within walking distance of the stock exchange. When stocks were bought or sold, the certificates themselves never had to leave the underground vaults at the Depository Trust, which is owned by the NYSE, the NASD and the brokerages.

Central storage of certificates, which the securities industry calls "immobilization," marked a first step toward nimbler electronic stock-processing systems that allowed development of trading strategies involving short sales, stock loans and other sophisticated maneuvers. A related push, known as "dematerialization," aims to rid the world of pesky paper certificates altogether by recording all stock ownership in an electronic bookkeeping form.

Most shares today exist only as computer bookkeeping entries. Stock trading has exploded: Average daily volume on the NYSE has soared 100-fold since 1973, when Depository Trust opened. Short selling has grown almost five times as fast. On a typical day in 1973, combined short positions for all NYSE companies totaled about 18 million shares. As of mid-January, almost 8.5 billion shares—more than 2 percent of the outstanding stock of all NYSE companies—were loaned out to short sellers.

The exchange posts those aggregate numbers; the Wall Street firms that lend out shares don't have to report the names of shareholders or borrowers. "The customer doesn't know this is happening," says John Wilcox, head of corporate governance at TIAA-CREF, the biggest private U.S. pension plan for teachers. "Often, the broker still permits the customer to vote the shares even though they're out on loan. That policy is not sound. It definitely means that shares can be voted twice."

Concerns about overvoting have been raised for years by stock transfer agents and proxy firms that manage corporate balloting. These are mostly small companies with little clout, working in an arcane corner of the securities industry. "They've been the lone voice crying in the wilderness, but it has to be a grave concern for anyone who takes corporate governance seriously," Swingvote's Faulk says.

One solution would be for Wall Street brokerages to clearly disclose who can and can't vote in corporate elections. Until that happens, double and triple voting on one share will continue to make a mockery of shareholder democracy.

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BLOOMBERG TOOLS

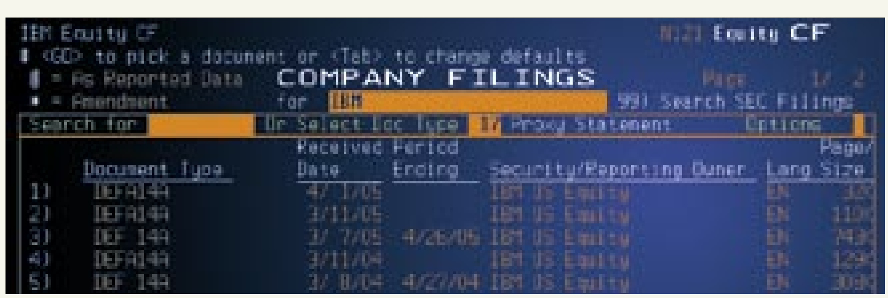
## Tracking Short Interest

While many investors don't bother to vote in shareholder elections, the high volume of short selling reveals that some traders who want to see a company's value fall may be voting in a company's elections. The outcome can hurt long-term investors. To display monthly short-interest information for a stock traded on the American Stock Exchange, Nasdaq Stock Market, New York Stock Exchange or Toronto Stock Exchange, use the Short Interest (SI) function. For example, if you type IBM US <Equity> SI <Go>, you'll see graphs that chart stock price, the number of shares sold short and average trading volume to illustrate short-interest activity for International Business Machines Corp.

You can customize the date range by entering new dates in the fields in the upper-left corner. Short-interest information is available on the NYSE from September 1991, on the Nasdaq from January 1991, on the Amex from October 1990 and on the Toronto exchange from January 2002. Press <Page Fwd> to display the short-interest information in table form.

To see proxy statements from past years for a specific company, you can use the Company/Security Filings (CF) function. Type CF <Go>, tab in to the SELECT DOC TYPE field, enter *17* to select Proxy Statements/Voting Matters and press <Go>, as shown below. A list of proxy statements appears, dating back to 1996. Tab in to the OPTIONS field for a menu of display options. You can click on a document for download options, which give you the ability to view, send or store the document.

JOHN RUSSELL




To graph monthly short-interest data for the Nasdaq Stock Market, type NASINASD <Index> GP <Go>.