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Heart of Darkness: The Problem at the Core of the US Proxy System and Its Solution

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Abstract

Voting rights are a shareholder's main legal channel to exercise control internally over the company in which she invests her savings. Under the corporate law of the US states, a shareholder is someone registered on the stockholders' list, not a person who has title to shares. When in the 1970s transferring paper certificates became impossible on high-volume markets, Congress ordered that the market's securities be put into the vaults of a central depository and that claims against the depository's accounts be transferred rather than the shares themselves. Once this was done, however, issuers no longer knew who owned their shares; they only knew a depository or its broker participant was registered as a shareholder. The heart of the securities market went dark. Communications with shareholders became impossible, so to facilitate the delivery of proxy materials to shareholders, the SEC formulated "shareholder communication" rules, which require financial intermediaries to pass along proxy packets to their customers for a fee. As this process is complex and the deadlines short, votes get lost and misattributed. An entire industry has sprung up to help issuers distribute proxy materials and collect votes. Issuers, who the law forced to give shareholder data to intermediaries, now pay these same intermediaries for information services. But paper certificates, the cause of this dilemma, are rarely used in contemporary securities markets. So why does the problematic system still persist? Because it generates a substantial transfer of wealth from the issuers to the financial intermediaries, and the latter understandably do not welcome its dissolution. This paper shows how the indirect holding system impedes the effective exercise of voting rights, exposes the interests that support the system's persistence, and proposes a practical solution for the disintermediation of securities settlement, which will allow the restoration of issuer-shareholder transparency.

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I. Introduction

When shareholders invest in public companies they agree that all management power rests in a board of directors and the managers the board hires. Shareholders retain three basic powers to influence the company's management: (i) they can use the votes attaching to their shares to elect directors and approve or veto major corporate decisions, such as changes in the business or its structure, (ii) they can sell their shares, exiting the company and potentially driving its stock price down, or (iii) if the management breaches its duty under the law, shareholders can sue them in court directly or on behalf of the company, depending on the type of breach.[1] Of these three rights, voting is the power within the corporate organization with which a shareholder can promote her interests, for when a shareholder sells her shares, she leaves the company, and if she sues the directors, this is no longer internal governance, but subjecting the latter to an external check. Voting rights are thus a shareholder's main legal channel to exercise control internally over the company in which she invests her savings: voting rights are essential to corporate law.[2]

All US corporate statutes provide for companies to issue registered (as opposed to bearer) shares,[3] and thus each share of stock is registered as belonging to a specific person or persons. Accordingly, corporation law defines a shareholder as someone who is registered on the stockholders list,[4] not a person who has title to shares. Notice of meetings is given to the shareholders who are on the stockholder list on the "record date," and these persons have the right to vote at such meetings.[5] This is a simple and effective system that has been used since the first stock corporations; it promotes both efficient communication and a certain sense of responsibility in shareholders. The shareholders remain in direct communication with the company and the company knows its owners. Affirming the importance of this relationship, the United

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1 These rights are found in contemporary corporate law statues such as the Delaware General Corporation Law (Del. Code Ann. tit. 8) and the Revised Model Business Corporation Act (RMBCA). The rights as to control and management are mainly voting rights that may be exercised in various circumstances (Del. Code Ann. tit. 8, §§ 212, 211(b), 242(b), 251(c), 271, 275(c); RMBCA §§ 7.21(a), 7.28, 8.08, 9.21, 9.52, 10.03, 10.20, 11.04, 12.02, 14.02). The right to transfer shares is assumed unless expressly restricted. The remedial rights include the right to bring a derivative suit (Del. Code Ann. tit. 8, § 327; § 7.01 RMBCA). *See also* ROBERT CHARLES CLARK, CORPORATE LAW 13 (1986); JAMES D. COX, THOMAS LEE HAZEN & F. HODGE O'NEAL, CORPORATIONS § 13.1 (2002); FRANKLIN A GEVURTZ, CORPORATION LAW 179, 195, 210, 387 (2000); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATION 375 (1946).

2 *See* e.g., Blasius Industries v. Atlas Corp., 564 A. 2d 651, 659 (Del. Ch. 1988) („The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

3 A search in the library "All States" on WestLaw for the words "bearer share" pulls up only cases referring to foreign companies (usually South or Central American) in US Courts. Also, an examination of the corporate law statutes of the states of Delaware, New York, California, Illinois and Texas, as well as the Model Business Corporation Act confirms that only registered shares are foreseen.

4 *See* e.g., Del. Code Ann. tit. 8, §219(c); Williams v. Sterling Oil of Oklahoma, Inc., 267 A.2d 630, 634 (Del. Ch. 1970); RODMAN WARD JR., EDWARD P. WELSCH & ANDREW J. TUREZYN, FOLK ON DELAWARE GENERAL CORPORATION LAW § 219.4 (2002); COX, HAZEN & O'NEAL, *supra* note 1, at §13.18.

5 *See* e.g., Del. Code Ann. tit. 8, §219.

Kingdom in 2006 specifically carried forward an older provision into its newest revision of its Companies Act: the provision allows a company to suspend the voting and dividend rights for any shares if the registered shareholder does not provide the company with the identity of the real (beneficial) shareholder.[6]

The prevalent moral tenets in the United States certainly promote responsible ownership no less than do those of the United Kingdom, yet the United States has taken a very different stance on the transparency of ownership for reasons completely unrelated to corporate law. The lack of transparency in the United States is justified as a necessary outgrowth of having an efficient capital market.[7] It is the purpose of this paper to explain the connection between market structure and transparency, sketch the resulting undesirable effects on the exercise of shareholder voting rights, and propose how the situation can be corrected. One reason that US regulators have not yet been able to correct the situation is that its explanation requires a patient audience to understand how commercial law is connected to the operation of securities exchanges, and then how that design affects the exercise of shareholder rights under corporate law. These connections can be briefly summarized as follows:

At the heart of every securities exchange there is a system to settle the trades executed on that exchange, and the process is called "securities settlement". Its purpose is to deliver ownership in cash equaling the purchase price of securities to the seller and to deliver ownership in the sold securities to the buyer. The delivery of ownership in the sold securities must follow the rules for transferring negotiable instruments, and in the case of a stock transaction, specifically the rules for transferring *registered shares*. Because transferring registered shares evidenced by paper certificates is physically burdensome (mountains of paper) and legally cumbersome (each certificate must be endorsed to the buyer, the seller struck from the register, and the buyer entered as a shareholder and issued a new certificate), the markets sought a shortcut. Here is the connection between commercial law and securities exchange design. The design chosen by the New York market and endorsed by the US Securities and Exchange Commission (SEC) and the US Congress was to avoid transferring registered share certificates altogether, by putting them into the vaults of a central depository and transferring claims against the depository's accounts rather than the shares themselves. This process is referred to as "immobilization", and the transactions on accounts containing immobilized shares are called "book-entry" transfers.[8] Immobilization has a long history of good

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6 *See* UK Companies Act of 2006, Part 22, "Information about interests in a company's shares."

7 Concept Release on the U.S. Proxy System, SEC Release No. 34–62495, 75 *Fed. Reg.* 42982, 42983 (July 22, 2010), and for an earlier statement, *see* S. REP. NO. 94-75, at 237 *et seq.* (1975) (hereinafter "SEC Concept Release on the U.S. Proxy System").

8 Committee on Payment and Settlement Systems [CPSS] & Technical Committee of the International Organization of Securities Commissions [IOSCO], Recommendations for Securities Settlement Systems 45-47 (2001).

performance, and was used as early as 1873 in Vienna, Austria.[9] Since in the United States this process concerned *registered* securities, it was necessary to register the securities in the name of the bank, an entity it controlled, or a financial intermediary that holds an account with it. In the United States, most shares have been registered in the nominee of the central custodian bank,[10] which bears the name of "Cede & Co.", "Cede" being short for "*ce*rtificate *de*pository". Here is the connection between securities exchange design and the exercise of shareholder rights. Once a corporation's shares are registered in the name of "Cede & Co.", the issuer no longer has a list of its "real" (i.e., economically interested, property holding) shareholders. Moreover, because corporate law provides that the registered shareholder is the only legitimate shareholder, the people who invest in US corporations are no longer shareholders, legally speaking. Issuers no longer know who owns them, and owners no longer have legal legitimacy as such. By transplanting a heart of darkness into the New York market, the United States effectively and legally cut off investors from the corporations in which they invested, the transparent ownership inherent to registered shares was eliminated, and corporate governance went dark.

Congress and the SEC were well aware of this danger and took steps immediately to study the effects of the shareholder register going dark after immobilization,[11] as well as to bring some light back into the broken relationship between investors and their companies. A series of rules discussed below are appropriately grouped under the rubric "shareholders communication".[12] As the SEC observed in July 2010, these rules bring a certain level of complexity into the distribution of proxy materials:

> The manner in which proxy materials are distributed and votes are processed and recorded involves a level of complexity not generally understood by those not involved in the process. This complexity stems, in large part, from the nature of share ownership in the United States, in which the vast majority of shares are held through securities intermediaries such as broker-dealers or banks; this structure supports prompt and accurate clearance and settlement of securities transactions, yet adds significant complexity to the proxy voting process.[13]

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9 *See* THEODOR HEINSIUS ET AL., DEPOGESTZ – KOMMENTAR ZUM GESETZ ÜBER DIE VERWAHRUNG UND ANSCHAFFUNG VON WERTPAPIEREN VOM 4. FEBRUAR 1937 § 5 margin no. 1 (1975).

10 Rules, By-laws and Organization Certificate of the Depository Trust Company (version of Sept. 2009), available at http://www.dtcc.com/legal/rules_proc (hereinafter "DTC Rules"), Rule 6.

11 *See* SEC, Final Report of SEC on the Practice of Recording the Ownership of Securities in the Records of the Issuers in Other Than the Name of the Beneficial Owner of Such Securities 6, 52 (1976) (hereinafter the "Street Name Study").

12 Exchange Act Release No. 11,079, 39 *Fed. Reg*. 40766 (Oct. 31, 1974); SEC Release, Final Rule: Requirements for Dissemination of Proxy Information to Beneficial Owners by Issuers and Intermediary Broker-Dealers, Exchange Act Release No. 13,719, 42 *Fed. Reg*. 35953 (July 5, 1977); SEC Release, Final Rules: Facilitating Shareholder Communications Provisions, Exchange Act Release No. 34-20021, 48 *Fed. Reg*. 35082 (Aug. 3, 1983); Final Rules: Shareholder Communication Facilitation, Exchange Act Release No. 34-23847, 51 *Fed. Reg*. 44267 (Dec. 9, 1986).

13 SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42983.

These rules are designed to use the same simple pass-it-along process that we might use when ordering takeout for our colleagues at the office. Office worker A contacts takeout server B, and the latter asks the former how many dinners he needs, and then A adds up the needs of all the people he is acting for and tells B the total, so that B can prepare the packages and deliver them to A for distribution. That is simple enough, but for distribution of proxy materials there are some significant differences. First, although there is still only one person (here, the issuer) preparing the packages for delivery, the person requesting the order (the depository) will also ask persons C through, say, K (participating banks and brokers) how many packs they need, and they will then respond on behalf of persons L through Z (x 1000) who are the "beneficial" owner shareholders. Another difference is that the process has to take place very quickly if the shareholders are to have any time to make decisions on the agenda items for the meeting. Following the food analogy, one might compare it to taking orders from and delivering unrefrigerated ice cream – during an August afternoon in Washington DC – to 10,000 widely dispersed people standing on random street corners. Another significant difference from the simple takeout scenario is that rather than being paid to provide the packages, the issuer must pay for the entire process, which cost is ultimately passed on to the beneficial owner shareholders. The intermediaries, on the other hand, are both compensated for their services and able to record the delivery information regarding customer locations and preferences as a self-paid bonus for future business development.

No one has ever been satisfied with the pass-it-along process caricatured above and discussed in Part III.B, below. The SEC has amended it, and periodically publishes requests for suggestions on how to improve it, like the request published in July 2010.[14] However, all concerned have accepted the inconvenience because all agree it would be much worse to endorse stock certificates for every transaction on a securities exchange and send them around the world by courier service. It would not only be worse, it would be physically impossible. In fact, markets collapsed as far back as 1968 because of this process, as discussed in Part II.A, below. So we have borne the negative externality of this system's corporate darkness because it was necessary as a matter of efficient market structure, not of choice. As long as securities trading involved mountains of paper, immobilization in a depository and registration in a central name was necessary. This argument is repeated today, just as it was evoked in 1968, but suffers from one significant weakness: it is not true. Today securities transfers *do not* involve mountains of paper, and most do not involve *any* paper. Government debt led this trend in a number of major markets. Germany dematerialized[15] part of its debt issues as early as 1910,[16] and then all of them in 1972;[17] in 1981, France

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14 SEC Concept Release on the U.S. Proxy System, *supra* note 7.

15 That is, replaced paper certificates with uncertificated account entries, whether manually entered in registers or electronically recorded on computer drives.

16 *See* CLAUS-WILHELM CANARIS, BANKVERTRAGRECHT margin no. 2052 (2nd ed. 1981).

17 *See* HEINSIUS ET AL., *supra* note 9, § 42 margin no. 6.

began dematerializing its entire market by legislative decree;[18] the United States government followed in 1986, by completely dematerializing its government securities,[19] although US securities exchanges still allowed paper certificates for newly listed companies until 2008.[20] Since the 1990s, corporations have increasingly issued their debt and equity as book-entry securities in uncertificated form.[21] Such securities are issued by booking them in the issuer's register of securities holders. There is very little left to immobilize in depositories. The network of depositories and custodians are no longer necessary. But why do intermediaries remain entrenched like opaque walls between issuers and their shareholders? Why do they continue to take the place of America's shareholders? Why are proxy communications distributed via the same, ineffective pass-it-along process?

Indeed, why did London's boatmen resent the bridge builders, Wyoming's stagecoach operators resent the railroad, Ohio's railroad owners lament the interstate highway system, and the cinema industry fear pay-per-view streaming video? Because they all had a direct economic interest in retaining the existing infrastructure. All infrastructural choices – whether they are roads, data spines, or something in between – create winners and losers. The infrastructure of a securities exchange is no exception. With the market's securities registered in the name of the depository, its nominee or one of its broker participants, issuers no longer have information about their shareholders. Only the depository or its participants have legal rights as registered owners and know who beneficially owns what. This gives the depository, now in possession of all the market's information on ownership, an opportunity to sell information-based services ("proxy" and "corporate action" services) to the issuers and the securityholders, in effect selling them back their own information.[22] When the SEC consults these very entities for advice on how to improve the system, there is an obvious conflict of interests, and it is no surprise that the consulted entities do not advocate eliminating their own functions.

This paper focuses a spotlight on how the heart of the US securities settlement infrastructure condemns listed issuers and their shareholders to a darkness in which only financial intermediaries can

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18 *See* Antoine Maffei, *Pour une modernisation du régime de la dématérialisation en France: le projet Paris Europlace*, *in* 20 ANS DE DÉMATÉRIALISATION DES TITRES EN FRANCE: BILAN ET PERSPECTIVES NATIONALES ET INTERNATIONALES 103, 103 (Hubert de Vauplane ed., 2005).

19 *See* EGON GUTTMAN, MODERN SECURITIES TRANSFERS §1:13, 1-49, 1-53 (3rd ed., updated to 2009), 31 CFR §§ 357.0 – 357.45.

20 *See* the discussion of mandatory dematerialization in connection with the direct registration system applicable to US securities exchanges in Part IV.B.1.

21 According to DTCC, transactions in certificated securities constitute only about 0.01% of daily trading volume. Because storing large amounts of negotiable paper requires large, acclimatized, secure facilities, DTCC has for years advocated the elimination of paper, and the number of certificates it holds on deposit has steadily decreased. Between 2001 and 2007 the number of certificates DTC held in its vaults decreased by about 60% from approximately 6.7 to 2.7 million certificates. Michael Bellini, Dematerialization Makes Steady Gains, @DTCC News and Information for DTCC Customers 12 (June 2007), *available at* www.dtcc.com.

22 *See* the discussion of this economic interest in Part IV.B.2, below.

connect them with each other. **Part II** explains why and how the United States introduced a securities settlement structure based on immobilization and intermediation. **Part III** shows the efforts the SEC has undertaken to mitigate the substantial negative externalities the depository based system generates for corporate governance. **Part IV** analyzes the reasons and interests that have led to the endurance of the depository model even after paper has greatly disappeared, leaving very little to deposit. **Part V** proposes a way forward, out of this infrastructure-imposed darkness. The paper offers historical evidence of a major attempt to decentralize the depository model when the SEC failed to include the model's negative effects and the interests of the intermediaries in the calculus of its decisions, and also summarizes the current interests of persons profiting from the system to perpetuate its continuance. The paper then explains how a modern and rational securities settlement infrastructure can disintermediate the relationship between issuers and shareholders, returning the US proxy system to the relationship envisioned in the corporate laws of the 50 states.

II. The Rise of the Indirect Holding System

A. The "paper crunch"

The current US depository model of securities settlement was implemented following a major market failure that culminated in 1970,[23] a disaster referred to with names like the "paper crunch" or "paper blizzard".[24] Up until the 1970's, most securities firms took care of their securities transfer paperwork through the manual work of clerks. A study performed by North American Rockwell Information Systems at that time found that brokers might use an average of 33 different forms for a single security transfer.[25] As trading volume steadily increased in the late 1960's, brokers fell behind in this "back office" processing of transaction settlements. Although the volume was slight by today's standards, the unforeseen growth had dramatic effects. Daily volume on the New York Stock Exchange (NYSE) more than quadrupled from about three million shares per day in 1960 to approximately 13 million shares per day in 1968,[26] without the industry taking any serious steps to increase the efficiency of their settlement activity.[27] The increase was loaded mostly into the back end of the period, and from 1966 to 1967 annual trading volume increased

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23 U.S. SECURITIES AND EXCHANGE COMMISSION, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS 28 (December 1971) (hereinafter "UNSAFE PRACTICES STUDY"), at 28. Also *see* CHRIS WELLES, THE LAST DAYS OF THE CLUB 172 *et seq.* (1975) and DONALD T. REGAN, A VIEW FROM THE STREET 104 *et seq.* (1972).

24 WELLES, *supra* note 23, at 134; GUTTMAN, *supra* note 19, at §1:13, 1-49, and James S. Rogers, *An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision*, 31 IDAHO L. REV. 689, 691 (1995).

25 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 176; also *see* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN FINANCE 489 (3rd ed. 2003); HURD BARUCH, WALL STREET: SECURITIY RISK 280 (1971), and REGAN, *supra* note 23, at 163.

26 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 28, and BARUCH , *supra* note 25, at 85 *et seq.*

27 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 28, 96.

by 33%, reaching 2.53 billion shares.[28] During 1969, the inability of some brokerage firms to settle securities transactions created enormous backups in deliveries, so that unperformed obligations could range from 70% to 200% of a firm's total assets.[29] Firms were forced to cover short positions caused by missing securities through open market purchases. This worked as long as cash flow was strong, but as the market turned downward in 1970, brokers found their working capital diminished, which forced them into default on outstanding delivery obligations for which the securities had been lost or misplaced.[30] As a result, over 100 brokerage firms either entered bankruptcy or were acquired by stronger competitors.[31] Although this is not remembered as one of the more important market crises of US financial history, it was the largest challenge to the securities exchanges since the crash of 1929, and led directly to the Securities Acts Amendments of 1975.[32] Some details of the nature of this market failure will help to explain why, in the early 1970s, the SEC and Congress decided to move most securities settlement activity under the umbrella of a self-regulatory organization (SRO), and away from individual issuers.

Both the SEC[33] and a number of authors writing in the 1970's, including Chris Welles,[34] Hurd Baruch,[35] and Donald Regan,[36] documented in some detail the circumstances that led to this improbable crisis. During the "go-go" years of the 1960's, it was common for brokerage firms to settle their own securities transactions, and a number of brokerage firms greatly expanded their sales forces without similarly investing to increase their capacity to settle the transactions that they entered into.[37] Welles speculates that the monopolistic position of the New York brokers, who at this time enjoyed both fixed commissions and rules against outside competition, dissuaded them from tying up funds to improve their internal settlement systems by installing the type of automated data processing that had been offered to them since the 1950's.[38] Yet as the number of orders and transactions grew, so did the volume of unfulfilled deliveries. One relatively large brokerage firm that had been a member of the NYSE since 1941,

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28 *Id.* at 13.

29 *Id.* at 102. Losses from fails and related unperformed obligations climbed nearly 300% between 1961 and 1969. *See Id.* at 100.

30 *Id.* at 96.

31 *See* S. REP. NO. 94-75, at 183 (1975); BARUCH , *supra* note 25, at 189 *et seq.*, WELLES, *supra* note 23, at 134.

32 S. REP. NO. 94-75, at 183 (1975).

33 SEC, UNSAFE PRACTICES STUDY, *supra* note 23.

34 WELLES, *supra* note 23.

35 BARUCH, *supra* note 25.

36 REGAN, *supra* note 23.

37 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 11 *et seq.*

38 WELLES, *supra* note 23, at 125 *et seq.*

Dempsey-Tegeler & Company, Inc.,[39] saw its unfulfilled deliveries climb from about $2.6 million in 1968 to approximately $12 million in 1969, a sum which was twice the firm's total assets.[40]

During the last six months of 1968 and part of 1969, the volume of failed deliveries forced the NYSE to close one day per week and hold abbreviated trading hours during their remaining business days in order to give members time to catch up on their paperwork.[41] Even after taking such measures, however, in December 1968 the NYSE still showed more than $4 billion in outstanding delivery failures.[42] Because securities usually carry rights to distributions such as dividend or interest payments, the backlog of paperwork meant that such distributions were not paid on time. For example, in 1969 Dempsey-Tegeler failed to pay out approximately 80% of the dividends due its clients although it had actually received the funds from the respective issuers.[43] During the same year, even Merrill Lynch, Pierce, Fenner & Smith Inc., at the time one of the strongest brokerage houses, did not pay about $21 million in dividends to its clients on time.[44] In order to cover such outstanding obligations, some brokers illegally resorted to a ponzi-scheme like behavior, using the free balances of some clients to cover obligations due to others.[45]

Some firms tried to implement automated systems on the run during the bull market – occasionally with disastrous results.[46] These failed attempts to automate may well have colored the decision-making at a later date, when the SEC and market participants chose between high- and low-tech solutions to the securities settlement problem. One example that Welles describes in detail is the ill-fated attempt of McDonnell & Company, a prosperous brokerage firm of the 1960's, to make the transition to automated settlement. When the booming market approached its apex in 1968, McDonnell paid a computer firm named Data Architects about $ 3 million to design and install a computerized settlement system to take over the settlement burden from the firm's flagging team of back-office clerks.[47] Because, during the installation period, McDonnell continued to engage in high volume trading, it was forced to outsource much of its settlement processing to another firm at significant cost.[48] Unfortunately for both McDonnell and Data Architects, the latter's "innovative" system design had some bugs and the contractors failed to formulate a feasible transition plan or train McDonnell employees on the new system; in addition, these

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39 WELLES, *supra* note 23, at 212.

40 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 101 *et seq.*

41 REGAN, *supra* note 23, at 104, and SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 219-20.

42 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 19; also *see* REGAN, *supra* note 23, at 104.

43 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 109 *et seq.*

44 *Id.* at 109.

45 *Id.* at 123 *et seq.*; also *see* BARUCH , *supra* note 25, at 21 *et seq.* and 33 *et seq.*

46 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 13 *et seq.*

47 WELLES, *supra* note 23, at 196.

48 *Id.* at 195.

same employees also apparently sabotaged the new system out of fear that they would lose their jobs to a computer.[49] As a result, the transition to automated processing never occurred, and in December of 1968 McDonnell had about $ 9.3 million in securities that it could not place to specific owner-customers and unfulfilled deliveries of approximately $ 1.3 million for which it simply could not find the relevant securities to be delivered.[50] Pinched between the cost of outsourcing its settlement activities and the funds it needed to cover its own back-office shortfalls, McDonnell apparently turned to securities fraud. It purchased 200,000 shares of the inept Data Architects for a penny a share, offered the shares to the public in an IPO that it arranged for the company without disclosing its own disastrous experience with the issuer's work, and pocketed about $2 million from the transaction.[51] However, as the market turned downward in late 1969, McDonnell's cash flow was still not sufficient to fund both the open market purchases necessary to replace lost and misplaced securities and the cost of its outsourced settlement work, so it was forced into bankruptcy.[52] At the same time, the SEC took action against the broker for the misleading omission in the prospectus it used to sell the Data Architect shares.[53] Although McDonnell was liquidated in the spring of 1970, it took clerical employees until 1974 to straighten out the firm's securities settlement records.[54]

Unlike widespread market collapses that we have since seen in 2002 and 2008, the imploding of firms like McDonnell, Dempsey-Tegeler, and another 100 or so brokerages[55] was almost solely a matter of poor organization, and although this poor organization tended to be due to individual flaws within each firm, it was market-wide and technology based. Perhaps one might think of a cobbler that from its own bad organization failed to meet orders during a surfeit of productive activity and was thus unable to pay its suppliers of leather. The natural evolution of the market transformed tradesmen cobblers into rational shoe factories producing standardized shoes, and it was observed that US securities settlement needed a comparable transformation. Congress acted first to shore up market confidence by creating deposit guarantee insurance for retail investors through the Securities Investor Protection Act of 1970 (SIPA).[56] In this Act, Congress instructed the SEC to investigate the causes of the paper crunch, and the latter produced a detailed report on broker activity in the 1960's, appropriately called the "Study of Unsafe and Unsound

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49 *Id.* at 187 *et seq.*

50 *Id.* at 196.

51 *Id.* at 196.

52 *Id.* at 206 *et seq.*; also *see* SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 29.

53 WELLES, *supra* note 23, at 198.

54 *Id.* at 208 *et seq.*

55 S. REP. NO. 94-75, at 183 (1975); SELIGMAN, TRANSFORMATION, *supra* note 25, at 1366, BARUCH, *supra* note 25, at 189 *et seq.*, WELLES, *supra* note 25, at 134.

56 The Securities Investor Protection Act of 1970, Pub. L. 91-584, 84 Stat 1636, (1970) codified in 15 USC §78 aaa *et seq.*

Practices of Brokers and Dealers."[57] On the basis of this Report and other considerations, Congress then passed the Securities Acts Amendments of 1975.[58] This Act among other things imposed the immobilization of exchange-traded securities and created the "indirect holding system"[59] for securities as part of a new "national market system."[60]

B. Choosing the central depository model

As said, the SIPA instructed the SEC to investigate the causes of the back office crisis, and the SEC prepared an in-depth report on broker activity in the 1960s. In connection with this, on June 29, 1971, the SEC convened a conference of market participants to discuss and evaluate the existing recommendations and possible solutions for the paperwork crisis.[61] A number of studies were aired and discussed, and most recommendations went to the rationalization and standardization of the settlement process.[62] For example, a study commissioned by the NASD recommended that individual long and short positions of brokers in specific classes of securities be set off against each other so that only the net amounts of funds and securities would actually have to be delivered.[63] Such netting had been, like immobilization, successfully used since the 1870's,[64] and is still considered an essential technique for securities settlement.[65] Another study, commissioned by the American Stock Exchange, recommended standardizing documentation by making buy and sell orders machine-readable.[66] Such machine-readable standardization is still recommended as a best practice by expert committees like the Group of Thirty.[67] It was also recommended

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57 *See* SEC, UNSAFE PRACTICES STUDY, *supra* note 25, at Chapters II, III & IV.

58 Securities Acts Amendments of 1975, Pub. L. 94-29, June 4, 1975, 89 Stat. 97 (1975).

59 This is the term used by the National Conference Of Commissioners On Uniform State Laws when amending the Uniform Commercial Code to meet the needs of the new settlement system. *See* UCC, Article 8 Prefatory Note, at Sec. 1.C „Evolution of the Indirect Holding System".

60 The 1975 Amendments are primarily remembered for eliminating the system of fixed commissions that had protected brokers' income since 1792. 15 U.S.C. § 78f(e)(1); LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION §7-D.2 (3rd ed. 2004). It also introduced the national market system program, which is designed to allow trades and information to flow freely between all national and regional exchanges. 15 U.S.C. § 78k-1; S. REP. NO. 94-75, at 180 *et seq.* (1975); LOSS & SELIGMAN, *supra*, at §7-A.1. Although the national market system was mainly designed to open up isolated, uncompetitive pockets of trading and price information to all market participants, thereby promoting competition between the NYSE and regional exchanges and segments, it was also intended to create a national system for clearing and settlement. 15 U.S.C. § 78q-1; S. REP. NO. 94-75, at 183 *et seq.* (1975); LOSS & SELIGMAN, *supra*, at §6-C-6.

61 *See id.* at 168.

62 *See Id.* at 173 *et seq.*

63 *See Id.* at 175.

64 *See* HEINSIUS ET AL., *supra* note 9, § 5 margin no. 1.

65 CPSS & IOSCO, *supra* note 8, Recommendation 4; THE GROUP OF THIRTY, GLOBAL CLEARING AND SETTLEMENT: A PLAN OF ACTION RECOMMENDATION 16 (2003). In December 1969 NASD established the "National Clearing Corporation", which still operates under the name "National Securities Clearing Corporation" as a subsidiary and the clearing entity of The Depository Trust and Clearing Company.

66 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 176 *et seq.*

67 *See* THE GROUP OF THIRTY, *supra* note 66, Recommendations 1 and 2.

that securities certificates themselves be issued in the form of "punch cards",[68] an early precursor of the bar code, which led to the creation of the "CUSIP" number used in the United States today as the primary means of identifying separate classes of securities.[69]

The topic that dominated the 1971 Conference was, however, the choice between two competing models of securities settlement. For both models there was no question about the main problem, which was paper certificates. One model, often referred to as a "Transfer Agent Depository," or TAD,[70] was conceived as decentralized, following the electronic concept employed in the then newly introduced National Association of Securities Dealers Automated Quotation (NASDAQ) system. It would have linked issuers' transfer agents (private registrars who keep the registers of issued securities and must comply with specific SEC rules)[71] in a computer network so that transfers of uncertificated (dematerialized) securities could be electronically recorded by book entry.[72] In this model, the "account" on which transfers took place would also have been the "register" in which the securities were originally created by the issuer. Exchange trades would have immediately removed the seller and added the buyer to the company's register of shareholders. The other model has that already been discussed in Part I, above: a centralized depository in which claims to securities immobilized in the depository's accounts are traded as book entries. Both models would have successfully eliminated the troublesome physical delivery of shares, but use of the first model would have required issuers themselves to actually "dematerialize" share certificates, whilst use of the second model allowed issuers to keep issuing paper, placing the burden on financial intermediaries to create a kind of feigned dematerialization by locking the paper certificates away in their vaults and electronically trading claims to the securities on their accounts.

In the 1970's, the electronic network model faced a number of significant obstacles: it required as a prerequisite that all securities traded on exchanges be dematerialized, it required a linked, secure computer network capable of carrying settlement information between the stock exchanges and the transfer agents at high speeds, and it would have (especially following the creation of the NASDAQ system) weakened America's troubled financial center, New York City, which was at the time approaching a default on its municipal debt.[73] The depository model was advocated by the Banking and Securities Industry Committee (BASIC), which was chaired by Morgan Guaranty Chairman John M. Meyer (one of the creators of

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68 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 183.

69 *See Id.* at 34 *et seq.*, 198. CUSIP numbers are assigned by the Committee on Uniform Security Identification Procedures, for which the acronym stands.

70 *See Id.* at 180; SEC STREET NAME STUDY, *supra* note 11, at 41 *et seq.*

71 *See* 17 CFR § 240.17Ad.

72 *See* SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 191 *et seq.*; Welles, *supra* note 23, at 320 *et seq.*

73 For a discussion of the New York debt crisis, *see* RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 619 *et seq.* (1990).

Euroclear, a successful depository-based settlement entity located in Brussels).[74] On behalf of the largest US banks, BASIC argued that the Central Certificate Service, which the NYSE had already set up, was the best way to ensure efficient settlement of transactions.[75] Because the most burdensome aspects of transferring shares are i) endorsing and delivering the old certificates, ii) registering transfers on the stockholders' list and iii) issuing new certificates, transfer was dramatically simplified by always keeping the shares in one place and in one name: preferably that of the central depository's nominee (later "Cede & Co.") or at least of one of its participating firms (referred to as "street names").[76] The logic of this model feeds strongly on economy of scale: the greater the percentage of a market's securities held in a single depository and registered in a single name, the greater the possible liquidity of the market in book-entry claims, and the more efficient the system.[77] Thus the most efficient exploitation of this model would be to place all outstanding securities of an economy into one depository and register them in the name of one person, so that transfers on that person's books would resemble a complete dematerialization of the market.[78]

The 1971 SEC Report explained that most market participants backed the model that would have used an electronic network to transfer dematerialized securities, but were concerned that it could not be implemented quickly and safely, given the state of the law and of technology in 1971.[79] The legal change would have required the corporate statutes of all 50 states to allow the issue of uncertificated stock. Also, a Rand Corporation Study called the proposal to eliminate stock certificates a "utopian solution",[80] arguing that shareholders have an unshakable psychological aversion to giving up paper.[81] As the NYSE's Central Certificate Service was already in operation, and was based on nothing more high tech than a bank's vault and a banker's fiduciary duties, it was eventually adopted, but as a "temporary" measure on the way to what was then called the "certificateless society".[82] The SEC Report summarized its findings:

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74 PETER NORMAN, PLUMBERS AND VISIONARIES: SECURITIES SETTLEMENT AND EUROPE'S FINANCIAL MARKET 41 (2007).

75 SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 184 *et seq.*

76 *See* LOSS & SELIGMAN, *supra* note 60, at §6-C-6.

77 *See* SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 187.

78 When considering BASIC's 1971 argument to make NYSE's Central Certificate Service the core of the US clearing and settlement infrastructure, the SEC explained that in the case of a centralized system based on the immobilization of certificates, "for maximum effectiveness, the depositories would have to encompass close to the maximum number of transactions effected in the marketplace in which it is designed to serve." *See id.* In 1980, the SEC repeated this opinion as a criterion for registering clearing agencies. *See* SEC Release No. 16900, cited in note 81, *supra.*

79 *See* SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 168, 173.

80 *Id.* at 194.

81 *See id.* at 194 *et seq.*

82 *See* SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 186.

> The many points of difficulty in the delivery and transfer process manifestly call for attack on various fronts: the expansion of facilities, the removal of artificial stumbling blocks; the modernization of those processes through the improvement of clearance procedures, the immobilization of the certificate through the advancement of the development of depositories, such as the NYSE Central Certificate Service, the development of machine readable certificates, and, hopefully, the ultimate achievement of a certificateless society.[83]

Given the damage caused by the "paper crunch" and the state of technology, it is not surprising that the depository-based model was initially adopted, especially considering its promotion by the country's leading banks following Morgan Guaranty's experience in creating Euroclear. However, this model was not adopted in a temporary way, subject to "hopefully, the ultimate achievement of a certificateless society," but was imposed in the very unusual way of the statute ordering use a specific technique that was currently debated rather than pursuit of a general principle or policy aim: As amended, § 17A Exchange Act requires the SEC to "use its authority . . . to end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities . . .",[84] i.e., to impose the immobilization of securities certificates in a depository. There is no mention of working towards eliminating such certificates or reinstating the previously-enjoyed transparency of shareholdings. Legislating specific technological models is very unusual given the rapid rate of technological change in the securities markets, and providing the expert details for solutions in that area is exactly the role of the SEC. The entire body of important and voluminous proxy rules hang on a small legislative hook of a summary delegation of power.[85] Nevertheless, §17A(e) Exchange Act made certain that the technique of immobilization was in the market to stay. In this way, what was considered an "interim step" on the way to the "certificateless society" became the permanent basis of US securities settlement.

A number of factors, both technical and political, contributed to this decision. It was certainly decisive at the time that a dematerialized market would have required amending the corporate laws of the states in which listed companies were incorporated so that they could issue uncertificated securities, but this does not explain the imposition of immobilization without provision for future review and adjustment. Certainly, the individual issuers' mismanagement of their own settlement processes in the lead-up to the paper crunch made transfer of this activity into a centrally managed SRO attractive. We have seen the regulators take similar steps recently with respect to derivatives trading.[86] However, as will be shown in Part IV, the

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83 *Id.* at 168, 203 ("... the ultimate objectives of the certificateless society and the standardization of documents used in the clearing, settlement and delivery process").

84 15 U.S.C. § 78q-1(e) (2000).

85 *See* §14(a) Exchange Act which outlaws behavior regarding proxies that violates "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n(a) (2000).

86 The Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, §723(a)(3), provides, for example: "It shall be unlawful for any person to engage in a swap unless that person submits such swap for

largest contributor to the permanent character that immobilization has taken was likely the fact that a depository-based system generates its negative effects in corporate governance, specifically affecting the exercise of shareholder rights, an area distant from, and usually not considered in the design of, the financial architecture.

C. The company that owns America: Cede & Co. and the system around it

Thus the depository model was chosen. A Central Certificate Service (CCS), which was operated by the NYSE was in 1973 transformed into The Depository Trust Company (DTC), and registered as a registered clearing agency with SRO status in 1983.[87] Deposited securities were registered in the name of "Cede & Company", DTC's nominee. During the same period, the National Securities Clearing Corporation (NSCC) was created to act as the clearing agent of the National Association of Securities Dealers (NASD). In 1999, DTC and NSCC became subsidiaries of a newly created holding company, the Depository Trust and Clearing Corporation (DTCC), which is a stock corporation staffed primarily by seconded officers of its customer-shareholders,[88] major US banks and brokers. NSCC currently serves as the central counterparty for the US securities markets.[89]

For the depository model to be truly effective, it must contain enough securities to enable a liquid market in claims on its accounts. As the SEC explained when backing the centralized, depository-based system for the US market, "for maximum effectiveness, the depositories would have to encompass close to the maximum number of transactions effected in the marketplace in which it is designed to serve."[90] In 1980, the SEC repeated this opinion as a criterion for registering clearing agencies.[91] Placing 100% of a market's securities in the hands of one entity and entering them all in its name obviates both the physical movement of securities and the need to change the stockholders list in connection with a transfer. With respect to paperwork, total immobilization has nearly the same effect as if all securities in circulation on the market had been dematerialized. Today this end has been achieved by DTCC. It has been estimated that

clearing to a derivatives clearing organization that is registered under this Act or a derivatives clearing organization that is exempt from registration under this Act if the swap is required to be cleared."

87 *See* Depository Trust Co., et al; Order, SEC Release No. 20221, File No. 600-1 et al. (Sept. 23, 1983).

88 DEPOSITORY TRUST & CLEARING CORPORATION, ANNUAL REPORT 2008, 52 *et seq.* (2009).

89 *See* National Securities Clearing Corporation, Rules & Procedures (version of Dec. 31, 2009), available at http://www.dtcc.com/legal/rules_proc (hereinafter "NSCC Rules"), Rule 2, Rule 8, Sec. 1, Rule 11, Sec. 1 (a). *See* also GUTTMAN, *supra* note 19, at §9:14, p. 9-27 *et seq.*

90 *See* SEC, UNSAFE PRACTICES STUDY, *supra* note 23, at 187.

91 Regulation of Clearing Agencies, SEC Release No. 16900, (June 17, 1980), published in Vol. 20 SEC Docket p. 434 (July 1, 1980) ("The clearing agencies registered with the Commission are essential to Congressional policy which includes a national clearance and settlement system for securities and the encouragement of broad scale participant [sic.] therein by securities professionals so as to reduce the physical movement of securities certificates. Such broad scale participation will result in the concentration of securities in a limited number of entities").

the DTCC system includes more than 99% of the depository-eligible securities in circulation on the US capital markets.[92] Since securities are now issued with the intention of introducing them into the DTCC system, they are certificated as "jumbo" or "global" certificates[93] that evidence millions of dollars of securities on one certificate, and whose size is limited only by the amount for which DTC can obtain insurance on a single piece of paper.[94] According to its 2009 annual report, DTCC and its subsidiaries held in custody securities valued at $33.9 trillion at year end,[95] down from $40.1 trillion in 2007,[96] the decrease likely being attributable to the market drop during the financial crisis, not to any downsizing. During 2009, the DTCC group processed an average of $92.3 million transactions each business day.[97] Overall, for 2009, DTCC settled transactions with a total value of about $1.48 quadrillion (i.e., 1.48 x 10^{15}).[98] NSCC serves as the central counterparty for trades settled on US markets.[99] NCSS has roughly 4,000 clearing participants[100] whose short and long positions against each other NSCC nets multilaterally, so that it must actually make deliveries only on the remaining, net positions through settlement accounts the participants hold with DTC and in the Federal Reserve System.[101] In 2009, NSCC succeeded in netting out 98% of the delivery value of the $209.7 trillion in settlement transactions it processed among the participants of the DTCC settlement network, making actual delivery of $5 trillion. [102] If the transactions are in certificated securities "deposited" with DTC, its nominee Cede & Co. remains the registered shareholder of all securities transferred.[103]

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[92] In 2004 DTCC's General Counsel Richard B. Nesson estimated that "somewhere North of 99%" of the depository-eligible securities in the United States were included within the DTCC system. SEC Historical Society, Fireside Chat: "Business Recovery Requirements for Clearance and Settlement in Light of September 11th" (Nov. 11, 2004), available at www.sechistorical.org. In 2000, the Securities Industry Association reported that approximately 83% of the securities traded on the NYSE were processed in the DTC system. SECURITIES INDUSTRY ASSOCIATION, SECURITIES DEMATERIALIZATION WHITE PAPER 17 (June 2000).

[93] UCC, Article 8 Prefatory Note, at Sec. 1.D.

[94] In early 2002, an employee of DTC told the author that the maximum insurable amount at that time for a single global certificate was $750 million.

[95] DEPOSITORY TRUST & CLEARING CORPORATION, ANNUAL REPORT 2009 at 27 (2010).

[96] DTCC 2008 ANNUAL REPORT, *supra* note 88, at 36.

[97] DTCC 2009 ANNUAL REPORT, *supra* note 95, at 15.

[98] *Id.* at 4.

[99] NSCC Rules, Rule 11, Sec. 1 (b). The transactions processed in the DTCC system include not only those of the NYSE and the Nasdaq Stock Market, but also those executed on the regional exchanges. DTCC 2008 ANNUAL REPORT, *supra* note 78, at 36. *See* also GUTTMAN, *supra* note 19, at §9:15, 9-31.

[100] *See* the NSCC Membership Directory (version of December 2009), available at www.dtcc.com.

[101] NSCC Rules, Rule 11. *See* also GUTTMAN, *supra* note 19, at §9:14, 9-28 *et seq.*

[102] DTCC 2008 ANNUAL REPORT, *supra* note 88, at 15.

[103] DTC Rules, Rule 6.

III. Damage Control for Corporate Governance: the SEC's Shareholder Communication Rules

A. Serious conflicts with corporate law

As noted in Part I, stock corporations exist and their internal affairs are operated pursuant to state law.[104] Under state corporation law, a shareholder is defined as someone who is registered on the stockholders list,[105] not a person who has title to shares. The same principle holds true for state commercial law, where the Uniform Commercial Code (UCC) gives an issuer the right to deal solely with the registered shareholder in respect to rights arising out of a share of stock.[106] As explained above, Congress ordered that shares traded on exchanges be immobilized, which obviates both physical delivery of certificates and registration of transfer, as the shares usually remain registered in the name of a depository or its nominee. This process creates a discrepancy between ownership of the share itself (economic or beneficial ownership) and the legal status as shareholder (registered stockholder).[107] This is the primary reason behind use of the famous dichotomy between "registered" and "beneficial" ownership in SEC regulations. Today, it is wholly possible that a listed company will have only one registered shareholder, "Cede & Co."

The content of the stockholders list, which derives from the fact that the company issues registered shares, is eliminated through this process. However, pursuant to corporate law it is exactly this list that plays a crucial role in communication with and between shareholders. The names, addresses and holding positions of shareholders are supposed to be used to send shareholders invitations to annual meetings and determine who may vote and receive dividends.[108] They should also be available to shareholders to enable them to contact their fellow shareholders directly, so that they can organize for the exercise of their rights.[109] The information is likewise valuable for issuers and market stability because it allows issuers to communicate with their existing investors regarding the state of the company. Because under §14 Exchange Act the SEC is charged with regulating the proxy process, the imposition of immobilization also challenged it to find ways that issuers could communicate with shareholders despite the fact that

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104 CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 70 (1987); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (refusing to apply the federal securities laws to matters of internal corporate management), citing Cort v. Ash, 422 U.S. 66, 84 (1975).

105 *See supra* note 4.

106 UCC §8-207(a) (2005). It should be noted, however, that this rule does not place formal registration above a reasonable analysis of the circumstances. If a buyer demonstrates to the company that she has purchased the a share from the registered owner, this will be sufficient to rebut the presumption in favor of the registered owner. *See* UCC §8-207(a), Off. Comm. No. 2 (2005). *See* also GUTTMAN, *supra* note 19, at § 1:5, 1-16, § 2.2, 2-8; Estate of Bridges v. Mosebrook, 662 S.W.2d 116, 120 (Tex. App. Fort Worth 1983); Johnson v. Johnson, 764 S.W.2d 711, 715 (Mo. Ct. App. E.D. 1989).

107 *See* Egon Guttman, *Transfer of Securities: State and Federal Interaction* 12 CARDOZO L. REV. 437, 451 *et seq.* (1990).

108 *See* e.g., Del. Code Ann. tit. 8, §§ 213, 219.

109 *See* e.g., Del. Code Ann. tit. 8, §220.

stockholder lists no longer provided the requisite information. The result has become a web of complex rules weaving proxy communication and voting through the chain of brokers, banks and depositories comprising the "indirect holding system." This pass-it-along technique of communications, discussed in detail below, is so inefficient that it spawned its own industry – proxy service companies – which feed off the difficulties issuers and shareholders experience under the SEC regime.

B. Distributing proxies to the clients of intermediary shareholders

Even before Congress adopted the 1975 Securities Acts Amendments, the SEC had drafted a rule that would have required intermediaries to disclose shareholder information to issuers.[110] Following approval of the Act, the SEC then discussed broadening the applicability of the disclosure rules adopted under § 13(d) Exchange Act in order to provide information regarding shareholders other than those with large holdings who intended to influence management.[111] Neither of these paths was ultimately followed. Rather, beginning in 1974, the SEC began to build on the common law principles expressed in cases such as *Walsh and Levine v. Peoria and Eastern Railway Company*,[112] which required issuers, when sending out proxy materials, to inquire beyond the wall of intermediaries they found in the stockholders list and request that those intermediaries pass along the proxy documents to their clients.

The first rule that was adopted, Rule 14a3-(d) (now Rule 14a-13),[113] requires issuers whose stockholders list contains the name of a clearing agency to ask the latter for a list of the agency participant entities that hold the issuer's shares.[114] The issuer must then ask the entities named by the clearing agency, together with any intermediaries directly entered in the shareholders register, whether they hold stock for clients, and if so, to specify the number of proxy material packages required for such clients.[115] The issuer must then provide the specified quantity of materials to the intermediaries or their agents and reimburse them for the distribution.[116] This issuer duty originally piggybacked on existing exchange rule duties of brokers to provide information regarding required quantities of proxy materials and to forward such materials to their clients, but left a gap where no such exchange rule applied, such as for issues traded on the OTC markets.[117] After about three years, the Commission filled this gap by adopting Rule 14b-1.[118]

110 RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL §8.02[B] (3rd ed. 1998, Supp. 2001).

111 *See* the Street Name Study, *supra* note 11, at 6, 52.

112 Walsh & Levine v. Peoria & Eastern Railway Co., 222 F. Supp. 516 (S.D.N.Y. 1963).

113 Originally adopted with Exchange Act Release Nr. 11,079, *supra* note 12, and now codified at 17 CFR § 240.14a-13. *See* also LOSS & SELIGMAN, *supra* note 60, at §6-C-6.

114 17 CFR § 240.14a-13, Note 1.

115 17 CFR § 240.14a-13(a)(1).

116 17 CFR § 240.14a-13(a)(4)-(5).

117 THOMAS & DIXON, *supra* note 110, at §8.02[B], footnote 78.

118 Originally adopted by Exchange Act Release No. 13,719, *supra* note 12, now codified at 17 CFR § 240.14b-1.

This rule requires brokers to inform issuers of the number of proxy material packages necessary for their clients and – upon receiving assurance of reimbursement – to forward the packages to such clients.[119]

Another, perhaps more well known provision of this rule appears to create the disclosure that would enable direct communications, but regretfully does not. In 1983 the SEC amended Rules 14a-13 and 14b-1 to give issuers a right to ask brokers to provide them with a list of those client-shareholders who did not object to their identities being disclosed to the issuer ("Non-Objecting Beneficial Owners," or "NOBOS").[120] This would seem to have solved much of the communications problem except for the significant catch that the NOBO list may be used solely for the limited purpose of sending the annual report or "voluntary" communications.[121] The proxy statement[122] or information statement,[123] as the case may be, must still must be distributed *indirectly* through the intermediaries, although nothing but cost would prevent an issuer from sending an identical second copy of proxy materials directly to the names on the list.[124] The late Professor Louis Loss and Dean Joel Seligman rightly criticized this limitation as a missed opportunity to support direct communications.[125] Perhaps what holds the SEC back from allowing direct dispatch of proxy cards is that the recipients (beneficial shareholders) would in any case not be shareholders under corporate law, and thus could not cast votes without receiving a proxy from the registered shareholder – the intermediary.[126] The same difficulty reappears in the 2007 Rule on the Internet Availability of Proxy Materials,[127] pursuant to which the proxy materials themselves may be posted on a website, but a Notice of Internet Availability of Proxy Materials must be sent indirectly through the record holding intermediaries.[128] As long as state corporation law provides for registered shares, and shares are registered in the name of an intermediary, communication will remain disrupted and at best indirect. The

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119 17 CFR § 240.14b-1(b).

120 Originally adopted by Exchange Act Release No. 34-20021, *supra* note 12, now codified at 17 CFR § 240.14b-1(b)(3)(i) in connection with § 240.14a-13(b)-(c).

121 17 CFR § 240.14a-13(c).

122 17 CFR § 240.14a-101.

123 17 CFR § 240.14c-101.

124 *See* GUTTMAN, *supra* note 19*, at* , § 2:2.

125 LOSS & SELIGMAN, *supra* note 60, at §6-C-6.

126 Some might object to the weight that is here placed on *registered* shareholders by pointing to § 7.23 Revised Model Business Corporation Act, which allows corporations to "establish a procedure by which the beneficial owner of shares that are registered in the name of a nominee is recognized by the corporation as the shareholder." However, the only way that this could be done would be through the registered shareholder. Thus, (1) the nominee would have to prove it was the registered holder and (2) the beneficiary would have to prove that he enjoyed a contractual or property right to benefit from the nominee's holding. Such provisions do not eliminate the necessity of registration, but actually add to it the necessity of also being registered in the account of the intermediary.

127 Final Rule: Internet Availability of Proxy Materials, Exchange Act Release No. 34–55146, 72 Fed. Reg. 4148 (Jan. 29, 2007). (hereinafter "Internet Publication Rule").

128 17 CFR §240.14a-16(a)(2); §240.14b-1(d); §240.14b-2(d) .

SEC seems to have realized this by promoting a European style mode of communication through general publication,[129] as is used in legal systems that issue bearer shares, which provide the issuer no information regarding the identity of its shareholders, but the move towards an anonymous bearer share model is a serious mistake in an era when most securities exist only electronically – i.e., on registers – which requires attribution to a name or other designation for ownership.

Another problem with the distribution of proxy materials pursuant to Rule 14b-1 is of course that not only brokers, but also banks, hold shares in custody for clients. Because the SEC does not have primary jurisdiction over banks, they were not covered by Rule 14b-1. To fill this gap in the communications chain, Congress enacted the Shareholder Communications Act of 1985, which gave the SEC authority to adopt a rule like 14b-1 that would apply to banks.[130] As a consequence, the Commission in 1986 adopted Rule 14b-2, which is closely modeled on the twin rule for brokers, with a single exception.[131] Rule 14b-2 not only requires information on numbers of necessary packages, the forwarding of such packages, and the generation and delivery of NOBO lists, but it also requires banks to reveal any respondent banks for which they hold shares and imposes similar duties on such respondent banks.[132] This allows issuers to follow the chain of intermediaries from a large international bank that belongs to DTC to the regional banks with which the beneficial shareholder has her direct account relationship. Oddly, a like duty was never added to Rule 14b-1 to allow issuers to look for further intermediaries beyond the large clearing brokers.[133]

The complexity of this pass-it-along system created a niche for a new form of business. Automatic Data Processing (ADP) entered the shareholder communications business in the 1980's to profit from issuers and intermediaries that did not wish to perform this extremely cumbersome process themselves.[134] ADP spun off its shareholder communication activities to Broadridge Financial Solutions, Inc. on March

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129 *See* section B.4, *infra*.

130 The Shareholders' Communication Act of 1985, P.L. 99-222, 99 Stat. 1737, codified at 15 U.S.C. §78n.

131 Originally enacted in Exchange Act Release No. 34-23847, *supra* note 12, now codified at 17 CFR § 240.14b-2.

132 17 CFR § 240.14b-2(b)(1)(i). Another difference that is perhaps still worthy of note is that for trust accounts opened on or before December 28, 1986, clients must give affirmative consent (as opposed to not objecting) in order that their names be disclosed to the issuer. *See* 17 CFR §240.14b-2(b)(1)(ii)(B)(1).

133 This problem was raised over 10 years ago by Shaun M. Klein, *Rule 14b-2: Does It Actually Lean to the Prompt Forwarding of Communications to Beneficial Owners of Securities?* 23 J. CORP. L. 155, 169 (1997).

134 For a description of ADP's activities, *see* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC AND THE PUBLIC CORPORATION §18:13 (updated to 2005). In its annual report for 2006, the last year before ADP spun off its proxy services to Broadridge, ADP announced that it: "Served the investor communications needs of approximately 13,000 U.S. publicly traded corporations and 450 mutual funds and annuity companies, on behalf of more than 850 brokerage firms and banks. Distributed nearly 1.1 billion pieces of investor communications materials. . . , including proxy ballots covering more than 565 billion shares [and] Delivered nearly 50 million investor communications via the Internet . . . ." Automatic Data Processing, Focus on Growth: 2006 Summary Annual Report (2007), available at http://www.investquest.com/iq/a/adp/fin/annual/index.htm.

30, 2007.[135] Thus the private sector quickly moved in to profit from the need to comply with the SEC's shareholder communication rules.[136] In this regard, it is useful to keep in mind the sequence of events: corporate law had always provided for direct communications with shareholders, and to do so relied on the information in registered shares. Trading volume made the transfer of certificated registered shares impossible to continue. A new industry of intermediaries was created to hold and manage the paper certificates, which facilitated exchange trading, but regretfully disrupted the issuer-shareholder relationship. Because these intermediaries disrupted direct communication, they and other companies sold communication and "corporate action" services back to the issuers. In this way, the financial industry profited from its own negative externalities: this is comparable to a company that pollutes a community's water setting up a for-profit clinic to treat the digestive problems resulting from impure water, or a logistics company that digs a canal through the center of a city to facilitate its distribution network then building toll bridges over the same canal.

The process of shareholder communications foreseen by the corporation laws of the 50 states is unambiguous: First, look in the stockholders list for names and addresses, and second, send the materials to those persons at those addresses. After the proxy rules were bent around the indirect holding system, the process turned into a complex parlor game of pin the proxy on the beneficiary. There are three important rules in this game: First, the issuer plays blindfolded, and cannot know what lies beyond the next wall in the intermediary pyramid before making an inquiry – inquiry always precedes communication. Second, the registered shareholder's right to cast votes under corporate law is directly contradicted by the beneficial owner's right to cast votes under the Exchange Act, and probably also under the voting provisions of custody and brokerage agreements. This last rule means that during an annual meeting a basket of votes and instructions received from various levels of the pyramid will have to be sifted and matched against the actual number of votes that the registered owner (perhaps solely Cede & Co.) may cast. Third, the shareholders' meeting has a real purpose for corporations, and the time span between fixing the shareholders of record entitled to vote and the actual meeting must be between 10 and 60 days in most jurisdictions.[137] This framework was designed for direct communication between issuer and shareholder; any time remaining after distribution of the materials is meant to allow the shareholder to think over her

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135 *See* Form 10-K of Automatic Data Processing, Inc. for the fiscal year ended June 30, 2007, available at www.sec.gov.

136 *See* J. Robert Brown, *The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility?* 13 J. CORP. L. 683, 758 (1988); Klein, *supra* note 133, at 175 *et seq.*; LOSS & SELIGMAN, *supra* note 60, at §6-C-6; The Business Roundtable, Request for Rulemaking Concerning Shareholder Communications, SEC File no. 4-493 (April 12, 2004). A more recent addition to the literature refers to the system of suffering from a "pathology of complexity". *See* Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1249 *et seq.* (2008).

137 *See* e.g., Del. Code Ann. tit. 8, §222(b) and Model Business Corporation Act §7.05(a).

decision, not to accommodate multiple levels of processing, inquiry, distribution and redistribution within a maze of intermediaries.

For illustrative purposes, the following list briefly sets out the steps to be taken in the current inquiry and forwarding process under Rules 14a-13, 14a-16, 14b-1 and 14b-2. ***

1. Weaving inquiries, information, and instructions through the depository pyramid

One: The stockholders list may well contain one name, "Cede & Co.", so Rule 14a-13 requires that the issuer contact DTC at least 20 business days prior to the record date of the shareholders' meeting to request a securities position listing specifying the names of its participant firms that hold the issuer's stock for beneficiaries (often referred to as a "Cede breakdown").[138]

Two: DTC must promptly furnish the securities position listing to the requesting issuer and collect a fee designed to recover the reasonable costs of providing the listing.[139]

Three: Still within the timeframe of 20 business days before the record date, the issuer must ask the banks and brokers on the position listing whether they hold for beneficial owners and if so, the number of copies of the proxy materials necessary for supplying such beneficial owners, as well as whether any banks on the listing hold for a respondent bank.[140]

Four: Banks must within one business day provide the names and addresses of each respondent bank that holds the issuer's securities for beneficial owners.[141] Both banks and brokers must within seven business days provide the number of their customers who need proxy materials and, if requested, a NOBO list for the issuer to distribute its annual report.[142]

Five: Within one business day of receiving the name and address of a respondent bank, the issuer must ask such bank for information as in step Three.[143] Respondent banks must then follow step Four, providing information on any further respondent banks and numbers of beneficial owner customers. This process of pass-it-along offers ample opportunities for error, the details of which will be discussed in more detail below. As the SEC cautiously expressed it in July 2010: "Once the search card process is complete, the issuer *should* know *the approximate number* of beneficial owners owning shares through each securities intermediary."[144] Although a slim margin of votes may indeed be decisive for a crucial corporate decision

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138 17 CFR § 240.14a–13(a)(3)(i) and Note 1.

139 17 CFR § 240.17Ad–8(b).

140 17 CFR § 240.14a–13(a)(1)(i).

141 17 CFR § 240.14b–2(b)(1)(i).

142 17 CFR § 240.14b–1(b)(1) applies to brokers and 17 CFR § 240.14b–2(b)(1)(ii) applies to banks. *See* Brown, *supra* note 136, at 740 *et seq.*

143 17 CFR § 240.14a–13(a)(2).

144 SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42987, emphasis added.

on a disputed transaction, the pass-it-along process does not lead to exact figures, but as the SEC phrases it, an issuer *should know the approximate number* of shareholders voting. Next, the issuer must supply, in a timely manner,[145] each intermediary with copies of the proxy materials in the quantities and at the place(s) named,[146] approximate or not. If the issuer intends to make the proxy materials available by internet, it must also provide the brokers and banks with the information necessary to prepare and send out a "Notice of Internet Availability of Proxy Materials" well before the shareholders' meeting.[147]

<u>Six</u>: Provided they are paid a fee to cover reasonable costs,[148] the intermediaries must now distribute the materials within five days of receipt to their beneficial owner customers.[149]

<u>Seven</u>: the customers of a clearing brokerage may very likely be retail brokers who in turn hold shares for individual, retail investors. Even though Rule 14b-1 does not require inquiry down the entire chain to the retail customer, contractual duties and exchange rules would likely require further distribution of the proxy materials to the beneficial owner of the stock. In the case of a bank, this step would be required by Rule 14b-2.

<u>2. Votes and voting instructions given by the clients of intermediaries (beneficial shareholders)</u>

Since only shareholders of record can vote,[150] and in our example Cede & Co. is the only shareholder of record, it is necessary for Cede & Co. to give its participants an "omnibus proxy",[151] which covers all the shares a given participant holds with DTC. The participant institutions would then issue further proxies to their customers or, more likely, request voting instructions from them.[152] Rule 14b-2 expressly requires that banks provide their respondent banks with "omnibus proxies" so that they can exercise the voting rights of the shares in question.[153] Although Rule 14b-1 does not contain a corresponding provision for brokers, stock exchange rules would normally require a broker to issue a proxy or request voting instructions when

145 The SEC has defined "timely manner" in this case to mean: "mailed sufficiently in advance of the meeting date to allow five business days for processing by the banks and brokers and an additional time to provide ample time for delivery of the material, consideration of the material by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator." Securities and Exchange Commission, Timely Distribution of Proxy and Other Soliciting Material, Exchange Act Release No. 34-33768, 59 Fed. Reg. (March 22, 1994).

146 17 CFR § 240.14a–13(a)(4).

147 17 CFR § 240.14a–16(a).

148 17 CFR § 240.14b–1(c)(2)(i) applies to brokers, and 17 CFR § 240.14b–2(c)(2)(i) applies to banks.

149 17 CFR § 240.14b–1(b)(2) applies to brokers, and 17 CFR § 240.14b–2(b)(3) applies to banks.

150 *See* e.g., Del. Code Ann. tit. 8, § 213(a) and §219(c).

151 This is done in practice, although it is not yet expressly required by law. *See* Kurz v. Holbrook, 989 A.2d 140, 170 (Del. Ch. 2010), rev'd on other grounds*,* Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377 Del. 2010), discussed in SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42987. Also *see* THOMAS & DIXON, *supra* note 110, at §8.02[A]; Brown *supra* note 136, at 753.

152 SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42987 *et seq*.

153 *See* 17 CFR §240.14b-2(b)(2)(i).

forwarding the proxy materials to a customer.[154] In our example, a retail investor is casting a vote, but in the case of a mutual fund, the fund manager would likely have power to vote under the investment adviser contract,[155] which would add another level of complexity to the process because there would be a further split between beneficial ownership in the fund and voting discretion in the manager.

The final steps in the pass-it-along communication game are thus as follows:

Eight: Together with the proxy statement and the annual report (if the latter is not sent directly through a NOBO list), the beneficial owner will receive a voting instructions form, or less likely, a signed proxy card, which must be filled out and returned. She will then provide instructions or cast her vote and return the completed forms either to the proxy service acting for the broker, her broker, or the company.

Nine: If the materials are returned to the broker, it must gather the voting instructions or proxies and pass them along to the proxy service, the issuer, its transfer agent or vote tabulator.

Ten: Either the transfer agent or vote tabulator will tabulate any instructions[156] and forward them together with any completed proxy cards not sent directly to the meeting. All costs for each step of this process, including the fees of a proxy service, are borne by the issuer, and thus indirectly by the shareholders.[157]

As mentioned above, this process will likely be handled from start to finish by a proxy service of the type that has stepped in since the 1980's to help issuers and intermediaries with this process.[158] They root out the names of beneficial owners,[159] build lines of communication between intermediaries,[160] and collect proxy cards and tabulate voting instructions.[161] When an annual meeting is approaching, they – rather than the issuer itself – may well set the process in motion.[162] As discussed in Part IV, the SEC sees these

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154 *See* e.g., NYSE Rules, Rule 451(b)(2).

155 Amit Goyal & Sunil Wahal, "The Selection and Termination of Investment Managers by Plan Sponsors," November 2004, p. 2 available at http://ssrn.com/abstract=675970; Nell Minow, *Institutional Investors: New Tactics and Old Duties*, p. 107 Practicing Law Institute (1998); John C. Coffee, Jr., *Taking Stock: Reflections on Sixty Years of Securities Regulation*, 15 CARDOZO L. REV. 837, 861 (1994); John C. Coffee, Jr., *Liquidity Versus Control: the Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1310 (1991).

156 SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42988.

157 THOMAS & DIXON, *supra* note 110, at §8.03[C].

158 For a description of Broadridge's role in this process, *see* Kahan & Rock, *supra* note 136 at 1244 *et seq.*

159 At least in the past, proxy services could compare information on account movements over a number of years with published information on holding levels, deduce the beneficial owners from the correlation and then sell this information to issuers. *See* JAMES E. HEARD & HOWARD D. SHEARMAN, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM 84 *et seq.* (1987).

160 *See* the description of proxy services at Georgeson Shareholder, www.georgesonshareholder.com.

161 Paul Myners reported in 2004 that approximately 90% of US institutional investors cast their vote through ADP. PAUL MYNERS, REVIEW OF THE IMPEDIMENTS TO VOTING UK SHARES, REPORT TO THE SHAREHOLDER VOTING WORKING GROUP 4 (2004).

162 BLOOMENTHAL & WOLFF, *supra* note 134, at §18:13.

entities as key partners in its regulatory activity. Indeed, when recently amending its rules on internet availability of proxy materials, the SEC heavily relied on information and advice from Broadridge Financial Solutions, which dominates proxy distribution services with 98% of the market,[163] and in its brief presentation of the amended rule the word "Broadridge" appears 18 times, while the word "vote" only appears 10 times.[164] Without private services, the pass-it-along process would likely not function, and the existence of this proxy industry attests not only to the dimension of the negative externalities generated by the depository model (they are sufficient to support an entire industry that feeds off the inefficiencies), but also to the virtues of a free market for services. However, we must make no mistake that these are negative externalities of immobilization which need not every have existed. Section 17A(e) Exchange Act, by mandating the indirect holding system, did provide a quick solution to avoid another "paper crunch", but it eliminated the governance function of registered shares. Rules 14a-13, 14a-16, 14b-1 and 14b-2 are costly, cumbersome and ultimately ineffective tools to bring that function back. The problem and its solution lie with the structure itself, not with indirect communications or the privately run services that have made the structure workable (at the issuers' expense). In another area of the law, it would seem odd that a regulator discuss its rules with an exaggerated wink at the fact that everyone knows private companies really create an alternative route. It would be difficult to imagine the US Immigration and Naturalization Service, in assessing the quality of its rules for obtaining a US working visa, to base its evaluation on information provided by professional handlers who bring foreign labor to the industries that employ them.

3. The costs of communicating through intermediaries

Fees sufficient to support an industry of proxy services are not the only costs of communicating around and through the indirect holding system. The negative effects of such communication are much higher: votes are lost and miscounted, information is distorted, and shares can be loaned in such a way as to cut against the very interests of the "beneficial" shareholders. Two relatively recent studies of the field offer significant evidence of how introducing intermediaries between issuers and shareholders reduces the time each participant has to fulfill its respective statutory duties and increases the probability of mistakes.

In 2004, Paul Myners prepared a study on the exercise of voting rights in the United Kingdom.[165] It states that in the 2003 annual meeting of Unilever plc, the high number intermediaries participating in distributing the information on the meeting and casting shareholder votes led to a significant number of the votes not being recorded, i.e., being lost.[166] Evidence presented to the Department of Trade and Industry showed that in connection with the Unilever annual meeting records indicated that the 10 largest

[163] SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42988, note 57.

[164] Final Rule: Amendments to Rules Requiring Internet Availability of Proxy Materials, SEC Release Nos. 33–9108; 34–61560, 75 *Fed. Reg.* 9074 (Feb. 26, 2010).

[165] MYNERS, *supra* note 161.

[166] *Id.* at 6.

institutional investors had apparently cast less than 50% of their votes. Unilever contacted these investors and inquired why they chose not to vote, but the investors' records showed that relevant intermediaries never received the voting instructions of three of the investors.[167] Myners found that the major problem affecting the exercise of voting rights was the "large number of participants through whom information and votes must pass," which is a result of how the securities custody and settlement system is set up.[168] As he explains:

> There is little transparency in the process. Where a custodian is appointed, the registered or legal owner of the shares (and hence the person recognised by the issuer's registrar as entitled to vote) is normally the custodian's nominee company. The registrar may well not be aware of the identity of the beneficial owner nor will it necessarily know who is the person responsible for the voting decision (in many cases the investment manager).[169]

Myners found that the best way to avoid the problems resulting from opaque layers of intermediaries is for the shares to be specifically designated in the name of the person entitled to vote them.[170] Specifically designating a part of a global account would do much to reinstitute the direct relationship that is broken by immobilization. As the efficiency of immobilization comes from having the shares in one name, and thereby both avoiding physical delivery of certificates and registration of transfer, however, a specific designation subdividing a larger custody account would thus create some additional costs for transfer services. Myners concluded that at least in the case of the largest 200 Pension Funds, designating the fund or its manager as entitled to exercise voting rights would bring "considerable benefits in terms of voting transparency, audit trail and corporate governance for little incremental cost."[171]

Another 2004 study, by Oxford Economic Research Associates (Oxera) focused on "corporate actions", which is a term used by the settlement industry to designate all actions requiring communication between issuers and shareholders, such as rights issues, tender offers, conversions, mergers, early redemptions and dividend payments.[172] Oxera found that corporate actions involve "a range of intermediaries that operate between the issuer and the final investor. The corporate action chain is highly complex, probably *because of the way in which it has been formed over time* in response to market and institutional challenges."[173] We have seen that immobilization was introduced as a kind of *faux* dematerialization of paper certificates through the vaults, accounts and books of intermediaries. At the

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167 *Id.* at 1.

168 *Id.* at 6.

169 *Id.* at 6. For a recent discussion of the complexities of the US voting system, see Kahan & Rock, *supra* note 136, at 1249 *et seq.*

170 MYNERS, *supra* note 161, at 16.

171 *Id.* at 16.

172 OXFORD ECONOMIC RESEARCH ASSOCIATES (OXERA), CORPORATE ACTION PROCESSING: WHAT ARE THE RISKS? 4 (2004).

173 *Id.* at 8.

time that Oxera performed its study, a number of markets had been completely dematerialized, and the depository-based structure was no longer a technological necessity, but the remnants of an historical process. As the previous section also made clear, the result of this structure is that issuers are blindfolded: "most issuers will only have information on the custodian nominees . . . they cannot observe directly through the register/agent who the ultimate beneficiary investor is."[174] The result is a process in which each member of the chain only sees its next proximate link and only the proxy service companies have an idea of the entire process from start to finish. An issuer or broker at position 3 cannot know if the information from position 1 was altered by passing through position 2. As Oxera observes, this process gives rise to the following operational risks:

- failure in the processing of a voluntary corporate action (or mandatory corporate action with options), such as the exercise of a conversion right;
- late payment of mandatory corporate actions, such as dividend payments;
- sub-optimal trading decisions by the front office, arising from corporate action information failures, such as an instruction to accept a tender offer being lost or changed; and
- failure to exercise shareholder rights, which may have an impact on the effectiveness of corporate governance.[175]

Such errors can enter the intermediary chain from upstream (as information flows from issuer to shareholder) or downstream (as information flows from shareholder to issuer).[176] The preceding section showed that, in the case of distributing proxy materials through a chain of banks and respondent banks, the more links in the intermediary chain the shorter the period each link in the chain will have to perform its required duties for a corporate action.[177] There are tight practical and legal limits on how far in advance a call to meeting or solicitation of proxies may be dispatched. Once this period is segmented and allocated out to the pass-it-along process running over many links in the intermediary chain, little will be left for shareholder decision-making, which is the entire point of the process. Moreover, as we saw with the bifurcated request that must be made to banks under Rule 14a-13, asking (i) the number of materials necessary and (ii) information on respondent banks, the very number and multiplication of types of intermediaries increases the amount of inquires that must be made and the information that must be passed along. The result of having to process more information within shorter deadlines is of course error.[178] Also, once an error enters the information flow, it tends to be passed on and multiplied both in the downstream and in the returning upstream information flows. Oxera estimated in 2004 that failures in

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174 *Id.* at 10.

175 *Id.* at 12.

176 *Id.* at 12.

177 *Id.* at 14.

178 *Id.* at 12.

processing corporate actions could cost the European asset management industry between € 90 million and € 143 million per year.[179]

The answer from the side of the intermediaries has of course not been to reduce their presence and create a direct relationship between issuers and shareholders, in spite of the introduction of a direct registration option, as will be discussed in Part IV.B. Rather, they have added "services" like "information scrubbing" to counteract the negative effects of their presence. In this way, they multiply the costs borne by issuers. Oxera reported in 2004 that a single intermediary may employ up to 40 persons for the sole purpose of "scrubbing" information to reduce errors and increase accuracy.[180] The more sources and types of information that are forced through an intermediary, however, the greater the challenge for scrubbing. As DTCC stated in its 2006 annual report, its "corporate action experts provide 'round-the-clock support, in 16 languages" and in 2006 "provided 'scrubbed' information on about 900,000 events from 160 countries."[181] The industry generally finds that DTCC performs this task as well as anyone could expect. The question is, however, whether a single company, or indeed the financial industry, should be in possession of all the nation's information regarding security holdings and whether another company should control 98% of the market that exploits this information for corporate governance purposes. This unusual circumstance stems from an infrastructure the SEC referred to as a "temporary" measure in 1971, a measure which is obsolete and damaging today.

Although studies like the Myner and Oxera reports have not been prepared with respect to the US market, which is the principal focus of this paper, the disruption that the intermediary chain causes for the shareholder voting is well documented in judicial opinions. One of the better known examples is found in the Delaware case of *Blasius Industries v. Atlas Corporation.*[182] As the Court of Chancery noted in that case, "[t]he multilevel system of beneficial ownership of stock and the interposition of other institutional players between investors and corporations . . . renders the process of corporate voting complex."[183] *Blasius* involved a raiding 9% shareholder (Blasius) with a bad idea – to heavily leverage the company (Atlas) and use the proceeds to pay shareholders as a special distribution – waged a "proxy fight" against management using consents pursuant to §228 Delaware General Corporation Act.[184] Both sides solicited consents and amended solicitations that answered the solicitation of their opponent, constituting two

179 *Id.* at 29.

180 *Id.* at 11, 13 ("These resources represent an inefficiency in the system").

181 DEPOSITORY TRUST & CLEARING CORPORATION, ANNUAL REPORT 2006 31 (2007). By 2009, this had dropped to 118 "countries and territories." *See* DTCC 2009 ANNUAL REPORT, *supra* note 95, at 5.

182 *Blasius* Industries *v. Atlas Corp.*, 564 A. 2d 651 (Del. Ch. 1988).

183 *Blasius*, 564 A.2d at 668.

184 *See* Del. Code Ann. tit. 8, § 228.

mailings each to shareholders.[185] Thus, if a shareholder answered all the solicitations, he or she could have sent in four different votes: one on the management consent card, another on the challenger card (which had the effect of revoking the first consent), yet another on the amended management card (thus revoking the second consent), and a final one the amended challenger card (revoking the third consent). The problem arose primarily from the fact that the financial intermediary in whose names the shares were registered did not earmark consents to the customer subaccounts for which the shares of Atlas registered in the institution's name were held.[186] Thus, because less than 100% of the beneficial owners sent in consent cards on the first round, the election inspectors were unable to ascertain whether the second round of consent cards were fresh votes from beneficial shareholders who did not vote on the first round or new votes that revoked consents given on the first round.[187] The arrival of consent cards in the third and fourth rounds of the voting process complicated the problem even further. If each beneficial owner was also a registered shareholder, calculating the votes would be a simple and accurate process, but with pools of shares in which unknown persons issued voting instructions, even the most thorough calculation of the vote was riddled with guesswork. The reality of this situation makes the great efforts spent debating active investment and the value of engaged voting for good corporate governance look rather empty, as their exercise is greatly subject to random occurrences.

The anonymity, complexity and uncertainty created by the indirect holding system is aggravated by share lending and the related practice of short selling. The case of abusive "naked" short sales (i.e., selling shares that one neither owns nor has borrowed), in particular, illustrated a direct conflict between the interests of issuers and shareholders on the one hand, and those of the intermediaries on the other, with respect to the depository system. In 2004, a number of listed companies detected irregular share prices swings that they attributed to manipulative short sales of shares held through layers of intermediaries, and they used the only tool they had at their disposal "to protect their shareholders and their share price from 'naked' short selling" and restore confidence to the market – transfer restrictions under state corporation

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185 *Blasius*, 564 A.2d at 664.

186 *See Blasius*, 564 A.2d at 665.

187 *Id*. Perhaps a simple, numerical example is helpful here. Suppose Broker A holds 2000 shares of Company C for its customers. Because it is the registered shareholder, it signs the proxy or consent cards received from Company C or an opposing shareholder and sends them out to its customers. In the first round, customers of Broker A sign and send in to Company C proxy cards for 1000 shares. In the second round, reacting to the opponents' recommendations, customers of Broker A then send in to Company C proxy cards for 1000 shares. If the shares cannot be linked to specific customers of Broker A, it is impossible to know whether these 1000 proxy cards (i) are new and in addition to the votes on the first round, (ii) refer to the same shares as in the first round and thus revoke the first proxy cards, or (iii) are in part new and in part revoke the original proxy cards. If, in the third round, Company C receives another 1000 proxy cards, any accurate attribution of the newly received votes is impossible. This, however, is an extremely simple example. In *Blasius*, each consent card contained five items up for vote, and thus a new card could revoke some, but not all, of the items on the previous card, which dramatically multiplies the difficulty of counting the votes.

law to be applied unless the beneficial shareholder was registered.[188] In adopting a rule to prohibit such issuer self-help, the SEC swept aside their apprehension of damage to investor confidence and patiently reiterated the doctrine of beneficent intermediaries:

> The use of securities depositories in order to minimize the physical movement in connection with the settlement for securities traded in the public market is essential to the prompt and accurate clearance and settlement of securities transactions. The effort by some issuers to restrict ownership of publicly traded securities by securities intermediaries can result in many of the inefficiencies and risks Congress sought to avoid when promulgating Section 17A of the Exchange Act. Restrictions on intermediary ownership deny investors the ability to use a securities intermediary to hold their securities and to efficiently and safely clear and settle their securities transactions by bookentry movements.[189]

Of course, after the demise of Bear Stearns and Lehman Brothers, the latter triggering the worst financial crisis in a century, the SEC began to think differently about measures restricting "naked" short sales. Mirroring the concerns of the issuers whose efforts the SEC blocked in 2004, it explained that naked short selling can cause "unexplained declines in the prices of equity securities … deterioration in investor confidence in our financial markets …. giv[ing] rise to questions about the underlying financial condition of an entity, which in turn can create a crisis of confidence even without a fundamental underlying basis."[190] At the time, however, the legitimate concerns of issuers about the dangers of the indirect holding system were essentially ignored in light of a strong belief in the depository model. The reasons for such seeming unawareness of the model's dangers will be discussed in Part IV, below.

4. The SEC's neo-bearer share model is no solution

Given the costs of communicating through the intermediary chain in terms of time, errors and fees, it is not surprising that the SEC has tried to address the problem. It is also not surprising that issuer interest groups such as The Business Roundtable have requested rulemaking to address the high costs to issuers.[191] However, for reasons that will be explained in Part IV, the SEC has not moved toward changing the infrastructure to reintroduce direct issuer-shareholder relationships, but rather attempted to bend corporate law still further around the DTCC system. Since immobilization in effect erases the "registered" aspect of shares by registering all shares in the name of a single fiduciary, it is well complemented by the type of system of anonymous communications used in countries in which shareholders have traditionally been

188 Final Rule: Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, Release No. 34–50758, 69 *Fed. Reg*. 70852, 70855 (Dec. 7, 2004). It may offer some perspective to note that a similar remedy is available under UK law, and was specifically retained in 2006 when the UK overhauled its corporate law. *See* UK Companies Act 2006, secs. 793 *et seq.*

189 SEC Release No. 34–50758, *supra* note 188, at 70852. The logic that finds measures designed to protect investors as unsustainable because they rob the same investors of freedom is somewhat reminiscent of a US Supreme Court that found preventing a baker form working more than 80 hours per week robbed him of his freedom of contract. *See* Lochner v New York, 198 U.S. 45 (1905).

190 Final Rule: Amendments to Regulation SHO, Release No. 34–60388, 74 Fed. Reg. 38266 (July 31, 2009).

191 *See* The Business Roundtable, *supra* note 136.

unknown to the companies in which they invest. In Continental Europe, bearer shares are historically common, even if during the last decade of the 20th Century, registered shares became much more popular. Just as when the share capital of a company is registered in the name of an intermediary, an issuer of bearer shares has no record of its shareholders. Because the issuer cannot convene an annual meeting by sending invitations directly to shareholders, it provides notice of the meeting through a publicly accessible medium, which was traditionally a business newspaper or a type of "federal gazette", and is now more often a website or an electronic forum designed for shareholder communications.[192] This type of communication would have been much more efficient than randomly asking custodian banks to send invitations to their clients.

The SEC moved in this direction in 2007 by introducing a type of proxy communication that allows proxy materials to be posted on a website for general and anonymous access.[193] The legal transplant of a technique designed for bearer shares into a body of corporate law based on registered shares of course ran the risk of problems. To address these, Rule 14a-16 requires that a "Notice of Internet Availability of Proxy Materials" be sent to beneficial owners through the intermediary chain using the same multistep process discussed above in connection with paper materials.[194] As the beneficial owners are not shareholders for purposes of corporate law, the intermediary record holders must still provide their customer beneficial owners only with requests for voting instructions or a signed proxy.[195] Further, even after a beneficial owner has received notice that the materials are available on the internet and that he has a right to obtain hard copies of the materials, he may not obtain such copies from the issuer, but only from the *intermediary*.[196] Showing just how deep the logic of the indirect holding system dominates communication, the Rule allows respondent banks, whose names are not on the stockholders list but have been provided by other banks pursuant to Rule 14b-2, to request materials directly from the issuer,[197] but does not grant the same privilege to a beneficial shareholder who has released her name on a NOBO list. She must still

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192 In Germany, where stock corporations traditionally issue bearer shares, § 124(1) of the German Stock Corporation Act requires the call to annual meeting to be published in designated business newspapers, and pursuant to § 25 of this Act, the requirement is satisfied by posting the notice on the electronic version of the *Official Gazette*, which is a designated, internet bulletin board at https://www.ebundesanzeiger.de/research/banzservlet. Pursuant to § 127a of this same Act, a "shareholders' forum" (*Aktionärsforum*) has now been created on the same website for shareholders to post proposals and coordinate strategy online before the annual meeting. It should be noted that § 125(2) of the Act requires the corporation to notify *registered* shareholders (i.e., owners of registered shares entered in the shareholders' register) *directly*.

193 Internet Publication Rule, *supra* note [●], at codified at 17 CFR §240.14a-16.

194 17 CFR §240.14a-16(a).

195 *See* 17 CFR §240.14b-1(d)(2); § 240.14b-2(b)(2), (d)(2).

196 17 CFR §240.14a-16(j); §240.14b-1(d)(4); §240.14b-2(d)(4).

197 17 CFR §240.14a-16(j) ("The registrant must send . . . to the record holder or respondent bank . . . a paper copy of the proxy statement, information statement, annual report . . . .").

communicate with the issuer through her broker or bank. In the same way, not the issuer but the *intermediary* sends out the Notice of Internet Availability to the beneficial owners.[198]

In order to make the posting of materials more efficient, the next logical step would be to change over to bearer shares, so the corporate law rights designed with a system of registered shares would no longer collide with the existence of the indirect holding system. That would indeed be difficult. Today, all states provide only for registered shares (as opposed to bearer shares) and allow the company to treat the registered shareholder as the person entitled to exercise the rights from the shares. Moreover, as discussed below, paper certificates are becoming rare on the securities markets. Yet it appears that the indirect holding system has become so deeply entrenched that our regulators are more willing to suggest changing all types of law and behavior that conflict with it, rather than simply overcoming the interests of the financial intermediaries and reintroducing direct communication, as was planned before the indirect holding system was created. How is it, that regulators approved an infrastructural form that generates so many negative externalities and continue to accept it, even though its very *raison d'être* – paper certificates – are rarely used? Part IV offers some explanations for this regulatory failure.

IV. Regulatory Failure in the Design of Market Infrastructure

As the markets steadily evolve toward electronic, uncertificated securities,[199] it becomes increasingly unacceptable for corporate governance in general, and the proxy system in particular, to bear the heavy externalities of a securities settlement model designed to avoid the transfer problems of paper certificates. The depository-based model of securities settlement has lost its reason to exist, yet it shows no sign of retreating. This Part explains some of the interests and gaps in information that work to keep this problematic structure in place.

A. Making decisions with incomplete, sometimes biased, information

1. Information on negative externalities is not included in the institutional analysis

Although the securities markets contain very little paper that could be deposited in a vault, CSDs multiply their services and are viewed as essential to best-practice securities settlement. Why? A primary reason for this permanence of the CSD is the type and nature of information regulators use to make decisions on settlement infrastructure. First, the information used is not objective and unbiased. It usually comes from the owners of the very same infrastructure under evaluation, and the companies who own and

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198 *See* 17 CFR §240.14a-16(a)(2).

199 According to DTCC, transactions in certificated securities constitute only about 0.01% of daily trading volume. Because storing large amounts of negotiable paper requires large, acclimatized, secure facilities, DTCC has for years advocated the elimination of paper, and the number of certificates it holds on deposit has steadily decreased. Between 2001 and 2007 the number of certificates DTC held in its vaults decreased by about 60% from approximately 6.7 to 2.7 million certificates. Michael Bellini, Dematerialization Makes Steady Gains, @DTCC News and Information for DTCC Customers 12 (June 2007), *available at* www.dtcc.com.

help to navigate around the depository system cannot seriously be expected to dwell on its negative aspects. For example, in preparing its July 2010 Concept Release on the US proxy system, the SEC consulted a number of persons over a period of nearly one year to obtain information about serious problems and realistic proposals for improvement. Of the 24 entities which it states it consulted, 10 focus on proxy related services, i.e., their revenue is generated by helping issuers to overcome the externalities caused by the depository model, one represents the securities intermediaries who the model thrusts between issuers and securityholders, and three are firms advising the financial industry, while only four of the entities consulted have interests clearly aligned with shareholders, and only one academic was on the list.[200] This overdependence on persons with obvious conflicts of interest is not new, as the discussion of the direct registration system in section IV.B, below, reveals.

The SEC should not bear full responsibility for using biased information because very little disinterested commentary exists: aside from peripheral comments in the literature on securities transfer, only three articles focusing on how the indirect holding system blocks shareholder communication were published over a period of 22 years.[201] In spite of its central importance for the financial system and its enormous impact on the exercise of shareholders' rights, the topic of securities settlement has to date attracted very little academic attention. Almost all of the available detailed information on the settlement process is generated by the intermediaries themselves. In this field, it is unfortunately not just hubris when on its website DTCC labels the link to its white papers, newsletters and the speeches of management as "Thought Leadership."[202] Very few people working in the area of shareholders' or bondholders' rights look to defective market structure as the cause of their problems. Although the registration of Cede & Co. in the United States for settlement purposes is well known, since DTC's creation very few corporate law scholars or market regulators have expressed any opinion except that Cede & Co.'s role is inevitable. Thus, for years the indirect holding of a large segment of the US economy in the name of "Cede & Co." has appeared a curious oddity for those who noticed it, but little more. Brown published an article in 1988,[203] drawing the connection between the indirect holding system and faulty shareholder communications, but the facts Brown offered were not carried forward by others in the field until 2004. At that time, the Business Roundtable (perhaps the strongest, organized lobby group for US corporate management) proposed a rule to shift some costs of distributing proxy materials from issuers to intermediaries, relying heavily on Brown's 1988 article, but gave no indication they were aware the design of the settlement

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200 *See* SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 42984, note 16.

201 *See* Brown, *supra* note 136, Klein, *supra* note 133, and Rock & Kahan, *supra* note 136.

202 *See* www.dtcc.com.

203 Brown, *supra* note 136.

system was connected to their problem of high-cost proxy distribution.[204] There has been some recent movement, however. When the Business Roundtable next addressed the proxy system in 2006, they had teamed up with the Securities Transfer Association (the lobby group for transfer agents) and the Society of Corporate Secretaries (Secretaries have traditionally being involved in corporate communication with shareholders), and requested that the settlement system be reviewed for structural change.[205] Kahan and Rock presented information comparable to the studies offered by Myners and Oxera, discussed in Part III.B.3, above, for the United States, showing how the indirect holding system creates costs and risks for the US voting process.[206]

Second, decision-making on the design of securities settlement infrastructure professionally excludes consideration of impact on areas like corporate governance, or indeed on the exercise of rights attaching to any kind of securities involved, from the institutional purview of its focus. This work initially fell under the auspices of central banking regulators like the Bank for International Settlements' Committee on Payment and Settlement Systems (CPSS). Such regulators view the settlement infrastructure in the context of systemic risk to the overall financial system, not in relation to issuers or their securityholders. As Scott, one of the most authoritative voices in the area of international financial regulation, observes: "The chief aims of clearing and settlement are *efficiency* and *safety*."[207] This can even lead to viewing the rights attaching to securities as an obstacle for safe and efficient settlement. Thus the European Giovannini Group has concluded that the differing provisions for the exercise of voting rights, such as variation in the period between the record date and the shareholder meeting, or the exercise of a pre-emptive right to buy new shares present an obstacle to efficient securities settlement.[208] The Group of Thirty, in which the United

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204 *See* The Business Roundtable, *supra* note 134.

205 *See* Comments of Steve Odland, Chairman and CEO, Office Depot, Inc., Chairman, Corporate Governance Task Force, Business Roundtable, on Internet Publication Rule, February 10, 2006, *available at* www.sec.gov/rules/proposed /s71005.shtml.

206 *See* Kahan & Rock, *supra* note 136, at 1249 *et seq.*

207 *See* HAL S. SCOTT, INTERNATIONAL FINANCE: LAW AND REGULATION 278 (2004) (emphasis added).

208 The Giovannini Group, Second Report on EU Clearing and Settlement Arrangements, Barrier 3 (April 2003), *available at* http://ec.europa.eu/internal_market/financialmarkets/docs/clearing/second_giovannini_report_en.pdf. This comes from focusing on the efficiency and security of process to the exclusion of preserving its content. Most processes are made more complex and expensive if the properties of the characteristics of the items processed are heterogeneous or unstable. Take the example of fresh milk, which is more expensive and cumbersome to transport than water. A truck to deliver bottled water need be neither sealed nor refrigerated, while a truck to deliver fresh milk must be both. The physical properties of the material transported necessitate the additional expense. An obvious way to cut costs and increase delivery efficiency would be to eliminate the disruptive physical properties of milk upstream before placing it in the distribution chain. If milk is subjected to ultra-high temperature treatment or dried and pulverized, the resulting substances can be delivered like water, without refrigeration or other extraordinary measures against bacteria. By changing the nature of processed content, the basic process of delivery may be kept at its cheapest and most basic form. The same principle has been applied to securities. The cleanest and most efficient type of settlement system would probably resemble that for single currency cash debts. Within the currency area, cash is universally fungible it requires neither that a

States plays a leading role, has taken the same position.[209] If the deadlines for the execution of proxies or the acceptance of a rights offering were fixed and standardized nationally and internationally, it would be easier for a central settlement facility to process them quickly without error.[210] Both the Giovannini Group and the Group of Thirty thus suggest that corporate law communications between issuers and shareholders be formulated as ISO 15022 protocol.[211] The International Organization for Standardization (ISO) develops messaging formats for the SWIFT (Society for Worldwide Interbank Financial Telecommunications) system that has been used internationally by banks for decades to send paymet instructions.[212] DTCC is now implementing these stanardizing recommendations of the Giovannini Group and the Group of Thirty in its own processing,[213] and this trend could gradually exert pressure on US states and securities exchange to formulate corporate statutes and investor rights *ab initio* for efficient processing in the DTCC subsidiaries, rather than primarily to meet the needs of issuers and investors. Of course this prioritization of efficient processing runs against the very *raison d'être* of a securities settlement system: to transfer ownership of *securities*, which are negotiable instruments certificating a bundle of rights specific to a given class of instruments. For shares of stock, these rights include the right to receive regular information from a listed company, to be invited to and vote at the general meeting, to receive a takeover offer for one's shares, and to receive dividends; for debt instruments, these rights include interest payments and notices of an indenture trustee regarding any rescheduling or impending default. If smooth processing in a central entity controlling the market for securities comes to dictate terms to the drafters of corporation law, the state of affairs will hardly be likely to promote efficient exercise of voting rights and communication with shareholders. One reason we have come so far in this direction is indeed that the information on the depository system's negative externalities is marginalized by the professional focus of regulators. However, this is not the only reason. Another is that such information has also been institutionally excluded through partitioning regulatory expertise.

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relationship with the issuer be preserved nor that its owner be allowed to exercise any right except sale. On the contrary, the legal properties of registered securities create additional burdens. Eliminating these properties would reduce processing costs. By altering the legal nature of the securities in circulation to make them look like cash, a simpler transfer process resembling that used for cash could be employed.

209 The Group of Thirty, *supra* note 66, Recommendation 8.

210 The Giovannini Group, *supra* note 208, at 10.

211 *Id.* at 10; The Group of Thirty, *supra* note 66, at 90.

212 *See* the website of the International Organization for Standardization, at http://www.iso15022.org and of SWIFT, at www.swift.com.

213 *See* DTCC 2009 ANNUAL REPORT, *supra* note 95, at 29, under the heading "Standardizing Corporate Actions."

2. Regulatory division: market structure versus corporate governance

The focus on market structure safety and efficiency to the exclusion of governance rights is clearly visible in the structure of the SEC. At least since the SEC performed its Street Name Study in 1976,[214] it has assigned the supervision of securities settlement structures to one division – Market Regulation[215] – and the task of finding a cure for the shareholder communications problem to another division – Corporate Finance. For over thirty years, the Division of Corporate Finance tried to repair damage to shareholder communications caused by the recommendations of the Division of Market Regulation. An early expression of this bureaucratic schism is displayed in the conclusion of the Street Name Study, which is very informative about what happens when a problem falls between the institutional cracks of a regulator. The governance advantages of a decentralized model that offers direct communication between issuer and shareholders are noted, but the SEC also observes that the introduction of such a model would not be a matter of proxy regulation, rather one of market structure:

> The TAD [Transfer Agent Depository] concept exhibits promise as an important long-term alternative. *It is not, however, a system for streamlining communications but rather an approach to a national clearance and settlement system* which, as a by-product, would improve issuer-shareholder communications. Development of TAD, therefore, must be integrated with other developments in clearance and settlement.[216] (emphasis added)

The Division of Market Regulation could have carried forward work on the TAD, which would have been beneficial for shareholder communications. However, it was extremely unlikely that a team of experts whose terms of reference focus on strengthening *safety* and *efficiency* would have diverted resources to consider a simple "*by-product*" of a possible model, i.e., that the model could improve *corporate governance*, an area outside of their assigned task. As will be explained in the next section, when the Division of Market Regulation (now Markets and Trading) did respond to concerns of issuers about 20 years later by allowing the development of the DRS, it underestimated both the importance of the communication issue, and the interests of the brokerage industry, leaving direct registration a mere "option" imbedded in the depository-based system.

On the other side of the Commission, the staff of the Division of Corporate Finance has made brave but futile efforts for over 20 years (enacting and amending Rules 14a-13, 14a-16, 14b-1 and 14b-2, discussed in Part III.B, above) to counteract the problems caused by the market regulation measures ordering immobilization. In this way, one Division tugged toward depository control while the other pulled toward corporate governance, apparently prevented by their particular divisional mandates from

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214 SEC, STREET NAME STUDY, *supra* note 11, at 41 *et seq.*

215 The title of this Division was in 2007 changed to "Division of Trading and Markets: Exchanges, Other Markets, Broker-Dealers, Clearing Agencies, Transfer Agents, and NRSROs." *See* www.sec.gov/divisions/marketreg /mrabout.shtml.

216 *Id.* at 43.

overcoming the boundaries of institutional focus.[217] Recently, however, this barrier seems to have been broken by seating proxy and settlement structure experts together at a recent roundtable discussion session at the SEC,[218] and a 2010 Concept Release expressly examines the link between market structure and shareholder communications.[219] Nevertheless, as discussed above, because most of the information provided on the settlement system comes from entities whose business model is to profit from the system's negative externalities, in assessing the value of such information we must evaluate whether such entities really do have an interest to maintain the current system and its negative impact on corporate governance.

B. The interests of the intermediaries

1. Brokers and banks both control and benefit from the current market structure

An industry which is crucial to the economy and in which the interested parties have a *de facto* monopoly on both the market and information regarding their industry begs regulation. However, they have apparently been seen historically as neutral, disinterested, and trusted advisors of the regulators. This should end. With the negative effects of the current system falling on issuers and the benefits running to the owners of the system, this area presents significant conflicts of interest coupled with near complete control by market participants over system design. As Schwarz and Francioni, explain, issuers have little place in decision-making on stock exchange infrastructure:

> Historically, exchanges have been membership organizations, and for a membership organization the answer is straightforward: The broker-dealer intermediaries, who are their members, are their primary customers. With a membership organization, the other two constituents (investors and the listed companies) are important primarily because they are critical for the profitability of the members. Nevertheless, the bottom line is, with a membership organization, the interests of the intermediaries come first.[220]

The listing of the major stock exchanges that began in the 1990's may gradually shift this balance of power, as institutional investors take larger stakes in the market infrastructure and become aware of problems that the indirect holding system causes for shareholder communications and voting. However, issuers currently remain distant from decisions about and the market's trading and settlement systems, and should be able to look to regulators to protect their interests. Yet in the mid-1990s, broker-dealer control of the market infrastructure and an absence of SEC protection led to the reversal of an issuer-driven project designed to restore transparency and shareholder communications. The project, a "direct registration system" (DRS),

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217 Brown, *supra* note 136, at 715 ("By promoting immobilization, the Commission essentially implemented a policy designed to increase the use of street name accounts. Thus, in the 1970s, the Commission both encouraged the use of street name ownership and recognized that these owners were not fully integrated into the proxy process.")

218 *See* List of Participants for the SEC Roundtable on Proxy Voting Mechanics, *available at* www.sec.gov/spotlight/ proxyprocess/proxy-parts052407.htm.

219 SEC Concept Release on the U.S. Proxy System, *supra* note 7, at 48999.

220 ROBERT A. SCHWARTZ & RETO FRANCIONI, EQUITY MARKETS IN ACTION: THE FUNDAMENTALS OF LIQUIDITY, MARKET STRUCTURE & TRADING 93 (2004).

was turned into a service option of DTCC, to which DTC regulates access and for which issuers now pay fees.[221]

The DRS project descended from the TAD system that was highly praised in 1971 and 1976, when market participants still considered immobilization as a temporary, second-best solution. It had been proposed in 1991 by a group co-chaired by the Securities Transfer Association (STA) and the American Society of Corporate Secretaries (ASCS) "to offer investors an additional choice of security ownership in the form of an account statement, so that their securities could be registered in their own name on the books of the issuer."[222] The main operational function of the DRS was and is to allow shares to be shuttled back and forth between the accounts of the transfer agent (for registration and holding), where shareholder communications would be facilitated, and the depository or participant broker, where book-entry transfer would be possible. In light of how embedded the depository system had become since the Exchange Act was amended in 1975 to impose immobilization, with Article 8 UCC being custom-tailored to transferring claims to custody accounts, and the proxy rules having been bent around chains of intermediaries, it should come as no surprise that DTC and its owners, the broker-dealer community, took the position that an "issuer operated" DRS was problematic.

Although an initial design of DRS did become operational on November 11, 1996,[223] during the years that followed, brokers successfully lobbied the SEC to remove the system from its original concept of an issuer-driven restoration of transparent shareholder relations. In 1999, brokers and DTC argued that DRS should be integrated into DTC's "Profile Modification System" (Profile) for communication purposes, the result of which subjected transfer agents to the supervision and approval of DTC because they became “limited” DTC participants in order to take part in DRS.[224] Brokers also argued that the system as designed presented "unreasonable delays" in allowing "shareholders to 'recover' their shares" out of direct registration and transfer them into the broker's accounts for trading purposes.[225] As the SEC explained, “commenters, representing primarily issuers and transfer agents, support continuation of DRS as it is currently operating. . . . These commenters contend that DRS as it is operating today (*i.e.*, without Profile)

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[221] *See* Concept Release, Transfer Agents Operating Direct Registration System, Exchange Act Release No. 34-35038, 59 Fed. Reg. 63652, 63653 (Dec. 8, 1994) (hereinafter "DRS Release").

[222] *Id.*

[223] Self-Regulatory Organizations; The Depository Trust Company; Order Granting Accelerated Approval of a Proposed Rule Change Relating to the Procedure to Establish a Direct Registration System, Exchange Act Release No. 34-37931, 61 *Fed. Reg.* 58600, 58601 (Nov. 15, 1996).

[224] Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Amendment and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Implementation of the Profile Modification System Feature of the Direct Registration System, Exchange Act Release No. 34-41862, 64 *Fed. Reg*. 51162, 51163 (Sept. 21, 1999).

[225] *Id.*

benefits the marketplace by providing shareholders with another option on how to hold their securities."[226] Once transfer agents had to become limited participants of DTC and issuers had to meet DTC eligibility requirements in order to use DRS, the DRS system was subjected to DTC control and the plan of a direct issuer-shareholder relationship independent of the central depository had been defeated. Yet in the many published releases regarding the adoption of DRS, the SEC never indicated awareness of a conflicting interest that brokers may have in advocating a system design that promoted their centrality. In reaching its decision, the SEC merely concluded that making the Profile Modification System a prerequisite to DRS created a "more efficient mechanism."[227] No other considerations were introduced into a decision that subjected the issuers to approval and ongoing oversight of the depository as its limited participants.[228] By 2006, DTCC already referred to DRS as "DTCC's Direct Registration System (DRS)."[229]

Although since 2008, all issues listed on the NYSE and the Nasdaq Stock Market had to be eligible for inclusion in the DRS,[230] it is unlikely that this requirement will lead to substantially more shareholder transparency. Like the depository system itself, the basic infrastructural design of the DRS will tend to perpetuate an intermediated lack of transparency. This is because DRS is in essence just a bridge between two mutually exclusive options: transparency and liquidity. In the DRS, uncertificated shares can be held transparently in databanks managed by transfer agents for issuers, but in order to be tranferred, such shares must then be pulled into a broker's account where they are re-registered in the name of Cede & Co so that a claim on a DTC account can be traded.[231] The "direct" side of the DRS bridge thus offers little more than a parking lot for untransferable shares; if a shareholder wants liquidity, she must place the shares back in the name of Cede & Co. As each move back and forth on this DRS bridge will generate a fee for DTCC and the broker, rational shareholders seeking to hold liquid shares have an incentive to avoid direct holding.

<u>2. How intermediaries benefit from the indirect holding system</u>

Perhaps first among the benefits obtained by broker-dealers from the indirect holding system is customer loyalty.[232] Like a garage that stores its customer's winter tires during the warmer seasons, a broker that has its customer's securities registered in its own name knows the customer will always return. This means that the broker always has each customer's current address, and can contact him to offer services and promote potential investments or sales. The advantage of this position is certainly obvious when compared to one in which shareholders were as unknown to the brokers as they currently are to the

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226 *Id.* at 51164.

227 *Id.* at 51165.

228 *Id.* at 51164.

229 DTCC 2008 ANNUAL REPORT, *supra* note 88, at 36.

230 *See* NYSE Listed Company Manual, § 501.00(B); and NASD Manual, Sec. 4350(L).

231 Exchange Act Release No. 34-37931, *supra* note 223, at 58600.

232 *See* WELLES, *supra* note 23, at 144.

issuers, and could contact any other broker based on current fees structure, quality of service and convenience to execute their next transaction.

A second advantage is that this information, although originally taken from the issuers themselves through the introduction of the indirect holding system, can be sold back to the same issuers. As discussed above, Rules 14a-13 and 14b-1 give issuers a right to ask brokers to provide them with a list of those client-shareholders who did not object to their identities being disclosed to the issuer, a so-called NOBO list.[233] People working in the area of investor relations for listed companies have told the author of this paper that a NOBO list for a Fortune 100 company can cost as much as $250,000. Intermediaries could look forward to selling such lists on an annual basis in the run up to the shareholders' meetings of listed companies. Fees of that magnitude for information they in any case have to generate for their own accounting purposes are no small incentive to support the continuation of the indirect holding system.

A third advantage that brokers enjoy is control of the securities. Depending on the terms of the brokerage agreement with the investor, a broker may be able to lend the shares to the market (such as to short sellers), earning an additional fee, and also may be able to increase its fees by swelling its assets under management. This last possibility arises from a kind of brokerage contract developed to avoid the risk that the broker will engage in unnecessary transactions to drive up her commissions ("churning"). The arrangement is sometimes referred to as a "wrap fee", according to which commissions are calculated in relation to an agreed-upon aggregation of transactions executed, advice rendered and total assets that the broker holds under management for the customer.[234] The indirect holding system brings assets under the broker's control more or less by *force majeure*, thus increasing the wrap fee. Depending upon the applicable law and any contractual agreement, the broker may also be able to employ the same securities as collateral or loan them to third parties, thereby generating additional income.

"Corporate actions" are another business open to intermediaries because of the depository-based system. As long as securities remain registered in the name of an intermediary, the "beneficial" owner of the security remains unknown to and has no property, contract, or corporate law rights against the issuer. As explained in Part III, intermediaries bridge this gap that their presence creates by distributing invitations to general meetings, requesting instructions from their customers on accepting or rejecting takeover offers or rights offerings, and distributing dividend and interest payments. One might be tempted to argue that a CSD as large as DTCC could offer economies of scale savings in performing corporate action services for issuers, but as also discussed in Part III, the insertion of intermediaries reduces available time for decision-

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[233] *See* 17 CFR § 240.14b-1(b)(3)(i) in connection with § 240.14a-13(b)-(c).

[234] For a discussion of "wrap fees" or "wrap accounts", also with particular regard to churning, *see* NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION § 16.01 (2nd ed. 2001); Loss & Seligman, *supra* note 60, §8-C-1; LAURA S. PRUITT, BROKER-DEALER REGULATION, ALI-ABA COURSE OF STUDY 34 (2006).

making, increases the risk that messages will be distorted or lost, and increases costs due to "information scrubbing". If an issuer had direct access to electronic addresses for its securityholders, mass communication would be no more expensive than sending the original notice to the CSD as required under the current Rule 14a-13. Companies like Broadridge exist only to reap profits from the depository system’s negative externalities. Such companies look at the creation of a truly functional system of direct registration the same way that London's famed boatmen looked at the building of more bridges across the Thames – an open threat to their very existence. Although their services are to be praised for allowing the US markets to excel despite a significant disruption of shareholder communications, it is obvious that such service providers would all but disappear if shareholders or their chosen agents were registered directly with issuers. This makes it very difficult to understand how the SEC can depend on such companies for unbiased information on market design.

V. Conclusions and Proposals – Disintermediating Shareholder Communications

The depository-based model of securities settlement currently used in the United States severely impedes shareholder communication and hinders corporate governance. It was designed for depositing paper certificates in custody accounts to allow book entry transfers of claims on those accounts. This structure dates back at least to 1873. It accelerates transfer by short circuiting "endorsement", "delivery" and "cancellation" of certificates, as all securities are and remain registered in the name of a single entity or a few intermediaries. The depository in effect issues uncertificated claims on the pool of assets (the underlying securities) kept in its accounts, creating an effect like dematerializing the securities. This shortcut allows efficient transfer of claims on certificated securities, but generates the significant negative externalities of severing owners from issuers, inserting intermediaries as new registered owners, and disrupting communication with shareholders. These effects on corporate governance have been discussed at length above. We have also seen that while directly damaging issuers and securityholders, the depository-based system significantly advantages intermediaries, as they become the registered owners of the economy's outstanding securities as well as of all the information about securityholders. They use this information to bind their clients to them and profit from value-added services that issuers cannot perform because they have transferred the information regarding their securityholders to the intermediaries. This all came to be as an escape from the difficulties of transferring paper certificates, yet although the market no longer issues new paper certificates and most previously existing certificates have been retired, the basic structure of the depository system remains. The total cost of this system should be understood to include not only fees paid to the service providers selling securityholder information back to issuers and enabling issuers to communicate through the maze of intermediaries, but also losses caused by miscommunication, lost votes and wrongly attributed votes. However, these are only the losses seen from the corporate governance perspective.

The *commercial law* flaws in this system can become much greater once paper certificates are completely removed from the market. With respect to the safety of this system, it should also be noted that because the depository-based model requires investors to trust that the booking of a security in an intermediary's account actually gives them a security, the law has found it necessary to guarantee that where there is a booking, there is a security.[235] Of course, this can lead to the creation of securities that were never issued. Each time another intermediary books a claim to one of its custody accounts, regardless of whether the claim is backed by deposited securities, this creates entitlements to securities, whether or not they have actually been issued by the listed company.[236] The number of securities booked in the accounts of intermediaries scattered over a number of financial centers may thus exceed the issued securities actually evidenced on the primary account of the issuer's list of securityholders. At the latest, when it comes time to pay dividends or interest, or when voting rights are exercised at an annual meeting, discrepancies between the number of securities actually issued than those "created" by intermediaries' credits to accounts will lead to problems. Thus in a paperless capital market, secondary and tertiary bookings on the accounts of intermediaries are not only unnecessary, but dangerous. The cost of procuring securities for the holders of these empty bookings would, under the UCC, fall on the negligently overbooking intermediary,[237] not the issuer, but these costs must still be factored into our estimation of the system's value or lack of it.

Beyond economic losses, costs and risks, there is also the problem of privacy. We often speak of immobilization creating attractive anonymity for securityholders, something that institutional traders who prefer that their activity go undetected by the market might enjoy as a welcome windfall of the depository infrastructure, but the fact is that no one remains anonymous: the intermediaries know what belongs to whom.[238] Investors should have the right to choose whether this information should be available to issuers, or kept *completely* confidential. As outlined above, intermediaries know well how to reap considerable direct and indirect benefits from the current structure. They receive custody fees for holding securities (even if only electronically), can use their clients' securities for loans or collateral if law or contract so allows, and can tie their customers to them in a way that would be impossible if they did not "own" their

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235 UCC § 8-501(b)(1) (2005).

236 France, which began eliminating all paper securities about 30 years ago, has faced this problem for some time. As Martin explains, "the intermediary does nothing more than keep its own books with respect to securities that exist in the issuer's register," and since "these book-entries are not an unrestricted game of displacing the securities to the extent of one's imagination: it is advisable to restrict entries to the primary account in which the securities originate" (author's translation). Didier R. Martin, *La théorie de la scripturalisation*, *in* de Vauplane, *supra* note 18, at 55, 70.

237 UCC § 8-504 (2005).

238 As DTCC remarked in 2000: "As the world's largest securities depository, The Depository Trust Company is a primary source of data on nearly 1.9 million securities and the financial activities associated with these assets. In many cases, it is one of the principal sources of data on actions ranging from tender and merger offers to dividend and redemption announcements." DEPOSITORY TRUST & CLEARING CORPORATION, ANNUAL REPORT 1999, at 30 (2000).

customers' property and were not the only persons capable of legitimizing their customers' claims against the issuer of the relevant security. For these intermediaries, a transition from indispensible middlemen to invisible facilitators might be costly, but it would restore privacy to investors if they chose not to reveal their identity to the issuer of the relevant securities.

There is also the question of competition. Imagine if the various national monopolies for telecommunication services had never ended. Would we have enjoyed the explosive innovation in voice and data services we saw over the last 20 years? If securities were to exist electronically only on the register of the issuer, no securityholder would be tied by *force majore* to an intermediary: as happened in the telecommunications industry during the last decades of the 20th century, customers would be free to change broker or bank for different sorts of transactions, depending on the price, expertise and quality of service. This would significantly lower entry barriers and trigger significant price and quality competition in brokerage services. This would be highly desirable, but given the existing balance of knowledge and expertise that heavily favors entities whose vested interests would be damaged by natural structural evolution, such evolution will of course be blocked by the financial intermediaries unless regulators step in to accelerate the process. It has been the purpose of this paper to shed light on the regulatory failure that has allowed the perpetuation of the indirect holding system, present the reasons for this problem, and point toward a desirable solution.

Securities settlement infrastructure should progress beyond the depository-based model, but how? The alternative is simple: transfer uncertificated securities, not claims on certificated securities. This is the model the UCC Drafting Committee supported in the 1978 amendments of Article 8, UCC, which would have allowed "changes in ownership … to be reflected by changes in the records of the issuer."[239] Uncertificated securities are transferred simply by registering the transfer on the books of the issuer.[240] This is because "delivery", which is an essential element for the transfer of a security, takes place for uncertificated securities either by registering the name of the transferee on the securityholders' list or by a third party (who, under the current UCC may not be a securities intermediary because it would create a "security entitlement"[241]) declaring to hold the share on behalf of the transferee.[242] Just as for a certificated security, in order to be protected against possible claims of third parties to the uncertificated security, the buyer would have to "give value", not have notice of any "adverse claim", and obtain "control" of the

239 UCC, Article 8 Prefatory Note, Sec. I.B. "The Uncertificated Securities System Envisioned by the 1978 Amendments."

240 *See* GUTTMAN, *supra* note 19, § 6:4 and UCC § 8-301 (2005).

241 As will be explained in Part II.A, if a securities intermediary were to act on behalf of the purchaser in acquiring a security, the purchaser would receive only a "security entitlement" against the intermediary rather than ownership of the security itself. *See* UCC, § 8-301(a)(3) (2005).

242 UCC § 8-301(b) (2005).

security. A transferee obtains "control" over an uncertificated security by having his name entered on the securityholders' list.[243] Thus registration on an account/register would fulfill the requirements both of "delivery" and "control",[244] providing safe settlement of the transfer transaction. Moreover, transferring uncertificated securities would mean that every owner of the security would simultaneously become the registered owner, holding all rights to vote and receive dividends or interest from the issuer. With this one change, the distinction between "beneficial" and "registered" owners would disappear (except in cases where the securityholder chose to remain anonymous); at the end of each trading day, when the dust of settled, every issuer would have an exact and complete list of its securityholders.

Although a change of this type would radically alter the power of financial intermediaries with respect to shareholder communications, it would not demand a radical redesign of settlement infrastructure. To avoid the creation of shadow securities through overbooking, uncertificated securities should be traded on their original register, and this would render ownership transparent, obviating disruptions to shareholder communications. However, the transfer of uncertificated securities could still be effected by the same high-speed CCP operations currently used to transfer claims on depository accounts. The relevant account/registers could be operated at decentralized locations, connected to the exchange with high speed links, by the issuers or their transfer agents, or centrally, by the same companies that now operate CSDs. Centralization or decentralization of the registers would be decided on the basis of desire, cost, efficiency and security – not pretended necessity. If this change were made, intermediaries would *process* and *communicate* trading information, not *own* securities and information about "beneficial" owners. Every owner of a listed security would simultaneously become a registered owner, transparently holding all rights to vote and receive distributions, unless the securityholder chose to remain anonymous. Every issuer would have an exact and complete list of its securityholders generated in real time at the close of each settlement cycle. Communication for corporate law purposes would be simple, cheap and direct. Although it is difficult to estimate the cost of the infrastructural changes necessary for a transition from custody accounts to account/registers, the savings to issuers and securityholders would be great: fees for "corporate actions", fees for "NOBO lists", fees for proxy distribution, and losses from disrupted communications, as well as the risks of over-issued shadow securities, would fall away.

In taking this next step toward disintermediated securities settlement and shareholder communications, we are faced with a situation that theorists of legal change call "strong-form path dependence":[245] the benefits of the new structure would be great, but even speaking meaningfully of the current problem and its possible solution is now difficult, as they not only fall into the disparate disciplines of commercial law,

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243 UCC § 8-106(c) (2005).

244 *See* GUTTMAN, *supra* note 19, § 6:4.

245 Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 Harv. L. Rev. 641, 651 (1996).

corporate governance, broker-dealer regulation and financial system management, but the current path is also considered necessary and optimal. Therefore, we cannot easily embark on the new path because even "just thinking about change clashes with our path-induced perception of 'normal' mechanisms."[246] Regulators diligently focus on the safety and efficiency of securities settlement in relation to the overall financial system, while historically ignoring its effects on corporate governance and the costs to issuers and securityholders. The SEC's Division of Corporate Finance's work on the proxy rules commits the converse omission. Although these same regulators should be in a position, given time, to recognize the danger that the intermediated system will lead to the creation of shadow securities through multiple bookings, their estimation of such dangers' existence clashes strongly with an embedded understanding that the depository-based system is safe and efficient. Moreover, given their historical dependence on system participants for good information about securities settlement, it is unlikely that regulators will break with the current path unless prompted to do so. They are not so prompted because very little independent commentary on securities settlement infrastructures and processes is published. This paper attempts to reduce that deficit by explaining the causal links between security settlement's dark heart and the negative impacts on transparency, shareholder communications and corporate governance. The road to a transparent, disintermediated form of securities settlement is not difficult, but it runs against many deeply entrenched interests and current gaps in regulatory focus and knowledge.

[246] *Id.*