

“Lost your right to make yourself heard?”

Report of the AFM investigation into the voting chain



The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

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Introduction

In 2012 the *Financieele Dagblad* published a series of articles suggesting that the voting chain was failing to perform optimally – especially for cross-border voting – because of fundamental flaws. An investigation had revealed that around 5% of the votes cast were lost in the voting chain.¹

Although the AFM has no direct formal powers over the voting chain, it was approached by stakeholders in political and academic circles,² who expected it to take steps to rectify the situation for the benefit of concerned parties in the Netherlands and Europe.

The AFM conducted an investigation to gain insight into the voting infrastructure and to ascertain whether problems do indeed exist in the voting chain. It also looked at how the voting chain works for Dutch investors and Dutch listed companies.

The investigation was carried out in the second half of 2013 and included interviews with various parties involved in the voting chain.

¹ Study by Broadridge in 2009 (*A Perspective on Proxy Voting in the Netherlands*)

² http://fd.nl/Print/krant/Pagina/Beleggen/747929-1206/afm-staat-met-lege-handen_bron_fd_krant
http://fd.nl/Print/krant/Pagina/Opinie/722643-1206/stemming-bij-avas-niet-eerlijk_bron_fd_krant

1 The voting chain

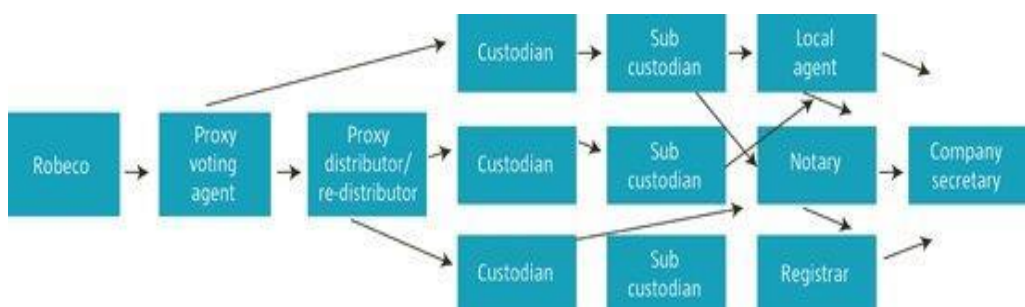
One of the shareholder's rights is to vote on agenda proposals put forward by the executive board of companies in advance of the Annual General Meeting (AGM). Basically, there are two ways of doing this: by attending the AGM, or by proxy voting. Needless to say, to obtain honest and reliable results, it is crucially important that the voting chain work optimally when proxy votes are being processed.

Nowhere near all the shareholders of large listed companies actually attend AGMs, often preferring to vote by proxy and remotely. Publicly listed companies count the votes that come in but cannot say whether all the votes cast have actually completed the journey through the voting chain. Due to growing awareness of stewardship and shareholder engagement, voting is on the increase, and investors want assurance that their votes are cast in accordance with their instructions. Issuers are also asking for more insight into shareholder engagement and voting procedures.

Investment portfolios – especially the portfolios of institutional investors – are becoming increasingly internationally diversified. Since voting systems may differ from one jurisdiction to another, investors often depend on several intermediaries to follow their voting instructions. Without proper supervision, the risk of error increases with every link in the chain. This, in turn, increases the risk of inadequate management by the corporate board.

Insight into the voting process

The diagram below shows what a voting process routinely looks like. An investor – in this case an asset manager – passes on voting instructions for a shareholders' meeting to his voting agent, who then passes them on to a custodian via one or two intermediaries. The custodian then sends the instructions to a sub-custodian, who often needs to call on the assistance of several parties – possibly a notary public or a registrar, depending on the jurisdiction – to get the votes to the Company secretary.



Source: Robeco³

³ <http://www.robeco.com/en/professionals/insights/sustainability-investing/insights/2012/audit-shows-flaws-in-the-proxy.jsp>

2 The investigation

The AFM sought answers to questions by holding interviews with market parties and academics:

1. Is there a problem in the voting chain?
2. What specific problems do Dutch parties encounter?
3. How could these problems be solved?
4. At which levels are solutions needed?
5. What steps has the market already taken?
6. Does the solution lie in regulation or in self-regulation?
7. Is there a role for the AFM to play?

The findings and conclusions are discussed below.

Findings and conclusions

1. Is there a problem in the voting chain?

The investigation uncovered various types of problems and aberrations.

- There are many parties in the chain, especially in cross-border voting chains. Agents, the CSD (Central Securities Depository), custodians, sub-custodians, proxy platforms, and service providers all form links in the chain between the holder of voting rights and the issuer.

In the absence of safeguards, the multiple links (parties) heighten the risk of errors in the voting chain. This is due to manual processes, differences in the systems of the intermediate links (patchwork), and differences in procedures for and manners of delivering information. The process is therefore far from transparent.

Studies by institutional investors have indicated that options to verify that votes have been cast correctly are few to none. There are various links in the chain from the issuer back to the voter, involving a diverse number of parties that make use of different systems and different registered 'names'. Good account identifiers are needed to establish a reliable audit trail, but these are not always available. To complicate things further, in a chain with so many parties, no-one can be held accountable for hitches – when identified – in any one of the links.

- The inefficiencies in the chain are caused by several factors. Among others: 1) the collection systems applied by custodians whereby all incoming votes are placed into one account; 2) privacy protection which prevents or complicates the disclosure of information; and 3) lack of access to different systems in the same organization. The market parties interviewed by the AFM indicated that they experienced such matters. All of these factors can disrupt the transfer of information.
- There are also legal problems. Cross-border proxy votes have to pass through several jurisdictions, where regulations may differ in relation to, say, voting rights or proxy authorisation, or where intermediaries may be subject to a duty to cooperate, or legal restrictions may exist whereby, for example, shares are subject to transfer restrictions between the record date and the AGM. As a result of share lending and borrowing and the lack of transparency in the chain, it is not always clear who actually holds voting rights. Finally, there may be interpretational differences about which information can or must be provided.
- The type of contract between the holder of the voting rights and the custodian may also exert an influence. The contract stipulates the services that are available, whether the client can vote directly or by proxy or by issuing instructions, and whether the vote cast is verified.
- The Shareholders Directive (2007) did not bring about harmonization of record dates, because the EU member states implemented the Directive in different ways in local legislation. The harmonization of AGM dates and record dates – with enough time in-between to, for example, retrieve shares in securities lending transactions – would at least give investors a clearer idea of where they stand. The widely divergent cut-off dates (deadline for passing on votes to the intermediary in the chain) applied by custodians simply add to the confusion.
- Custodians, sub-custodians, and adjacent service providers have a vested (financial) interest in the services they provide in the chain (a licence to operate). They earn money from these services, and therefore also from existing inefficiencies which require them to make extra efforts. It emerged from interviews that some custodians do facilitate the casting of a vote but do not check whether that vote has actually been cast correctly. Institutional investors are increasingly including vote verification in their contractual agreements with custodians.

Some custodians charge for forwarding the AGM agenda, for casting the vote, and for verification afterwards. On the other hand, proxy voting is not their main field of work or source of income, so improving the process is low on their list of priorities. This issue is expected to draw more attention in the years ahead as a result of the stronger emphasis on good corporate governance and shareholder engagement.

- Apart from custodians and sub-custodians there are service providers who facilitate electronic voting. Broadridge offers various services in the voting chain and holds a strong position in the European market. In the US, Broadridge is the undisputed market leader. But is such a monopoly position desirable? Efficiency in the chain would improve if everyone used the same codes, systems, and platforms. A level playing field and the best price is far from assured when only one provider exists.

2. What specific problems do Dutch parties encounter?

It emerged during the interviews conducted by the AFM that Dutch investors do not experience any problems in the way the voting chain works for Dutch listed companies. But they do come up against problems when they want to exercise votes attached to shares held in foreign companies.

- Voting on shares of Dutch listed companies, by Dutch parties, seems to run smoothly most of the time. This may be tied in with the fact that institutional Dutch voters are often physically present at the AGM, so errors in the chain are already precluded or less likely to occur.
- In the Netherlands, retail investors seem to have very little effort to vote on agenda items for Dutch companies, because banks involved in the voting chain run facilities to make voting easier.
- The majority of the interviewees did not identify with the 5% of votes that get lost in the voting chain as reported by Broadridge, especially not for the Netherlands. However, parties who have done their own research agree that this figure is realistic. The fact remains that people maybe simply not be aware that their votes have been lost, and that certain voting outcomes might have been different if votes had not been 'lost' in the voting chain.

Anecdotal evidence suggests that inefficiencies, missing votes, or wrongly cast votes have led to outcomes for Dutch companies that would have been different if the votes had been correctly processed and counted. As far as the AFM can tell, none of the interviewees had expressed any such concerns to the AFM or through any other channel at the actual time.

- The Dutch regulations for shareholder identification that came into force in July 2013 will not help to address problems in the voting chain because they suffer from the same omissions⁴: lack of clarity with regard to who holds voting rights and who has information rights. Market parties have not yet gained enough experience of the operation of this legislation to draw further conclusions at this time.

⁴ There is a provision in the Dutch Security Depositary Act that enables companies to find out the identity of shareholders. Companies can request the details of any member organization, intermediary or participant/shareholder.

- In theory, identification should lead to the last link in the custody chain of intermediaries. However, if the shares in the company are held via a cross-border custody chain, full disclosure of information will depend on the willingness of foreign institutions to cooperate. If these institutions are unfamiliar with the Dutch system, they will not be inclined to disclose the required information to the beneficiary, unless proper arrangements are in place locally. In the Dutch market there are several parallel channels that pass on the shareholder's voting instructions through the chain to the issuer. This situation creates a risk that votes will be counted twice, that voting instructions will be incorrectly passed on or not passed on at all, and that reconciliation problems will arise. As mentioned above, it appears that this risk is easily managed in practice in the Netherlands.

3. How could these problems be solved?

Solutions – especially solutions to cross-border inefficiencies – can be sought in technology, standardization, regulation, contractual provisions, and better cooperation.

- The problems could be solved with technology, but that would require investment. A standardized system for proxy voting might provide an answer. A start could be made by compiling an inventory in each country of the different voting chain systems. The International Corporate Governance Network (ICGN) is developing a scorecard to gain a clearer picture of the greatest voting barriers in each country.
- It should be technologically possible to set up a system similar to Swift, which is used worldwide, alongside giro payments, to process, for example, optional stock or cash dividends. This system *is* absolutely clear about who the shareholder is and who receives the dividend. Swift is also used for sending and receiving instructions between banks and financial institutions. At this moment in time, however, Swift is not used in communications with the issuer or the CSD.
- It is essential for holders of voting rights to reach clear and unambiguous agreement with custodians about voting services and the accompanying costs. Custodians should explain quickly whether they provide voting services – and if so, what they entail and what they cost. Usually, it is only the institutional investors who enter such specific agreements with custodians. It is moreover worth noting that some custodian may be more progressive and customer-oriented than others in this regard.
- Investors who want easier (and less time-consuming) vote verification should ideally be able to opt for separate accounts. Omnibus accounts – which complicate vote verification – are applied mainly because they are simple to administer. It saves effort and money to process information in batches. But simplicity comes at a price in terms of reliability and audit trail.

Custodians have observed that more and more investors are opting for separate accounts because of the transparency benefits.

- Custodians should be legally obliged to cooperate with the vote holder's right to exercise control. The European Commission included an obligation to cooperate in its proposals for new Securities Law Legislation (SLL) at the end of 2010.
- The timeframes in the voting chain should be harmonized in order to clarify record dates and cut-off dates in advance and to prevent timeframes from differing according to jurisdiction or custodian. Obviously, this timeframe must be long enough to prevent the effective use of shareholders' rights from being undermined.
- New legislation should make vote confirmation obligatory. Ideally, the responsibility for this should rest with the listed companies. This will allow the laying of an audit trail from the listed companies to the vote holders to ensure that shareholders receive confirmation that their votes have been cast in accordance with their instructions for all shares.

4. At which levels are solutions needed?

The solutions should be sought at a European or even a global level, rather than within the Netherlands.

- All the interviewees agreed that there was no need to seek solutions at a national level but they were divided on whether they should be sought at a European or global level.
- A legal obligation on custodians to cooperate and the harmonization of dates in the voting chain would have to be arranged at the European level. Both aims could be achieved via the Securities Law Legislation (SLL) and the Shareholders Directive. However, the SLL, which goes much farther than imposing a cooperation obligation on custodians, has been put on hold by the European Commission. The SLL issues are meeting with a wall of resistance from the member states because they lie in the grey area between financial markets and interference 'from Brussels' in national legislation.
- Cut-off dates for casting votes could be harmonized by introducing an amendment to the Shareholders' Directive followed up by a regulation that would make this part mandatory and immediately applicable in every member state.
- Technologically, a solution can be sought in a harmonized global communication system. Given that financial markets operate globally,

standards for electronic voting would be most effective when the maximum number of investors, custodians, and service providers used one system.

5. What steps has the market already taken?

Various parties are working on improving the voting chain, but progress is slow.

- Problems in and around the voting chain are not new. The search for solutions has been underway for years. The ICGN, for example, is developing best practices by building on the Market standards for AGMs.
- One of the interviewees stated that a European standard for the sharing of data and information is currently being developed and added that, ideally, this standard should be mandatory for every link in the voting chain.
- The parties in the chain move slowly. Most agreements made are unenforceable. Moreover, not everyone has equal interest in proxy voting, so not all parties are equally prepared to take on the extra costs it entails.

6. Does the solution lie in regulation or in self-regulation?

No clear answer has emerged yet as to whether the solution lies in regulation, or in an alternative such as self-regulation.

- The parties in the chain are unwilling to pay the costs of introducing a standard system across the chain, because there is no general agreement that the problem – lost votes – is serious enough to warrant the investment.

If the legislative authorities take the view that a solution must be found to, for instance, verify votes, then regulation seems the only option. However, there would be little point in tackling the problem only at national level since there are also foreign custodians and service providers on the Dutch market.

- When considering the feasibility of regulation as a solution, matters that will have to be taken into account are cost-benefit analyses, the importance the parties attach to voting, and the differences between institutional investors and retail investors. Investors have different motives for investing – e.g. influence on a company, dividends and/or upside potential, or divergent visions on long-term and short-term engagement.

Any regulatory measures would have to take account of who pays the costs. The interviewees said that the costs of transparency obligations would either be passed on directly to the investor in the form of higher fees or left with the listed companies. The benefits are better stewardship and more efficiency in the chain, which, in turn, will lead to better corporate governance and prevent unrepresentative voting outcomes. The latter effect

will also boost trust in the effectiveness of the capital market mechanisms, particularly when issues are subject to dispute.

7. Is there a role for the AFM to play?

The AFM's role is primarily to instigate debate at ESMA (European Securities and Markets Authority) to reach a European solution.

- As noted earlier, solutions to the inefficiencies in the voting chain should be sought at European and global level.
- The interviewees were unanimous that the only role the AFM could play at present is to set the issue on the ESMA agenda with a view to achieving Europe-wide regulation.

3 Recommendations

The AFM has taken due note of the above findings and conclusions and has formulated a series of recommendations for itself and the market:

AFM

- The findings and conclusions should be shared at European level within ESMA. The AFM is one of the 28 national regulators in ESMA. The Corporate Finance Standing Committee is the body within ESMA where the issue can be addressed. It can then advise the European Commission if it decides that the European regulations are in need of amendment.

The AFM will also ask the Dutch Corporate Governance Code Monitoring Committee to take a close look at the issue.

- The Ministry of Finance will have to be advised that attention must be paid to the role of the voting chain in the Securities Law Legislation by, amongst other things, according due consideration to the problems identified by the Dutch parties. The 2010 proposal that custodians be legally obliged to cooperate in the exercise of voting rights should be maintained in any proposals by the European Commission.
- Any regulation will lie in the grey area between financial markets and intervention in national legislation. The AFM can alert the Ministry of Justice and Security to the problems in the voting chain during the discussions on EU regulations for company law.

The market

- Establish standardized electronic forms for uniform use across the voting chain.
- Parties in the voting chain must work towards and promote uniform record dates and cut-off dates.
- Best practices and scorecards must be ready for the ICGN meeting in Amsterdam in June 2014.
- Voting chain services should be provided as a basic service by custodians or any other links in the voting chain.
- Shareholders must make an effort to acquire verification that their votes have been processed and cast in accordance with their instructions. Shareholders should also urge enterprises to make it easier to vote, electronically and otherwise.

4 Response to the report

One of the recommendations is that the AFM ask the Corporate Governance Code Monitoring Committee to take a close look at the issue. Accordingly, the AFM has forwarded its report to the Chair of this committee, Professor Jaap van Manen. The Corporate Governance Code Monitoring Committee warmly welcomed the report and responded as follows:

“The Corporate Governance Code Monitoring Committee is gladdened by the AFM report. The problems in and around the voting chain have been around for years and continue to give rise to concern. The previous Committee noted that the lack of transparency in the chain was undesirable. The previous Committee also took the view that the accurate operation of voting procedures in a chain directly relates to the ability to cast votes as one sees fit. The Committee will consider the findings of the AFM study in its work and research into the role of the shareholder.”

The AFM also asked the VEB (Dutch Association of Shareholders) and Eumedion, as investor representatives, to respond to the report.

The VEB welcomed the report on the problems in the voting chain.

“For years the VEB shareholders’ association has been working in various international and national contexts to solve and prevent problems in the voting chain. Voting rights are to an extent the most important rights that investors acquire upon the purchase of share capital. It is difficult for investors in cross-border situations to get their vote to companies via the voting chain. Moreover, there is often no verification of the vote or notification of the outcome. It is unacceptable that flaws in the voting chain can prevent votes that are believed to have been cast from being counted in the decision-making.”

The VEB supports the main recommendation of the AFM to address the problem as much as possible via ESMA and the European Commission, and to push for regulation at the international level. International regulation should assure investors that the votes they believe they cast were actually counted. When investors can challenge all the links in the chain and actually force them to cooperate, the number of lost votes will fall. This will improve decision-making at the AGM and strengthen trust in the financial infrastructure. Hopefully, the AFM report will push this issue to the top of the European legislation agenda in the near future.”

Eumedion, which represents the interests of its institutional investors, also welcomed the report. “Institutional investors are still coming up against serious technical and legal obstacles when they want to vote by proxy – particularly, but not exclusively, in cross-border situations. These obstacles make it difficult for institutional investors to fulfil their responsibility to act as engaged shareholders with a long-term focus, which society increasingly expects of them.

It is essential that Europe legally obliges custodian banks to cooperate in the exercise of shareholder voting, as the AFM proposes, in order to realize concrete

improvements in the voting infrastructure. Obligatory verification by listed companies that votes have been cast, again as the AFM proposes, would also bring about a significant improvement. Hopefully, the AFM report will speed up action from the European legislator in this domain.”

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Amsterdam, March 2014

