The Elimination of Broker Voting in Director Elections

Ali C. Akyol Konrad Raff Patrick Verwijmeren*

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Abstract

In 2009, the Securities and Exchange Commission (SEC) reformed shareholder voting by eliminating uninstructed broker voting in director elections. We use this reform as a quasi-natural experiment to assess the value of shareholder empowerment. Using different control groups and various cross-sectional tests, we find that the reform did not increase average equity values.

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*Ali C. Akyol: Department of Finance, University of Melbourne, Melbourne, Australia, Email: aakyol@unimelb.edu.au; Konrad Raff: Department of Finance, Norwegian School of Economics, Bergen, Norway, Email: Konrad.raff@nhh.no; Patrick Verwijmeren (corresponding author): Department of Finance, Erasmus University Rotterdam, Rotterdam, The Netherlands, Email: verwijmeren@ese.eur.nl. We thank Augustin Landier, Ron Masulis, Albert Menkveld, Oliver Spalt, Per Stromberg, Ralph Walkling, Qiaoqiao Zhu and participants at the 2011 FIRN conference and the 2012 FMA meeting for useful comments.

1 Introduction

The right to elect the board of directors is perhaps the most fundamental right of shareholders in a corporation. In 2009, the Securities and Exchange Commission (SEC) banned broker votes for the elections of directors.[1] Prior to the reform, registered brokers were allowed to vote at their discretion in director elections if their clients had not given them voting instructions before the annual meeting. Historically, such uninstructed broker votes were almost always cast in favor of management's nominees and amounted to approximately 11 to 14% of the votes cast (Bethel and Gillian, 2002). The stated goal of the reform was to improve corporate governance by making board elections more competitive.

For research in corporate governance the elimination of broker voting is of great interest because it provides a quasi-natural experiment to estimate the effect (if any) of shareholder empowerment on equity values. On the one hand, the reform may be beneficial for shareholders because it gives them more power to hold boards accountable in elections. On the other hand, both empirical and theoretical research recognizes that shareholder empowerment may be costly. For example, investors may lack relevant information, their intervention might discourage managerial initiative, or they might pursue specific agendas. In a survey article, Yermack (2010) discusses the costs and benefits of shareholder empowerment and conjectures that the elimination of broker voting is a major governance reform that, together with two other reforms (of voting standards and proxy access), will make shareholder voting more effective.

Understanding the costs and benefits of shareholder empowerment is not only impor-

[1]The final release by the SEC is available at https://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

tant for academics but also for practitioners. Indeed, the reform of broker voting received widespread attention and support by market participants, the business press, and by policy makers. In 2007, the Wall Street Journal (Scannell, 2007) wrote that "investors ... may soon get a boost, as the role of shareholder votes cast by brokers comes under closer scrutiny." The Council of Institutional Investors declared in 2009 that "this long overdue reform is needed now more than ever" and proxy advisor firms Glass Lewis and ISS were also strongly supporting the rule change.[2] In addition, the U.S. House of Representatives exposed the SEC to political pressure.[3]

We contribute to the literature on corporate governance by estimating the stock market's response to the elimination of broker voting in director elections. We consider nine important dates in the period between 2003 and 2009 that increased or decreased the probability that the reform would be implemented and run an event study using two different control groups. Our results suggest that the reform did not increase shareholder value. In almost all specifications we fail to find any valuation effect. In the few specifications that yield significant results, abnormal stock returns are negative. Moreover, in a cross-sectional analysis we examine subsets of firms for whom the reform was likely to be most relevant and again find no increase in value for these firms. Overall, our findings suggest that the reform was not effective and did not benefit shareholders.

Our paper is closely related to other recent studies of governance reforms. A contemporaneous working paper by Anderson and Nayar (2013) also examines the elimination of broker

[2]See http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692.shtml. ISS demanded already in 2003 that broker votes be abolished (see http://sec.gov/rules/proposed/s71903/iss121803.htm).

[3]See http://www.shareholdercoalition.com/marketoversighthearingtranscript.pdf.

voting. They focus on six dates and find that the reform had a value-neutral effect on five of their six event dates, which is consistent with our results.[4] Akyol et al. (2012) and Larcker et al. (2011) study the wealth effects of attempts by the SEC to facilitate shareholder proxy access and find a negative effect on shareholder wealth, whereas Becker et al. (2013) and Cohn et al. (2014) conclude that the stock market put a positive value on shareholder proxy access. Our finding that the reform of broker voting had a neutral (or negative) effect is more in line with Akyol et al. (2012) and Larcker et al. (2011), as it points out limitations of recent governance reforms.

2 Timeline of the Change in Broker Voting Regulation

Rule 452 of the New York Stock Exchange allows brokers to vote at their discretion at annual meetings on "routine" proposals if they have not received voting instructions from their clients.[5] Uncontested director elections were considered to be a "routine" matter until 2009, when the SEC approved a NYSE proposal that classified uncontested elections as "non-routine," thus eliminating broker votes. The reform became effective for annual meetings on or after January 1, 2010.

[4]Our methodology differs from theirs in several respects. While they, like us, consider a global market index as a control group, we moreover use a second control group, the returns of firms registered under the Investment Act of 1940. The latter type of firms was exempted from the rule change due to an amendment filed by the NYSE with the SEC on May 27, 2007. A second difference between the studies concerns the choice of reform-related event dates. While we consider nine event dates leading up to the rule change, they focus on six dates, including some of the same dates examined by us.

[5]NYSE Rule 452 lists "non-routine" matters on which brokers cannot vote without instructions from clients such as contested director elections and merger proposals.

Table 1: Events Related to Broker Voting

This table presents an overview of important regulatory and legislative events related to broker voting. The events are obtained by an extensive search in Factiva, Google, and the SEC's website. The last column reports whether the event increases or decreases the likelihood of the elimination of broker voting.

Event #	Event Date	Event Description	Regulation Likelihood
1	July 30, 2003	Broker voting lands on the SEC's radar screen	Increases
2	November 17, 2004	Early Dow Jones Newswire	Increases
3	April 25, 2005	First NYSE Working Group meeting	Increases
4	June 5, 2006	Recommendations of Working Group published	Increases
5	October 24, 2006	Rule proposed to the SEC	Increases
6	September 28, 2007	Reports on postponement	Decreases
7	May 21, 2008	Press reports about proposal being stuck	Decreases
8	February 26, 2009	Rule published for comment by SEC	Increases
9	July 1, 2009	Rule approved by SEC	Increases

We identify nine important event dates in the reform process. The regulation of broker voting first received attention in 2003. According to a detailed article in the Wall Street Journal (Plitch, 2003) on July 30, 2003 (event #1), the issue of broker voting has "landed on the Securities and Exchange Commission's radar screen." On November 17, 2004 (event #2), Dow Jones Newswire (Plitch, 2004) reports that the NYSE is considering a reform of its proxy voting system. In 2005, the NYSE established the Proxy Working Group with the mandate to review the exchange's voting process and especially Rule 452 on broker voting. The group held its first meeting on April 25, 2005 (event #3) and published a report on June 5, 2006 (event #4), recommending that the NYSE amend Rule 452 to eliminate broker votes in director elections.[6] On October 24, 2006 (event #5), the board of the NYSE adopted the recommendations of its Working Group and filed a proposed rule change with the SEC.

In the following year, the reform process slowed down. Dow Jones Newswires (Whitehouse, 2007) reported on September 27, 2007 (event #6) that the NYSE had put on hold

[6]The report is available at https://www.nyse.com/why-list/partnership/advocacy/ccg.

any plans to eliminate broker votes. On May 21, 2008 (event #7), a detailed article on Dow Jones Newswires (Burns, 2008) reported that the elimination of broker voting seems to be "stuck at the SEC." The situation changed after Mary Schapiro was appointed by President Barack Obama as SEC Chairperson in the beginning of 2009, when the SEC published the proposed rule change for comment on February 26, 2009 (event #8).[7] On July 1, 2009 (event #9), the rule was approved by the SEC and became effective on January 1, 2010.

3 Data and Summary Statistics

Our sample consists of firms in the S&P 500 index at the end of 2009. We require firms to report their industry classification, firm size and return on assets in Compustat, their stock returns in CRSP, their institutional holdings in the Thomson Reuters 13F filings database, their voting standard for director elections and anti-takeover provisions in ISS (formerly RiskMetrics), and their voting results for director elections in SEC Edgar. This leaves us with a sample of 457 firms.

Table II reports descriptive statistics of the firms in our sample for the 2009 fiscal year. The percentage of broker discretionary votes is the number of broker discretionary votes divided by total votes cast and is 12% on average. The approval rate is the percentage of votes cast in favor of a particular director. Because the rule change was not in effect in 2009, broker discretionary votes are included in the reported approval rates. We find that the average approval rate in 2009 is 93%.

[7]The SEC's notice of filing of the proposed rule change is available at: http://www.sec.gov/rules/sro/nyse/2009/34-59464.pdf.

Table 2: Summary Statistics

This table presents summary statistics for our sample of 457 firms. The data are from the 2009 fiscal year. Votes cast are reported in millions of votes. Percentage of discretionary broker votes is the number of discretionary broker votes divided by total votes cast. The approval rate is the percentage of votes being in favor of a director. We calculate the average approval rate per firm. Firm size is total assets and is reported in millions of dollars. Return on assets is measured by the ratio of operating income before depreciation to total assets. Institutional ownership is the proportion of outstanding shares held by institutional owners at the end of 2009. The entrenchment index based on Bebchuk et al. (2009) counts the number of provisions a firm has out of the following six: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. The Herfindahl-Hirschman index is the sum of the squared market shares of firms based on three-digit SIC codes. Majority voting equals one for a majority voting standard, zero for a plurality voting standard, and 0.5 for a plurality-plus-resignation voting standard.

Variable	Mean	Median	Standard Deviation	Minimum	Maximum
Total votes cast (in millions)	554	246	1,077	11	12,409
Percentage of discretionary broker votes	0.121	0.107	0.065	0.001	0.441
Approval rate	0.931	0.960	0.082	0.490	0.997
Firm size (in millions $)	52,559	11,848	194,279	680	2,223,299
Return on assets	0.128	0.118	0.088	-0.242	0.655
Institutional ownership	0.847	0.865	0.132	0.312	1.000
Entrenchment index	3.562	3.000	1.183	0.000	6.000
Herfindahl-Hirschman index	0.187	0.148	0.173	0.019	1.000
Majority voting	0.663				

4 Market Response to the Reform of Broker Voting

We study the effect of the elimination of discretionary broker voting in uncontested director elections on shareholder value. Selecting a control group is challenging because Rule 452 is a member rule, meaning that it applies not only to companies listed on the NYSE, but also to companies whose stock is held for customers by member firm broker-dealers. Hence, virtually every listed U.S. firm is affected. Following Zhang (2007) and Akyol et al. (2012), we therefore use a global market index that excludes U.S. stocks as a control group. As our

second benchmark, we use firms registered under the Investment Act of 1940 since they were exempted from the reform: On May 23, 2007, the SEC filed an amendment to the proposed rule change, requesting that these firms would be exempted if the reform were passed. We employ this control group only for our last four event dates after May 2007.

Because the events affect all firms simultaneously, we account for cross-sectional correlation of individual stocks by employing a portfolio approach. Specifically, we use the following model adapted from Schipper and Thompson (1983):

$$r_{pt} = \beta_0 + \beta_1 r_{m,t} + \sum_{e=1}^{E} \gamma_{pe} D_e + \epsilon_{pt}. \tag{1}$$

Here, r_{pt} is the day t return on the equally-weighted portfolio p and $r_{m,t}$ is the contemporaneous return of the control group. D_e is a dummy variable that equals one (minus one) for any event e that increases (decreases) the probability of the rule change, and equals zero otherwise.

When using the global index as a control group, we modify the Schipper and Thompson (1983) specification by including lead and lagged market returns, which mitigates the potential bias from non-synchronous trading due to time differences between countries in our global market index. We obtain the time series data of the Dow Jones Global ex-U.S. Composite Index from Reuters. The estimation period is July 30, 2002 until July 31, 2009. Our main event window is $[-1, 1]$. Panel A in Table III shows that the overall reaction to the rule change is not statistically significant when using the global index. The coefficient of the daily abnormal return is close to zero and the p-value is 0.804. To examine the wealth effects in more detail, Panel B reports the abnormal returns for each separate event date

described in Table I (by letting the dummy De equal one for one particular event at a time). We do not find statistically significant abnormal returns on any of the event days.

Next, we use our second control group, the equally-weighted returns of a sample of 372 listed companies that fall under the Investment Act of 1940. We obtain this sample by collecting closed-end funds from CRSP and we focus on the last four event dates as explained above.[8] Panel C documents a negative overall wealth effect that is weakly statistically significant. When we examine the events separately in Panel D, we only find a statistically significant effect for event 8, relating to the date that the rule was published for comments by the SEC, after it had appeared to be stuck. The effect of this event on abnormal stock returns is negative. In unreported tests we redo the entire analysis in Table III using alternative event windows ($[0, 1]$, $[0, 3]$ and $[-15, 1]$). Using these windows, we do not find any significant wealth effects around the events for either of the two control groups. Overall, we conclude that there is no evidence that the reform increased shareholder value. If anything, weak evidence suggests that the effect may have been negative.

Although overall wealth effects seem to be insignificant, a subsample of firms may be affected by the rule change. We examine the effect of the following eight variables on cross-sectional abnormal returns on the nine event dates. The elimination of broker voting is likely to be more relevant for firms with a higher percentage of broker votes (1), for firms in which average director approval rates are low (2) (since the reform makes it easier to vote a director off the board), and for firms with a majority voting standard (3).[9] Firms with weak

[8]Closed-end funds have a CRSP share code of 14.

[9]For a given percentage of approval votes, the probability of a director being removed from the board is highest with a majority voting standard and lowest with a plurality voting standard, with the plurality-

Table 3: Wealth Effects of Changes in Rule 452

This table presents daily abnormal returns around events related to changes in the rules for broker discretionary voting. The event window is $[-1, 1]$. In Panel A, we report overall daily abnormal returns of our sample of S&P 500 firms on the nine event dates as reported in Table I, with a global index (the Dow Jones Global Ex. U.S. index) as benchmark. In Panel B, we report the abnormal returns per event. Panel C shows the overall wealth effects when we use the returns of companies registered under the Investment Company Act of 1940 as a benchmark. In Panel D we report the abnormal returns per event. ***, **, and * indicate significance at the 1%, 5%, and 10% significance level, respectively.

Panel A. Overall Wealth Effects (Global Index)		
	Coefficient	p-value
Daily abnormal return	-0.001	0.804
Market return (t)	0.581***	0.000
Market return (t-1)	-0.157***	0.000
Market return (t+1)	0.532***	0.000
Intercept	0.000	0.407
Panel B. Wealth Effects per Event (Global Index)		
	Coefficient	p-value
Event #1	0.003	0.681
Event #2	-0.002	0.752
Event #3	0.000	0.964
Event #4	0.004	0.594
Event #5	0.001	0.931
Event #6	-0.002	0.798
Event #7	-0.002	0.736
Event #8	-0.010	0.133
Event #9	-0.004	0.539
Panel C. Overall Wealth Effects (Investment Company Index)		
	Coefficient	p-value
Daily abnormal return	-0.006*	0.096
Market return (t)	1.149***	0.000
Intercept	0.000	0.668
Panel D. Wealth Effects per Event (Global Index)		
	Coefficient	p-value
Event #6	0.001	0.916
Event #7	-0.005	0.516
Event #8	-0.019**	0.013
Event #9	-0.010	0.168

shareholder rights (4), as measured by a high score on the entrenchment index (Bebchuk et al., 2009), and small firms (5) are also more likely to be affected by the rule change. Regarding the latter variable, opponents of the reform have argued that the exclusion of broker votes will make it harder for firms to obtain a necessary quorum, forcing them to devote resources towards soliciting shareholder votes. This effect would disproportionally hurt small firms. We also examine the possibility that the reform mattered more for poorly performing firms (6) or for firms with larger institutional ownership (7). Finally, the relevance of the rule change might depend on the extent of product market competition (8). Giroud and Mueller (2010) suggest that corporate governance might not matter for firms in very competitive industries because market pressure serves as a disciplining device.

For cross-sectional analyses, Sefcik and Thompson (1986) provide a weighting procedure that controls for cross-correlation and cross-sectional heteroskedasticity in firm residuals. We follow their procedure and form a matrix F that has a column of ones and $P-1$ columns of characteristics. In our case, P equals nine as we examine eight firm characteristics. We then form P sets of portfolio weights and compute the portfolio returns for each set of weights as follows:

$$W = \begin{bmatrix} W_1' \\ W_2' \\ \cdots \\ W_P' \end{bmatrix} = (F'F)^{-1}F' \tag{2}$$

where W is a PxN matrix of portfolio weights, W_k' is the k^{th} row of portfolio weights, and F

plus-resignation voting standard being in between.

Table 4: Cross-Sectional Abnormal Returns

This table presents the results from the cross-sectional analysis. Event parameters are based on Sefcik and Thompson (1986). We regress the abnormal returns on eight firm characteristics. Data are from the 2009 fiscal year. Percentage of discretionary broker votes is the number of discretionary broker votes divided by total votes cast. The approval rate is the percentage of votes being in favor of a director. We calculate the average approval rate per firm. Majority voting equals one for a majority voting standard, zero for a plurality voting standard, and 0.5 for a plurality-plus-resignation voting standard. The entrenchment index counts the number of provisions a firm has out of the following six: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. Institutional ownership is the proportion of outstanding shares held by institutional owners at the end of 2009. Return on assets is measured by the ratio of operating income before depreciation to total assets. Firm size is the natural logarithm of total assets. The Herfindahl-Hirschman index is the sum of the squared market shares of firms based on three-digit SIC codes. Coefficients are multiplied by 100. p-values are provided in parentheses. ***, **, and * indicate significance at the 1%, 5%, and 10% significance level, respectively.

Variable	[-1,1]	[0,1]	[0,3]	[-15,1]
Percentage of	-0.167	-0.935	-0.893	0.182
discretionary broker votes	(0.754)	(0.150)	(0.053)	(0.421)
Approval rate	-0.110	-0.117	0.215	-0.020
	(0.714)	(0.748)	(0.407)	(0.876)
Majority voting	0.015	-0.029	-0.033	-0.008
	(0.808)	(0.702)	(0.538)	(0.772)
Entrenchment index	-0.021	-0.049	-0.010	-0.011
	(0.401)	(0.110)	(0.650)	(0.303)
Institutional ownership	-0.766**	-0.833*	-0.590*	-0.043
	(0.026)	(0.051)	(0.052)	(0.774)
Return on assets	0.070	-0.475	0.018	-0.125
	(0.907)	(0.517)	(0.972)	(0.624)
Firm size (in millions $)	-0.012	-0.026	0.021	-0.006
	(0.807)	(0.668)	(0.627)	(0.775)
Herfindahl-Hirschman index	-0.356*	-0.159	-0.024	-0.041
	(0.085)	(0.531)	(0.894)	(0.642)
Intercept	0.960	1.625**	0.253	0.200
	(0.133)	(0.038)	(0.649)	(0.463)

is an NxP matrix. We obtain the return on portfolio p on day t by $R_{pt} = W_p' R_{it}$, in which R_{it} is an Nx1 vector of individual firms' stock returns on day t. Finally, we run p portfolio time-series regressions by using Equation 1. The estimates from the regressions reflect the effect of each firm characteristic on the overall market reaction to the nine events, while controlling for the effects of other firm characteristics.

Table IV reports the cross-sectional results for four different event windows. Perhaps

most surprisingly, we do not find that firms with a relatively high percentage of broker discretionary votes have different abnormal returns around the event dates than firms with a relatively low percentage. Almost none of the variables that we examine have a statistically significant effect on the abnormal returns. Overall, we find little evidence that the change in Rule 452 affects equity values of any subsets of firms.

5 Conclusion

We study a reform that received widespread attention by academics and practitioners, namely the elimination of broker voting in director elections. We document that the reform did not increase equity values. The effect is value-neutral and in some specifications even negative. These findings are obtained for two different control groups and are corroborated by various cross-sectional tests.

Many attempts to reform financial markets presume that shareholder empowerment is beneficial to shareholders. Our findings raise doubts about this premise. They are in line with recent studies of another reform, shareholder proxy access, which document negative wealth effects and point to limitations of shareholder empowerment (Akyol et al., 2012; Larcker et al. 2011). Our study suggests that more research is needed on the potential costs of stronger shareholder rights. These costs may come in different forms. For example, shareholders may lack relevant information to take decisions or their intervention might stifle managerial initiative (Yermack, 2010).

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