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Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms

Law Working Paper N° 064/2006
May 2006

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Abstract

Most American publicly held corporations have a one-share, one-vote structure, in which voting power is proportional to economic ownership. This gives shareholders economic incentives to exercise their voting power well and helps to legitimate managers' exercise of authority over property the managers do not own. Berle-Means' separation of ownership and control suggests that shareholders face large collective action problems in overseeing managers. Even so, mechanisms rooted in the shareholder vote, including proxy fights and takeover bids, constrain managers not to stray too far from shareholder wealth maximization. The derivatives revolution and other capital market developments threaten this familiar pattern. Both outside investors and insiders can now readily decouple economic ownership of shares from voting rights to those shares. This decoupling - which we call the new vote buying - is often hidden from public view and is largely untouched by current regulation. Hedge funds have been especially creative in decoupling voting rights from economic ownership. Sometimes they hold more votes than economic ownership, a pattern we call empty voting. That is, they may have substantial voting power while having limited, zero - or, indeed, negative - economic ownership. Sometimes they hold undisclosed economic ownership, a pattern we call hidden ownership. Often, the hidden owners also have morphable voting rights - the de facto ability to acquire the votes if needed. Insiders can also use empty voting techniques. This article analyzes the new vote buying and its corporate governance implications. We propose a taxonomy of the new vote buying that unpacks its functional elements. We discuss the implications of decoupling for control contests and other shareholder oversight. We also propose a disclosure-based regulatory response. Our disclosure proposal would integrate and simplify five existing, inconsistent share ownership disclosure regimes, and is worth considering independent of its value with respect to decoupling. In the longer term, substantive responses to empty voting may be needed; we sketch some possible responses.

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Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms

*By Henry T. C. Hu and Bernard Black**

Most American publicly held corporations have a one-share, one-vote structure, in which voting power is proportional to economic ownership. This structure gives shareholders economic incentives to exercise their voting power well and helps to legitimate managers' exercise of authority over property the managers do not own. Berle-Means' "separation of ownership and control" suggests that shareholders face large collective action problems in overseeing managers. Even so, mechanisms rooted in the shareholder vote, including proxy fights and takeover bids, constrain managers from straying too far from the goal of shareholder wealth maximization.

In the past few years, the derivatives revolution, hedge fund growth, and other capital market developments have come to threaten this familiar pattern throughout the world. Both outside investors and corporate insiders can now readily decouple economic ownership of shares from voting rights to those shares. This decoupling—which we call "the new vote buying"—is often hidden from public view and is largely untouched by current law and regulation. Hedge funds, sophisticated and largely unfettered by legal rules or conflicts of interest, have been especially aggressive in decoupling. Sometimes they hold more votes than economic ownership, a pattern we call "empty voting." That is, they may have substantial voting power while having limited, zero, or even negative economic ownership. In the extreme situation of negative economic ownership, the empty voter has an incentive to vote in ways that reduce the company's share price. Sometimes hedge funds hold more economic ownership than votes, though often with "morphable" voting rights—the de facto ability to acquire the votes if needed. We call this "hidden (morphable) ownership" because under current disclosure rules, the economic ownership and (de facto) voting ownership are often not disclosed. Corporate insiders, too, can use new vote buying techniques.

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This article analyzes the new vote buying and its corporate governance implications. We propose a taxonomy of the new vote buying that unpacks its functional elements. We discuss the implications of decoupling for control contests and other forms of shareholder oversight, and the circumstances in which decoupling could be beneficial or harmful to corporate governance. We also propose a near-term disclosure-based response and sketch longer-term regulatory possibilities. Our disclosure proposal would simplify and partially integrate five existing, inconsistent share-ownership disclosure regimes, and is worth considering independent of its value with respect to decoupling. In the longer term, other responses may be needed; we briefly discuss possible strategies focused on voting rights, voting architecture, and supply and demand forces in the markets on which the new vote buying relies.

Contents

I. Introduction 1013
II. The New Vote Buying: Taxonomy and Public Examples 1020
A. Factors Underlying Decoupling and Decoupling's Functional Elements 1020
Table 1. Some Forms of New Vote Buying 1023
B. Empty Voting 1024
1. Empty Voting Through Equity Derivatives 1024
a. Perry-Mylan and Similar Examples 1024
b. Insider Hedging and Entrenchment 1026
2. Empty Voting Through Record Date Capture 1027
C. Hidden (Morphable) Ownership 1029
1. Morphing from De Facto to Formal Voting Rights 1029
2. Other Uses of Hidden Ownership 1031
D. Related Non-Host Assets 1033
1. Mergers 1033
2. Indirect Hedges 1034
E. The Extent of New Vote Buying 1034
Table 2. Decoupling Examples 1035
III. Current Ownership Disclosure Rules 1037
A. General Considerations 1037
Table 3. Current Ownership Disclosure Requirements Relating to New Vote Buying 1039
B. Existing Disclosure Requirements 1040
1. Large Shareholder Disclosure (Schedules 13D and 13G) 1040
a. Basic Requirements 1040
b. Application to Hidden Ownership 1041
c. Application to Empty Voting 1042
2. Reporting by Institutional Money Managers (Form 13F) 1043
3. Insider and 10% Shareholder Disclosure (Section 16) 1045
4. Mutual Fund Reporting 1046

IV. A Proposal for Integrated Ownership Disclosure 1047
A. General Considerations 1047
Table 4. Proposal for More Integrated Ownership Disclosure 1051
B. Large Shareholder Disclosure (Schedules 13D and 13G) 1052
C. Institutional Money Managers and Mutual Funds 1053
D. Disclosure of Empty Voting 1054
E. Summary 1055
V. Toward Additional Responses to Empty Voting 1055
A. General Considerations 1055
B. Strategies Focused on Voting Rights 1057
1. Direct Limits on Voting Rights 1057
2. Voting By Record Owners: Extension to Equity Swaps 1058
3. Corporation Opt-In 1059
4. State Corporate Law 1060
C. Strategies Focused on Voting Architecture 1062
D. Strategies Focused on Supply and Demand Forces in the Markets on Which the New Vote Buying Relies 1064
1. Encouraging Institutional Shareholders to Vote on Important Matters 1065
2. Safe Harbor for Voting Instead of Lending Shares 1066
3. Reducing the Attractiveness of Lending Shares and Providing Equity Derivatives 1066
4. Imposing Responsibilities on Share Lenders and Derivatives Providers 1067
5. The Demand Side: Executive Hedging 1068
VI. Conclusion 1069

I. Introduction

The governance structure of the modern corporation emerged in a period characterized by two core concepts. One was the "separation of ownership and control," which has been central to thinking about corporate governance since the 1930s. In stylized form, as conceived by Adolph Berle and Gardiner Means,[1] and converted to modern language, the professional managers of public corporations hold few shares yet substantial control. Shareholder-owners face large collective action problems in overseeing managers. Constraining managerial autonomy and reducing the divergence between managerial and shareholder interests are key elements of an overall governance system.

The second core concept was that a "shareholder" has economic ownership coupled with voting power. For much of the period in which modern thinking about corporate governance developed, one-share, one-vote structures were nearly universal, enforced by New York Stock Exchange listing standards. Although dual-class structures became possible around 1990, they remain uncommon. Our views

1. Adolph Berle & Gardiner Means, The Modern Corporation and Private Property (1932).

of the ways in which institutional investor oversight and the market for corporate control can discipline management depend on the coupling of economic interest and voting power. Terminology reflects this coupling: we use a single term, "ownership," to refer to possession of both the economic return on shares and corresponding voting power. The deference that courts pay to shareholder votes is premised on the belief that shareholders have an economic interest in increasing share value and will vote to further that interest. Beyond the instrumental role of voting, Delaware courts treat the concept of shareholder-as-owner-and-voter as the core ideological basis for managerial exercise of authority over property the managers do not own.[2] Securities and Exchange Commission (SEC) "large shareholder" disclosure rules also largely assume the coupling of economic ownership and voting power.[3]

The assumption that votes are tightly linked to economic interest has become increasingly fragile over the past few years. The derivatives revolution in finance, especially the growth in equity swaps and other privately negotiated ("over the counter" or "OTC") equity derivatives, and related growth in the stock lending market, are making it ever easier and cheaper to decouple economic ownership from voting power.[4] Both company insiders and outside investors can take advantage of this opportunity. Hedge funds, the emblematic opportunistic investors, have been at the vanguard; the rapid growth of hedge fund assets has coincided with the increase in decoupling. Sometimes they hold more votes than shares—a pattern we call "empty voting" because the votes have been emptied of an accompanying economic interest. In an extreme case, an investor can vote despite having *negative* economic ownership, which gives the investor an incentive to vote in ways that *reduce* the company's share price.

Investors and insiders can also have economic ownership that exceeds their formal voting rights. This ownership is often "hidden" because current large shareholder disclosure rules often focus on voting power rather than economic interest. Thus, even significant economic ownership may not be known to the outside world. Often, this economic ownership is combined with *de facto* ability to acquire voting rights at any time. The informal, "morphable" nature of these voting rights lets investors plausibly deny the voting power that would trigger disclosure. We use the term "hidden ownership" to refer to undisclosed economic ownership and "hidden (morphable) ownership" to refer to undisclosed economic ownership plus probable informal voting power.

2. *See, e.g.*, Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988); *cf.* MM Companies Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).

3. We provide citations to SEC rules and discuss these rules in Part III.

4. The complexities raised by the "new vote buying" are new examples of the challenges the derivatives revolution and modern financial innovation generally pose to corporate governance principles. For discussions of the overarching issue, see, e.g., Henry T. C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991) [hereinafter "Hu, *New Financial Products*"]; Henry T. C. Hu, *Behind the Corporate Hedge: Information and the Limits of "Shareholder Wealth Maximization,"* 9 J. APPLIED CORP. FIN. 39 (Fall 1996) [hereinafter "Hu, *Behind the Corporate Hedge*"].

We refer to empty voting and hidden (morphable) ownership together as "the new vote buying" or simply as "decoupling." In the past several years, this decoupling has affected takeover battles and control of public companies in (at least) Australia, Canada, Germany, Hong Kong, Italy, Japan, New Zealand, the U.K., and the U.S. How often decoupling has been used, and how often it has altered outcomes, is unknown. Policymakers abroad are beginning to confront the new vote buying, principally by requiring additional disclosure. Policymakers in the U.S. have barely begun to address it, but will soon need to.[5]

There are a number of ways to decouple votes from economic ownership. One common method relies on the stock lending market, which lets one investor "borrow" shares from another. Under standard lending arrangements, the stock borrower has voting rights but no economic ownership, while the stock lender has economic ownership without voting rights. A second approach relies in part on an equity swap, in which the person with the long equity side (the "equity leg") of the swap acquires economic ownership of shares, but no voting rights, while the short side (the "interest leg") often hedges its economic risk by holding shares, thus ending up with votes but no net economic ownership.[6] Finance-savvy readers will quickly see other possibilities, such as relying on put and call options or, where they exist, on single-stock futures.

Surprising results can flow from empty voting. A recent public U.S. instance illustrates the potential risks. Perry Corp., a hedge fund, owned seven million shares of King Pharmaceuticals.[7] Mylan Laboratories agreed in late 2004 to buy King in a stock-for-stock merger at a substantial premium. However, Mylan's shares dropped sharply when the deal was announced. To help Mylan obtain shareholder approval for the merger, Perry bought 9.9% of Mylan—becoming Mylan's largest shareholder—but fully hedged the market risk associated with its Mylan shares. Perry thus had **9.9%** *voting ownership* of Mylan but **zero** *economic ownership*. Including its position in King, Perry's overall economic interest in Mylan was **negative**. The more Mylan (over)paid for King, the more Perry stood to profit.

A second, potentially beneficial use of empty voting involves outside shareholders magnifying the voting power of an existing ownership position. Other things equal, this can reduce shareholder collective action problems. For example, a hedge fund can borrow shares just before the record date for a shareholder vote, then reverse the transaction afterwards. The first publicly reported instance of this "record date capture" strategy occurred in the U.K. in 2002.[8] Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a major U.K. property

5. The only public sector recognition in the United States that we know of is a July 2005 speech by Vice Chancellor Leo Strine, where he stated that what we term "empty voting" and "related factors" are "making it difficult for corporate law makers to avoid a fundamental look" at corporate law. David Marcus, *Thinking Big Thoughts*, CORPORATE CONTROL ALERT, Aug.–Sept. 2005, at 6.

6. The U.K. instrument corresponding to the equity swap is known as a "contract for differences" or CFD. In this article, we use the term "equity swap" to refer to both instruments.

7. We provide citations and further details on this example in Part II.B.1, *infra.*

8. We provide citations on this example and further details in Part II.B.2, *infra.*

company. At the annual general meeting, Laxey emerged with voting power over 9% of British Land's shares, the better to support a proposal to dismember British Land. Just before the record date, Laxey had borrowed 42 million shares. Hedge funds may see record date capture as a tool for responding to incompetent or self-serving management. Company managers will have a different view.

Empty voting by institutions is a close cousin to hedging by managers and controlling shareholders who retain formal ownership of shares, while shedding some or most of their economic ownership.[9] In the U.S., these strategies have typically been driven by such insiders' desire to shed risk while deferring taxes, rather than by vote buying motives. But insiders can also use empty voting techniques to cement their control.

Conversely, investors can have greater economic ownership than voting rights—but with the *de facto* ability to acquire those rights quickly when they are needed. With these "morphable voting rights," the investor likely has full ownership has a practical matter. But under existing disclosure rules, the lack of formal voting rights may let the investor's position remain hidden. Perry's stake in a New Zealand company, Rubicon Ltd., which came to light in 2003, illustrates this.[10] Perry used equity swaps provided by derivatives dealers to hold an undisclosed 16% economic stake, despite New Zealand's large shareholder disclosure rules, which, like section 13(d) ("Section 13(d)") of the Securities Exchange Act of 1934 (the "Exchange Act"),[11] require disclosure by 5% shareholders. When an election came along, Perry went back to its derivatives dealers, unwound the swaps, acquired the "matched shares" held by the dealers to hedge the swaps, and thus obtained formal voting rights. Perry had morphed its *de facto* voting rights into *actual* voting rights. Its failure to disclose the swaps was held not to violate New Zealand law. Morphable voting rights can also be useful for reasons unrelated to disclosure; for example, to avoid "mandatory bid" rules requiring large shareholders to offer to buy all remaining shares.[12]

The new vote buying is largely unregulated and often unseen. Corporate case law relating to "classic" vote buying is generally unlikely to reach the new vote buying without major changes in doctrine.[13] In the leading Delaware case, *Schreiber v. Carney*, vote buying is defined as "a voting agreement supported by consideration personal to the [selling] stockholder, whereby the stockholder divorces

9. *See, e.g.*, Donoghue v. Centillium Communications Inc., No. 05 Civ. 4082 (WHP) 2006 U.S. Dist. LEXIS 13221 (S.D.N.Y. Mar. 28, 2006) (discussing variable prepaid forward contracts and how they are regulated under Section 16 of the Exchange Act); J. Carr Bettis, John M. Bizjak & Michael L. Lemmon, *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insider*s, 36 J. FIN. & QUANT. ANALYSIS 345 (2001) (discussing zero-cost collars and equity swaps).

10. We provide citations on this example and further details in Part II.C.1, *infra.*

11. Securities Exchange Act of 1934 (ch. 404, 48 Stat. 881) [hereinafter "Exchange Act"], § 13(d) (codified as amended at 15 U.S.C. § 78m(d) (2000 & Supp. III 2003)).

12. We discuss other uses of morphable voting rights in Part II.C, *infra.*

13. Vote buying by insiders can, however, sometimes be challenged under fiduciary duty rules. See *infra* Part V.B (discussing, for instance, *Hewlett v. Hewlett-Packard*).

his discretionary voting power and votes as directed."[14] The focus is on a *transfer of voting rights* to a vote buyer from a **vote seller**; the court then assesses the seller's motives. In contrast, the new vote buyer can often follow a two-step process, in which neither step involves a transfer of voting rights or a vote seller. *First*, the new vote buyer buys shares in the open market. *Second*, it offsets economic ownership of the shares through derivatives transactions. Thus, in the Perry-Mylan situation, Perry purchased Mylan shares, and then hedged its economic ownership through equity swaps. That is, with modern decoupling, the vote is often acquired not through the transfer to a vote buyer of *voting rights* **by a vote seller**; but through the transfer **by a vote buyer** of *economic ownership*. The vote buyer is left only with voting ownership. It has engaged in two ordinary market transactions—purchasing shares and using derivatives for hedging purposes—which are not individually suspect. A new vote buyer using record date capture rather than the foregoing two-step process is also generally not reached by existing case law.[15]

Federal disclosure rules scarcely touch the new vote buying either. Institutional investors must disclose their share positions in public companies on Form 13F,[16] but generally need not disclose transactions that offset the voting rights or economic interest conveyed by these positions. Nor must they disclose economic ownership acquired through equity swaps or other OTC derivatives. The Schedule 13D and Schedule 13G rules[17] governing disclosure by 5% shareholders are more extensive but with some attention to legal niceties, hidden (morphable) ownership and empty voting positions can often be structured in a way that arguably evades the 13D/13G disclosure requirements, and is commonly not disclosed. Even in Perry-Mylan, where Perry filed a Schedule 13D, it made only partial, rather opaque disclosure of its hedging agreements.[18] Disclosure by insiders and 10% shareholders under section 16 of the Exchange Act ("Section 16")[19] focuses on economic ownership and thus captures empty voting through hedging (since hedging affects economic ownership) but likely does not cover empty voting through stock borrowing (since economic ownership does not change).

Because the new vote buying is often not captured by disclosure rules, its scale is unknown. We did, however, find over twenty confirmed or publicly rumored examples, almost all of which have occurred since 2002. These are set out in Table 2. It is no accident that most of these examples are quite recent, nor that most

14. Schreiber v. Carney, 447 A.2d 17, 23 (Del. Ch. 1982). *See also* Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776 (1979).

15. We discuss this in Part V.B, *infra.*

16. Form 13F, Information Required of Institutional Investment Managers Pursuant to Section 13(f) of the Securities Exchange Act of 1934 and Rules Thereunder, 17 C.F.R. § 249.325 (2005) [hereinafter "*Form 13F*"].

17. 17 C.F.R. §§ 240.13d-1–.13d-7 (2005); Schedule 13D, 17 C.F.R. § 240.13d-101 (2005); Schedule 13G, 17 C.F.R. § 240.13d-102 (2005).

18. News reports suggest that the SEC is considering an enforcement action against Perry, presumably under the 13D rules. *See, e.g.*, Ianthe Jeanne Dugan, *Hedge Funds Draw Scrutiny Over Merger Play*, WALL ST. J., Jan. 11, 2006, at C1.

19. Exchange Act § 16(b), 48 Stat. at 896 (codified as amended at 15 U.S.C. § 78p(b) (2000 & Supp. III 2003)).

involve hedge funds. The theoretical possibility of decoupling votes from economic ownership is not new.[20] What is new are investor ability to do so on a large scale, newer derivatives (such as equity swaps) which simplify decoupling, declining transaction costs, and a trillion dollar-plus pool of sophisticated, lightly regulated, hedge funds, largely free from the conflicts of interest and concerns with adverse publicity that may deter other institutional investors from using decoupling strategies.

The corporate governance challenges posed by new vote buying are clear, but the remedies are not. In the near term, we believe that enhanced disclosure (crafted with sensitivity to the costs of disclosure) is desirable, to let both regulators and market participants assess how much new vote buying occurs and how often it affects shareholder voting or transaction outcomes. If disclosures are made on a real-time basis (a step that goes somewhat beyond our proposal), they can also let the Delaware courts (the most likely venue) address voting rights on a case-by-case basis under general corporate law principles.

Four themes motivate our disclosure reform proposals. One is that disclosure rules should be internally consistent—they should treat substantively identical positions similarly, which current rules do not. In particular, given investors' ability to morph from economic-only to economic-plus-voting ownership, the rules must cover both economic and voting ownership. A second theme is to produce disclosure that is "good enough" to let regulators, companies, and investors assess how often vote buying occurs, without imposing large new costs on anyone. A third theme is to treat long and short positions symmetrically.

The fourth theme is simplification of the ownership disclosure rules. Currently, there are five distinct, idiosyncratic ownership disclosure regimes, applicable respectively to active 5% shareholders (Schedule 13D), passive 5% shareholders (Schedule 13G), institutional investors (Form 13F), insiders and 10% shareholders (Section 16), and mutual funds.[21] Our proposals would greatly simplify this complex scheme, and move toward an integrated system of share ownership disclosure, analogous to the current integrated disclosure regime for company disclosures. Moving toward integrated, consistent ownership disclosure could well be worthwhile independent of its role in addressing the new vote buying.

In proposing disclosure reforms, we take as given the rough economic and political logic behind the current rules. We do not revisit whether large shareholders or major institutions should disclose their share positions, nor the threshold levels for this disclosure. The optimality of these thresholds is contestable. We believe, however, that the thresholds are reasonable and that, whatever the thresholds are, the disclosure rules should be internally coherent, which at present they are not. Moreover, the political history of disclosure, in the U.S. and elsewhere, suggests that our political system will not tolerate hidden control of major companies, nor control contests waged behind closed doors. So disclosure there

20. For an example of how to hedge a share position with options, see, e.g., RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 570–72 (7th ed. 2003).

21. *See infra* Part III.B.

will be. Our aim is to make that disclosure coherent, simple, and therefore relatively low-cost.

As a regulatory response to hidden (morphable) ownership, disclosure alone may suffice. For empty voting, other responses may also be needed. Still, we consider it premature to adopt proposals that go beyond disclosure at this point.

One reason is that empty voting can sometimes be beneficial and sometimes not, depending on the circumstances. On one hand, empty voting by insiders can increase entrenchment and undermine external oversight. Empty voting with negative economic interest is also troubling. On the other hand, hedge funds using empty voting can, under certain circumstances, strengthen shareholder oversight of company managers. Empty voting could let votes move from less to better informed hands and, thus, could enhance the effectiveness of shareholder oversight.[22] Of course, supporters of management discretion will have a different view. Martin Lipton, for instance, believes that hedge fund activism and "abusive" takeovers can cause managers to focus too much on short-term results.[23] Under this view, decoupling by outside investors would tend to exacerbate the problem. We do not address here the optimal level or type of shareholder oversight of managers; we merely note that many observers believe that more external oversight would be beneficial on balance.

Another problem with some regulatory responses stems from the multiple forms that new vote buying can take, and the need to understand these forms before regulating them. As yet, we know too little about the new vote buying to know what rules to write. Yet delegating rule-writing power to companies is problematic, because company managers may well write rules that block vote-buying forms used by outside investors, while allowing forms used by insiders. Moreover, some substantive responses may exceed the SEC's statutory authority.

Nonetheless, over a longer term, additional steps could prove useful in addressing empty voting. We discuss three families of possible strategies at the end of this article. One family focuses directly on voting rights. The key question is: under which circumstances should empty voters lose voting rights? A second family of strategies focuses on updating the mechanics of shareholder voting. A

22. *See* Susan E.K. Christoffersen, Christopher C. Geczy, David K. Musto & Adam V. Reed, Vote Trading and Information Aggregation (Jan. 20, 2005) (unpublished draft), *available at* http://ssrn.com/abstract=686026; Hu & Black, *New Vote Buying*, *infra* note 24, at 857 (our analysis of foregoing draft).

23. *See, e.g.*, Martin Lipton & Steven A Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 210 (1991); Martin Lipton, *Is This the End of Takeovers?*, WASH. POST, Nov. 6, 1988, at H2; Martin Lipton et al., Wachtell, Lipton, Rosen & Katz, *Be Prepared for Attacks by Hedge Funds* (Dec. 21, 2005) (on file with *The Business Lawyer*).

Concerns that hedge fund activism may lead to such corporate "short-termism" are closely related to issues like conflicts among "generations" of shareholders and differences between running a company to maximize shareholder wealth based on share trading prices (i.e., "actual shareholder wealth maximization") and running a company to maximize shareholder wealth based on share intrinsic values (i.e., "blissful shareholder wealth maximization"). *See e.g.*, Hu, *New Financial Products*, *supra* note 4, at 1278–87 & 1300–05 (discussion of such matters); Henry T. C. Hu, *Buffett, Corporate Objectives, and the Nature of Sheep*, 19 CARDOZO L. REV. 379, 392–95, & 397–407 (1997) [hereinafter "Hu, *Nature of Sheep*"] (discussion of such matters and in relation to how Warren Buffett and Charlie Munger run Berkshire Hathaway).

third family of strategies focuses on supply and demand forces relating to the new vote buying, such as rules that would encourage or require institutional investors to recall lent shares around voting record dates.

This article proceeds as follows. Part II proposes a taxonomy of the elements of empty voting and hidden (morphable) ownership, and provides details on the public examples we have been able to locate. Part III discusses the current ownership disclosure rules. Part IV presents our integrated ownership disclosure proposal. Part V offers a menu of possible additional longer-term responses. Part VI concludes.

This article is part of a broader research agenda relating to the new vote buying. In two companion articles, one directed at an academic legal audience and the second at a finance audience, we discuss the theoretical and empirical literature (principally in finance) that bears on the benefits and costs of decoupling, present more details on the known examples of new vote buying and on longer-term regulatory options, and provide fuller citations.[24] As far as we are aware, this article and its companions are the first attempt to systematically analyze the new vote buying and its corporate governance implications.[25]

II. The New Vote Buying: Taxonomy and Public Examples

A. Factors Underlying Decoupling and Decoupling's Functional Elements

In their classic 1983 article on voting in corporate law, Judge Frank Easterbrook and Professor Daniel Fischel stated that "[i]t is not possible to separate the voting right from the equity interest" and that "[s]omeone who wants to buy a vote must buy the stock too."[26] This was an oversimplification then, but only a bit. For the most part, voting rights were linked to shares.

With the new vote buying, in contrast, the economic return on shares can be easily decoupled from the related voting rights. Modern financial innovations,

24. *See* Henry T. C. Hu & Bernard S. Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811 (2006), *also available at* http://papers.ssrn.com/abstract=904004 [hereinafter "Hu & Black, *New Vote Buying*"]; Henry T. C. Hu & Bernard S. Black, *Hedge Funds, Insiders and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies* (working paper 2006), *available at* http://ssrn.com/abstract=874098 [hereinafter "Hu & Black, *Hedge Funds and Empty Voting*"].

An initial version of the research that led to this article and its companions was first presented publicly in May 2005, at the annual meeting of the American Law and Economics Association (held at New York University Law School). *See* Henry T. C. Hu & Bernard S. Black, *Empty Voting: Shareholder Voting Rights and Coupled Assets* (Feb. 2005). Subsequent versions were posted on SSRN, beginning on January 6, 2006.

25. *See, e.g.*, David Marcus, *Hedge fund voting: The devil we don't know*, Corporate Control Alert, Mar.–Apr. 2006, at 10. Other articles or working drafts in the legal literature that have either discussed or touched on the issue include Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (preliminary draft, Apr. 9, 2006); David Skeel, *Behind the Hedge—In the Untamed World of Hedge Funds, Rigged Deals and Manipulated Markets Help the Wealthy Thrive While Ordinary Investors Wither*, Legal Affairs, Nov.–Dec. 2005, at 28.

26. Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & Econ. 395, 410 (1983).

especially OTC derivatives, have played a central role in this decoupling.[27] OTC derivatives are customizable tools that can be engineered to facilitate decoupling. The rapid growth in share lending over the last decade pushes in the same direction.[28] Share lending underlies most current decoupling strategies, both directly (for record date capture and short selling) and indirectly, by helping derivatives dealers hedge their exposure on equity swaps. We can expect the "supply" of financial technology available for decoupling to continue to increase.

Demand factors have also been at work. Hedge funds have grown rapidly in the last decade and now have over $1 trillion in investor assets, compounded by many funds' use of leverage.[29] Hedge fund managers typically have wide leeway as to the strategies they can use; many are comfortable with equity derivatives and other sophisticated financial tools. Unlike mutual funds and pension funds, they also face few regulatory constraints. And, in the past year or two, some have adopted corporate governance activism as an investment strategy.[30] Hedge funds usually have fewer conflicts of interest than other institutional investors, and less concern with adverse publicity, so can be more aggressive in using decoupling strategies.

Understanding the new vote buying must begin with identifying its core functional elements. Throughout this article, we assume a simple context: a publicly held corporation with one class of equity (each share carrying one vote) and diversified shareholders with homogeneous preferences. We treat shareholder wealth maximization as a corporate goal and do not consider non-shareholder constituencies.[31] We sometimes refer to an outside investor who engages in new

27. For analysis of the modern process of financial innovation and the emergence of the OTC derivatives market in the 1980s, see, e.g., Henry T. C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L. J. 1457 (1993) [hereinafter, "Hu, *Misunderstood Derivatives*"].

28. *See, e.g.*, Heather McKenzie, *Securities Lending Grows Up*, FIN. NEWS, Oct. 2, 2000; Gene Picone & Richard Warne, *Securities Lending—A Coming of Age*, PENSIONS MGMT., Sept. 1, 2003, *available at* http://www.pensions-management.co.uk/news/fullstory.php/aid/471/A_coming_of_age.html. For other sources on share lending, see *infra* note 130.

29. There is no reliable data on the number of hedge funds or their assets under management. *See* Securities and Exchange Commission, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS—STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 1 n.2 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter "SEC, HEDGE FUND REPORT"]. For the $1 trillion estimate in mid-2005, see *At Deadline*, PENSIONS & INVESTMENTS, Aug. 8, 2005, at 1 (reporting estimate by Tremont Capital).

30. *See, e.g.* Riva D. Atlas, *Some Funds Taking Role Far Beyond Just Investor*, N.Y. TIMES, Aug. 16, 2005, at C1; Lina Saigol, *Hedge Funds are Very Keen to Flex Their Secretive Shareholding Muscle*, FIN. TIMES, Aug. 9, 2005, at 19; Henny Sender, *Hedge Funds: The New Corporate Activists*?, WALL ST. J., May 13, 2005, at C1.

31. We also generally leave aside the distinctions between shareholder wealth maximization based on market prices and shareholder wealth maximization based on intrinsic share values, between the welfare of the corporation and the welfare of the shareholder, between shareholder welfare and shareholder wealth, and short-termism-related issues such as conflicts between short term and long term shareholders. *See, e.g.*, Henry T. C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985 (1995); Hu, *New Financial Products*, *supra* note 4; Hu, *Nature of Sheep*, *supra* note 23, at 388–407; *supra* note 23 (on "short-termism" and related issues).

vote buying as a "hedge fund" and an officer, director or controlling shareholder who does so as an "insider."

To proceed further, it helps to define a set of terms. By "**formal voting rights,**" we mean the *legal* right to vote shares under company law (as supplemented by SEC and stock exchange rules governing voting of shares held in street name), including the legal power to instruct someone else how to vote. Thus, in the common situation where a broker holds shares in street name for a customer, the customer has formal voting rights because it has the right under stock exchange rules to instruct the broker how to vote the customer's shares. By "**voting rights**" or "**voting ownership**" of shares, we mean formal *or informal* rights to vote shares, including the de facto power to instruct someone else how to vote. In Perry-Rubicon, Perry had voting rights because it had the informal power to return to its derivatives dealers at any time, unwind its equity swaps, and obtain Rubicon shares from the dealers.[32] The company at which voting takes place is the "**host company.**"

By "**economic ownership,**" we mean the economic returns associated with shares. This ownership can be achieved **directly** by holding shares, or **indirectly** by holding a "**coupled asset,**" which conveys returns that relate directly to the returns on the shares. Economic ownership can be either **positive**—the same direction as the return on shares—or **negative**—the opposite direction from the return on shares. Someone who owns voting shares has "**full ownership**," consisting of voting ownership plus direct economic ownership. Coupled assets include derivatives (such as options, futures, and equity swaps), contractual rights (such as rights under a stock loan agreement), and other financial products. A coupled asset can either increase or decrease economic ownership. Decoupling often involves owning both shares and a coupled asset.

By "**net economic ownership,**" we mean a person's combined economic ownership of host company shares and coupled assets. This net ownership can be positive, zero, or negative. We characterize as an "**empty voter**" a person whose voting rights substantially exceed his net economic ownership. Depending on the nature of the coupled assets, net economic ownership may depend on share price. Suppose, for example, that a company's shares trade at $50, and an executive enters into a zero-cost collar that caps the upside on the shares at $60 and limits the downside to $45. The executive will have higher net economic ownership for share prices within the $45–$60 range than outside this range.

An investor may also hold "**related non-host assets**"—assets, often securities of another company, whose value relate in some way to the value of the host company's shares. In Perry-Mylan, for example, Perry's shares in Mylan's target, King Pharmaceuticals, were a related non-host asset. The combined return on host shares, coupled assets, and related non-host assets produces what we call an "**overall economic interest**" in the host firm's shares. This overall economic interest can be positive, zero, or negative. In the Perry-Mylan example, Perry combined full ownership of the Mylan shares with coupled assets (equity swaps

32. We discuss the Perry-Rubicon example *supra* in Part I and *infra* in Part II.C.

and other hedges) that offset its economic ownership; this left it with **9.9%** *voting ownership* and **zero** *net economic ownership*:

[9.9% full ownership of shares] − [9.9% economic ownership (through coupled assets)]
= [9.9% voting + 9.9% economic ownership] − [9.9% economic ownership]
= [9.9% voting ownership]

But Perry also held a related non-host asset—shares of King Pharmaceuticals, which gave it a **negative** *overall economic interest*—it would profit if Mylan overpaid for King.

If a person has economic ownership that disclosure rules do not cover (or can reasonably be interpreted by the person as not covering), we call this "**hidden ownership.**" If this hidden ownership is likely to include informal voting rights, we term this "**hidden (morphable) ownership.**" These "**morphable**" voting rights derive from market customs and the economic incentives of the pertinent participants; these rights will generally not be formally enforceable or verifiable by outsiders. Perry's hidden (morphable) ownership of Rubicon offers an example.

Notice that whatever form new vote buying transactions take, only the host company can alter the total level of voting rights or economic ownership. If one investor holds more voting rights than economic ownership, someone else must hold more economic ownership than voting rights.

Table 1 offers some illustrative examples of the forms that new vote buying can take.

Table 1. Some Forms of New Vote Buying

Examples of some of forms of new vote buying. These examples are illustrative only. The Perry-Mylan, Laxey-British Land, insider hedging, and Perry-Rubicon examples are discussed in the text above. The other examples are discussed below.

Example	Voting Ownership	Economic Ownership	Coupled Asset	Net Economic Ownership	Related Non-Host Asset	Overall Economic Interest
Empty Voting						
share ownership hedged with short equity swap (Perry-Mylan)	yes	direct	equity swaps, others	no	yes (target shares)	negative
share ownership hedged with options (Coles Myer proxy fight)	yes	direct	short call + long put	zero	no	zero
share ownership hedged with related non-host asset (MONY-AXA)	yes	direct	possible	not known	yes (acquirer bonds)	negative
record-date capture via stock borrowing (Laxey-British Land)	yes (high)	Direct (low)	share loan	yes (low)	no	low
record-date capture via stock borrowing in combination with short-sale (Henderson Investment)	yes	negative	share loan + short sale	negative	no	negative
insider hedging	yes	direct (lowered)	equity derivatives	positive (lowered)	no	positive (lowered)

Example	Voting Ownership	Economic Ownership	Coupled Asset	Net Economic Ownership	Related Non-Host Asset	Overall Economic Interest
Deutsche Boerse-London Stock Exchange (for hedge funds that were long acquirer shares and short target shares)	yes	direct	no	yes	yes (target shares)	positive or negative, depending on stake in target
Hidden (Morphable) Ownership						
voting rights exercised by acquiring shares (Perry-Rubicon)	informal right to acquire shares from derivatives dealers	indirect	equity swaps	yes	no	high
voting rights exercised by directing votes of others (Marks & Spencer)	informal right to direct voting by derivatives dealers' matched shares	indirect	equity swaps	yes	no	high

B. Empty Voting

We turn in this Section B to a closer examination of the mechanics of empty voting. Section C addresses hidden ownership. Section D addresses the extra complexities introduced by related non-host assets.

1. Empty Voting Through Equity Derivatives

a. Perry-Mylan and Similar Examples

The Perry-Mylan example, discussed briefly in the Introduction, offers a good case study of empty voting through the use of OTC equity derivatives. As of late 2004, Perry Corporation owned seven million shares of King Pharmaceuticals, a generic drug maker.[33] Mylan Labs, a rival, agreed to acquire King Pharmaceuticals in a stock-for-stock merger at a significant premium over King's trading price, and thus a large profit for Perry. However, Mylan's shares dropped sharply when the deal was announced, and Mylan needed shareholder approval for the merger. Perry therefore bought a 9.9% stake in Mylan, which it could vote in favor of the merger. At the same time, Perry hedged its economic exposure to Mylan by taking the short or "interest" leg of equity swaps with derivatives dealers and entering

33. Our descriptions in this article of new vote buying examples rely in some cases on news reports that refer to market rumors or other sources which may not be accurate. Our description of Perry-Mylan is based on Perry Corp., Schedule 13D as to Mylan Laboratories, Inc. (Nov. 29, 2004), *available at* http://www.sec.gov/Archives/edgar/data/69499/000116923204005932/d61489_sc13d.txt; Complaint, High River Limited Partnership v. Mylan Laboratories, Inc., No. 04-2677 (M.D. Pa. Dec. 10, 2004) [hereinafter "Icahn Complaint"]; Tara Croft, *Mylan: King Deal Doomed*, Daily Deal, Jan. 13, 2005; Christopher Faille, *Perry Plans to Sell Stake in Mylan*, Hedge World Daily News, Mar. 23, 2005; Jesse Eisinger, *Icahn Cries Foul at Perry's No-Risk Play in Takeover Fight*, Wall St. J., Dec. 15, 2004, at C1; Andrew Ross Sorkin, *Icahn Accuses a Hedge Fund of Stock Manipulation*, N.Y. Times, Dec. 13, 2004, at C1; Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. Times, Dec. 2, 2004, at C1.

into other unspecified transactions. The derivatives dealers who took the long or "equity" leg of the Mylan swaps likely hedged their Mylan exposure, perhaps by selling Mylan shares short. A second hedge fund, Citadel, acquired another 4.4% of Mylan's shares and was rumored to have followed a strategy similar to Perry's.

Carl Icahn, a major Mylan shareholder, opposed the acquisition. He sued Mylan and Perry under federal securities law, including Section 13(d). He claimed that Perry and other unnamed hedge funds following similar strategies held 19% of the Mylan votes, yet no economic interest. If so, Perry and kindred investors had a negative overall economic interest in Mylan. They would want Mylan to complete the deal even if Mylan's value were to suffer. Indeed, the more Mylan overpaid, the better. The lawsuit became moot when Mylan abandoned the acquisition because of accounting problems at King.

Several other anecdotes illustrate how hedged share purchases can be used to influence voting outcomes.

- In 2004, French insurer AXA entered into a merger agreement to acquire MONY. To finance the bid, AXA issued convertible bonds, which were convertible into AXA shares at a discount to AXA's price *only if* AXA acquired MONY. Holders of AXA bonds apparently acquired MONY shares to vote for the merger, while short sellers of the AXA bonds (including the Highfields Capital hedge fund) acquired MONY shares to oppose the merger, with neither group's vote turning on whether the merger was good for MONY. The AXA bondholders may have hedged some or all of their MONY positions.[34]
- During Hewlett Packard's 2002 acquisition of Compaq, some holders of Compaq shares were rumored to have engaged in empty voting of H-P shares to support the merger. The merger announcement led to a sharp drop in H-P's price and to a proxy contest by Walter Hewlett opposing the merger. Empty voting might have affected the outcome of this very close vote.[35]
- In a 2002 proxy contest at Australian firm Coles Myer, investor Solomon Lew held 3% of Coles Myer's shares. To support his proxy campaign, he acquired another 4% of Coles Myer's shares while hedging his economic ownership with (short call, long put) options positions.[36]

34. *See In re* The MONY Group, Inc., Shareholder Litigation, 852 A.2d 9 (Del. Ch. 2004) and 853 A.2d 661 (Del. Ch. 2004); Theo Francis, *AXA Launches Offensive to Woo MONY Holders*, WALL ST. J., Apr. 28, 2004, at C5.

35. *See* Icahn Complaint, *supra* note 33, at 4; Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C1.

36. *See* Malcom Maiden, *Lew Confirms Hedging Coles Myer Shares*, ABIX—AUSTRALASIAN BUSINESS INTELLIGENCE—THE AGE, Oct. 24, 2002 (Lew confirmation that companies linked to him had hedged recent purchases); Mark Todd, *Lew Hedges Coles Gamble*, THE AGE, Oct. 10, 2002 (rumor that Lew had hedged recent share purchases); James McCullough, *The amazing war of Solomon Lew*, COURIER MAIL (Queensland, Australia), Nov. 9, 2002, at 77 (on Lew's 7% holding of Coles Myer).

These strategies are troubling. Many acquisitions turn out poorly for the acquirer.[37] The major U.S. stock exchanges require the acquirer's shareholders to approve a large stock-for-stock merger. Yet in practice, the acquirer's shareholders rarely vote down even apparently overpriced mergers. Empty voting on the acquirer's side by the target's shareholders, employed when the vote on a merger is likely to be close, could reduce the limited constraint the vote requirement now imposes on the acquiring firm's managers.

Moreover, these techniques can readily be extended to proxy fights for control. With control at stake, neither side can be counted on to play fair and simply solicit the votes of other shareholders. The temptation to buy votes quietly will be strong, especially if the other side may be doing so as well. Cleverness in vote buying—a characteristic not necessarily associated with either ability or incentive to run the company well—may become important for proxy fight success.

b. Insider Hedging and Entrenchment

Corporate executives are often ill-diversified. Both their human capital and much of their financial capital is tied up in the firm they manage. Controlling shareholders, often the founder's family, are similarly undiversified. These insiders often want to reduce their economic exposure to the firm's shares—hopefully without causing public concern that insiders are bailing out, triggering a tax bill, or, for controlling shareholders, giving up control. High levels of insider ownership are reasonably common. One survey of New York Stock Exchange-listed companies with 2001 revenues between $250 million and $1.5 billion found that more than one in ten had Chief Executive Officers who held more than 10 percent of the shares. About half of those companies had insiders who held more than 50 percent of the shares.[38] Lack of diversification will often cause insiders to be more averse to firm-specific risk than diversified outside shareholders.

Investment banks have developed strategies to accommodate the desire of insiders to hedge their economic exposure. Multiple techniques have emerged. One is a short equity swap position. Another, known as a zero-cost collar, involves buying a put option (to limit downside loss) and selling a call option (thus reducing potential gain).[39] Such a collar sharply reduces economic ownership but preserves voting rights. A 2001 study reports that senior executives in U.S. public companies, on average, use collars for 36% of their holdings and thereby reduced

37. *See, e.g.*, ROBERT BRUNER, DEALS FROM HELL: M & A LESSONS THAT RISE ABOVE THE ASHES (2005); Sara B. Moeller, Frederik B. Schlingemann & Rene Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757 (2005).

38. Dennis Simon, *In splitting leadership, look at CEO ownership*, DIRECTORS & BOARDS, Jan. 1, 2004, at 24, 25.

39. If the put and call options have the same exercise price and expiration date, this transaction is a complete hedge, economically equivalent to selling shares. More commonly, the call option exercise price is somewhat above the put option exercise price, hence the term "collar." In a "zero-cost" collar, the proceeds from selling the call equal the cost of buying the put.

their economic ownership position by 25%.[40] In the past five years, the use of derivatives by executives appear to have increased dramatically.[41]

To be sure, there are other ways for insiders to retain control while shedding economic ownership, including dual-class common stock and pyramidal ownership structures.[42] There may be justifications for insiders to use dual-class stock to raise capital without relinquishing control. In particular, the buyers of low-vote shares know what they are getting, and will pay a market price. So too for buyers of shares in companies controlled through pyramids. The new vote buying, however, is more akin to the criticized and now-banned dual-class recapitalizations of the 1980s, in which insiders acquired control without paying a market price for doing so. In some respects, the new vote buying is worse than a dual-class recapitalization—the recapitalization was publicly known and required a shareholder vote, while new vote buying requires no vote and can sometimes be hidden.

2. Empty Voting Through Record Date Capture

Thus far, we have focused on empty voting strategies that involve holding shares and hedging one's economic ownership. A second strategy, known as *record date capture*, involves borrowing shares in the stock loan market. In a typical stock loan, the borrower obtains shares (and accompanying votes).[43] The borrower contracts with the stock lender to: (i) return the shares to the lender at any time at the election of either side; and (ii) pay to the lender the value of any dividends or other distributions on the shares during the borrowing period. The loan is secured with cash or Treasury securities. This borrowing contract (a coupled asset in our terminology) leaves the economic risk of the shares with the lender. The borrower holds votes but no economic ownership. The lender has economic ownership without votes.

A traditional use of stock borrowing is to facilitate short selling. The borrower sells the borrowed shares in the market,[44] ending up with no votes and negative net economic ownership. Later, the short-seller closes out the short position by

40. *See* Bettis, Biszak & Lemmon, *supra* note 9.

41. *See* Ronald Fink, *Overexposed*, CFO, Apr. 2006, at 85, *available at* http://www.cfo.com/printable/article.cfm/5674520?f=options.

42. *See, e.g.*, Heitor Almeida & Daniel Wolfenzon, *A Theory of Pyramidal Ownership and Family Business Groups* (working paper 2005), *available at* http://ssrn.com/abstract=721801; Lucian Arye Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295–318 (Randall K. Morck ed., 2000).

43. For an overview of customary share lending practices, see, e.g., Bond Market Association, Master Securities Loan Agreement (2000) (under U.S. law); International Securities Lending Association, Global Master Securities Lending Agreement (2000) (under English law); Darrell Duffie, N. Garleanu & L. H. Pedersen, *Securities Lending, Shorting, and Pricing*, 66 J. FIN. ECON. 307 (2002).

44. By adopting Regulation SHO in 2004, the SEC sought to reduce the extent of "naked shorting," the practice of selling shares short without borrowing the necessary shares, thus creating the risk of failing to deliver shares to the buyer. Short Sales, SEC Rel. No. 34-50103 (July 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004); Aaron Lucchetti & Kara Scannell, *Despite SEC Rules, a Small Amount of Naked Shorting Appears to Persist*, WALL ST. J., Apr. 13, 2006, at C1.

buying shares in the market and delivering them back to the stock lender. But, omit the short sale, and stock borrowing becomes an easy route to empty voting.

Here is how the strategy works. Before a shareholder meeting, a company's board of directors establishes a voting record date.[45] Shareholders who hold shares on the record date have the right to vote at the meeting. The empty voter simply borrows shares before the record date, and returns them afterward. Efforts by pension funds and other stock lenders in the U.K. to respond to record date capture suggests that the practice is reasonably widespread in the U.K.[46] A recent working paper by Christoffersen, Geczy, Musto and Reed provides quantitative, albeit dated, evidence for the U.S. market. They report, based on stock loan data from a custodian bank in 1999 and a broker-dealer from 1996–2001, that stock loans spike on the record date, increasing on average from 0.21% to 0.26% of outstanding shares. The spike in borrowing is higher for firms that have had poorer financial performance, for meetings that result in a close vote, and for firms that experience higher support for shareholder proposals.[47]

The shares of most publicly traded stocks in the U.S. can be borrowed. A study by Gene D'Avolio of shares available from just one large financial institution found that the stocks that could not be borrowed accounted, in the aggregate, for less than 1% of market capitalization.[48] Borrowing shares is generally cheap: 91% of the stocks lent in this sample cost less than 1% per year to borrow. The number of borrowable shares is often large—during some recent corporate battles, up to 20% of a company's shares were held by borrowers.[49]

The Laxey Partners-British Land incident, discussed in the Introduction, offers an example of record date capture.[50] Laxey sought a breakup of British Land and opposed the reelection of British Land's chairman. British Land's chairman was a bit miffed at what he called Laxey's "rent-a-vote" strategy.[51] There was irony all around. British Land saw Laxey as abusing the corporate voting system, while Laxey perceived itself as calling weak management to account. Meanwhile, fund manager Hermes, one of the City's champions of good corporate governance, was (unknowingly) one of the stock lenders. Hermes did apologize.

45. *See, e.g.*, DEL. CODE ANN. tit. 8 § 213(a) (2001).

46. We discuss these efforts *infra* in Part V.D.3.

47. Christoffersen et al., *supra* note 22.

48. *See* Gene D'Avolio, *The Market for Borrowing Stock*, 66 J. FIN. ECON. 271 (2002).

49. *See* Kate Burgess & James Drummond, *Transparency finds a high-level champion*, FIN. TIMES, Apr. 22, 2005, at 1. Borrowing is cheap on average, but not for every company. In one recent case, Charter Communications took the unusual step of issuing 150 million shares in a public offering, supposedly to accommodate hedge funds frustrated by borrowing costs. *See* Peter Grant, *Charter's Unusual Issue May Have SEC Balking*, WALL ST. J., June 24, 2005, at C3; *Charter Share Issue Approved by the SEC*, WALL ST. J., July 19, 2005, at C3.

50. Our discussion of the Laxey-British Land encounter is based on Florian Gimbel, *The Big Picture: Uneasy Bedfellows with Money in Mind: Does Investing in Hedge Funds Compromise Pension Funds' Corporate Governance Activity?*, FIN. TIMES, Apr. 19, 2004; Jim Piccitto, *Laundering Money in the Free World*, GLOBAL INVESTOR, Dec. 1, 2004, at SS36; John Ritblat, Letter to the Editor, *British Land Buy-back Well Under Way*, FIN. TIMES, Jan. 13, 2003, at 18 (letter); Simon Targett, *Top Pension Funds Plan Securities Lending Code*, FIN. TIMES, June 14, 2004, at 1 (FT Report); John Waples, *Ritblat Hits at CSFB and Laxey for Vote 'Conspiracy,'* SUNDAY TIMES (LONDON), July 21, 2002, Bus. Sec., at 1.

51. Ritblat, *supra* note 50.

In early 2006, a far more questionable use of record date capture appears to have occurred in Hong Kong. Henderson Land wished to buy the 25% minority interest in Henderson Investment, a publicly held affiliate.[52] Henderson Investment's share price increased substantially, in anticipation that its shareholders would approve the buyout. Under Hong Kong law, however, the buyout could be blocked by a negative vote of 10% of the "free floating" shares—in this case about 2.5% of the outstanding shares. To everybody's surprise, 2.7% of the shares—75.5 million shares—were voted against the buyout. Henderson Investments shares fell 17% the day after the voting outcome was announced.

What happened? It appears that one or more hedge funds borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, thus profiting from its private knowledge that the buyout would be defeated. One hedge fund alone voted at least 72 million shares against the merger; that fund may have held enough shares by itself to defeat the buyout. Thus, a shareholder with negative economic ownership blocked a deal that would benefit other shareholders.

Consider next a variant on record date capture. An investor can buy shares just before the record date and sell them soon thereafter. The investor has economic exposure for a short period and can hedge some or all of this exposure through equity derivatives. The timing of the economic exposure further reduces any link between economic ownership and voting rights. The record date is well before the meeting date. There is no reason to expect company-specific news on the record date. By the meeting date, the investor will have sold his shares and will suffer no harm from voting in ways that reduce share price; indeed, as in Henderson Investments, the investor could even gain from doing so.[53]

C. Hidden (Morphable) Ownership

1. Morphing from De Facto to Formal Voting Rights

Equity derivatives can also be used to conceal ownership, against the background of disclosure rules that, as we discuss in Part IV, turn largely on voting rights rather than economic ownership. Perry has used equity derivatives for this purpose as well as for empty voting. In early 2001, Perry was a major holder of Rubicon Ltd., a New Zealand public company.[54] New Zealand has rules similar

52. This account draws on: *Asian hedge funds undermine lending*, Int'l Sec. Fin., Mar. 1, 2006, at 10(1); Patricia Cheng, *Hedge funds find loophole in H.K.*, Int'l Herald Trib., Feb. 16, 2006, at 18; Alex Frew McMillan, *Hong Kong studying voting issues on borrowed shares*, Infovest21 News, Jan. 25, 2006; Florian Gimbel & Francesco Guerrera, *Henderson stock lending fears*, Fin. Times (Asia Ed.), Feb. 15, 2006, at 15.

53. We thus disagree with Easterbrook and Fischel, who ignore the difference between the record date and the voting date. They claim that a person who buys shares "the day before the election, votes them, and sells the day after the election" will bear "the gains or losses attributable to the election." Easterbrook & Fischel, *supra* note 26, at 411 n.41. This is simply not so.

54. Our discussion of the facts is based on *Ithaca (Custodians) Ltd. v. Perry Corporation*, [2003] 2 N.Z.L.R. 216 (H.C.), *rev'd*, [2004] 1 N.Z.L.R. 731 (C.A.), *conditional leave to appeal refused*, [2004] 2 N.Z.L.R. 182 (C.A.).

to Section 13(d), which required disclosure of 5% ownership positions in public companies.[55] In June 2001, Perry gave notice that it had ceased to be a 5% holder. Then—to everyone's surprise—on July 11, 2002, Perry disclosed that it held 16% of Rubicon. It had bought 31 million shares from Deutsche Bank and UBS Warburg—just in time to vote at Rubicon's shareholder meeting.

What happened during the interim period? On May 31, 2001, Perry shed its voting rights but not its economic interest. It sold 31 million shares to Deutsche Bank and UBS Warburg and simultaneously took the long side of equity swaps covering these shares. Perry stopped reporting as a 5% owner because, it claimed, its equity swap position fell outside the New Zealand disclosure rules. When Perry needed voting rights, it terminated the swaps and bought the shares back from Deutsche Bank and UBS Warburg. Another major Rubicon shareholder challenged Perry's right to vote. Perry lost at trial but won on appeal.

How did Perry know that it had *de facto* ability to reacquire and vote Rubicon shares, when it chose to do so? The two banks needed to hedge their exposure on the swaps. Perry could expect them to do so by holding the shares they had bought from Perry. Another means of hedging was unlikely, given the thin market for Rubicon shares and the transaction costs to hedge in another way. Perry could also expect the banks to sell the shares back to Perry when Perry chose to unwind the equity swaps. Even the Court of Appeal, which ruled in Perry's favor, stated that:

> [I]t was almost certain that the shares would be sold to Perry Corporation upon the termination of the swaps if Perry Corporation wished to buy, provided the counterparties held the shares (. . . [which] was highly likely). We consider that this market reality would have been obvious to any reasonably informed market participant. Mr Rosen, head trader of Perry Corporation, said in evidence that he had always thought it likely that the shares would be held by the counterparties as a hedge. He also said that, if he wanted to terminate the swaps and purchase the shares, it would have been commercially sound for the . . . counterparties to sell him those shares.[56]

The Court of Appeal nonetheless concluded that disclosure was not required, partly because it believed disclosure would generally not be required in Australia, the United States, or the U.K.

Holding "matched shares" is a common way for a derivatives dealer to hedge the short side of an equity swap. Especially when the equity swap involves a large number of shares in a thinly traded company, alternative hedging strategies may be limited. When a dealer hedges through share ownership, a *de facto* practice is apparently emerging, at least in the U.K., in which the dealer, if asked, will either unwind the swap and sell the shares to its client (as in Perry-Rubicon) or vote the shares as its client wants (we cite some examples in Table 2). To refuse would risk the dealer's business relationship with its client, and perhaps its market reputation as a reliable counterparty. Indeed, dealers may hedge with matched shares precisely because doing so lets the swap dealer accommodate its client by un-

55. *See* New Zealand Securities Markets Act 1988, 1988 S.N.Z. Nos. 2, 5, 20–22.
56. *Ithaca (Custodians)*, [2004] 1 N.Z.L.R. 731, at ¶ 66.

winding the swap or voting the shares if needed. The Code Committee of the U.K.'s Panel on Takeovers and Mergers recently explained that it is "frequently the expectation" of a long equity swap holder that the derivatives dealer would "ensure" that the shares are available to be voted by its customer and/or sold to the customer on closing out the contract.[57] If the dealer hedged in another way, the holder would "normally expect" the dealer to acquire the necessary shares, even if this resulted in cost to the dealer.[58]

Market expectation that a dealer will unwind a swap, however, is not a guarantee. A 2006 buyout offer by Sears Holdings for the minority shares in its Sears Canada subsidiary, illustrates this.[59] A hedge fund acquired equity swaps in Sears Canada from Scotiabank. A unit of Scotiabank later became the dealer-manager for Sears Holdings' buyout offer. The offer required approval by a majority of the Sears Canada minority shareholders. The bid was opposed by Sears Canada's independent directors and by many Sears Canada shareholders. The hedge fund (presumably) thought it had morphable voting rights and asked Scotiabank to unwind the swap so it could vote against the offer. Scotiabank not only refused but committed to vote its Sears Canada shares *for* the offer. Scotiabank thus became an empty voter; perhaps with negative economic interest because of its relationships with Sears Holdings and Sears Canada. Another possible characterization is to see Sears Holdings as the empty voter, voting indirectly through its influence over Scotia Bank. The hedge fund complained about Scotiabank's failure to observe market conventions and said it was "looking forward to regulatory and legal scrutiny of this transaction."[60]

2. Other Uses of Hidden Ownership

An additional use of hidden ownership involves avoiding mandatory bid rules. In many countries, a shareholder who acquires more than a specified percentage of a company's shares must offer to buy all other shares at a formula price. Holding equity swaps instead of shares can let a shareholder avoid these rules.

In 2005, for example, the Agnelli family, which controlled Fiat, quietly entered into equity swaps for Fiat shares with Merrill Lynch.[61] The family wanted to retain

57. *See* Code Comm., Panel on Takeovers and Mergers, *Consultation Paper, Dealings in Derivatives and Options: Outline Proposals relating to Amendments Proposed to be Made to The Takeover Code and the SARS*, ¶ 3.3 (PCP 2005/1 Issued on Jan. 7, 2005), *available at* http://www.simmons-simmons.com/index.cfm?fuseaction=takeover.display&page=1868.

58. *Id.* For a U.S. example where a customer was unhappy enough that Citibank had hedged equity swaps in a manner that the client had not expected to bring a suit, see Caiola v. Citibank, N.A., New York, 295 F.3d 312 (2d Cir. 2002).

59. *See* Jesse Eisinger, *In Canada, A Face-Off Over Sears*, WALL ST. J., Apr. 12, 2006, at C1.

60. *Id.*

61. On the Agnelli-Fiat transactions, see *IFIL-Exor Investigation Merrill Lynch Milan HQ Searched*, IL SOLE 24 ORE, Mar. 10, 2006 (IFIL is the Agnelli family vehicle that acquired the swaps); *IFIL Receives Consolb Equity Swap Report*, IL SOLE 24 ORE, Feb. 23, 2006; *Italian Stock Market Regulator Rules Against IFIL in Fiat Case*, WORLD MARKETS ANALYSIS, Feb. 23, 2006; *Italy's Consob Rules IFIL Not Obliged to Bid for Fiat, but Swap Deal Probed*, AFX INTERNATIONAL FOCUS, Feb. 8, 2006; *Still in the driving seat—Italian finance*, ECONOMIST, Oct. 15, 2005; *Three Investigated in IFIL-Exor Equity Swap Affair*, IL SOLE 24 ORE, Feb. 25, 2006.

control of Fiat after dilution of its stake through a forthcoming debt-for-equity swap, in which Fiat would issue shares to various banks. If the Agnelli family had bought shares directly, it would have crossed a 30% ownership threshold, thus triggering Italy's the mandatory bid rule. The Agnellis also would have had to disclose their purchases, which could have affected Fiat's share price. After Fiat completed its debt-equity swap, the Agnelli family unwound the swaps and obtained the "matched" Fiat shares. The Italian securities commission ruled that the Agnellis did not violate the mandatory bid rule; it is still investigating the propriety of nondisclosure.

Avoiding a mandatory bid rule also animated the earliest example of decoupling we are aware of. In 1997, Brierley Investments used equity swaps to increase its stake in John Fairfax Holdings from 19.98% to 25%.[62] If Brierley had acquired more than 20% of the shares, it would have had to offer to buy all of the Fairfax shares. Unlike the Agnellis, Brierley disclosed its swap position to market participants; it merely sought (successfully) to evade Australia's mandatory bid rule.

The Agnellis had a second goal—to acquire shares more cheaply, by evading large shareholder disclosure rules. This theme emerged as well in Australia, during the 2005 takeover bid by Centennial for Austral Coal.[63] Rival Glencore acquired a "blocking position" (sufficient to prevent Centennial from reaching 90% ownership and then squeezing out remaining shareholders), through a combination of shares and equity swaps (which the derivatives dealers hedged with matched shares). Glencore claimed that the equity swaps did not need to be disclosed under Australia's large shareholder disclosure rules (which are triggered by 5% share ownership), and disclosed its combined position only after crossing 10%. The Australian Takeovers Panel held that Glencore should have disclosed its combined position when its economic ownership crossed 5% and assessed damages based on Glencore's estimated savings from purchasing its full stake prior to disclosure. However, the Panel's decision was reversed on appeal by the Australian courts.

Hidden ownership may not always be undesirable from the standpoint of corporate governance. For instance, consider the possible use use of hidden ownership to obtain a "toehold" stake in a target company in advance of a takeover proposal. An unresolved puzzle in finance is why more takeover bidders do not acquire toeholds, since doing so would appear to be highly profitable.[64] The usual

62. *See* Louise McCoach, The Glencore Decision: A Case for Reform? (Nov. 2005) (unpublished manuscript, on file with authors); Louise McCoach, The Glencore Decision: A Case for Reform? An Update? (Feb. 2006) (unpublished manuscript, on file with authors).

63. Our discussion of Austral Coal is based on Nigel Morris, Dir., Takeovers Panel, Austral Coal Ltd. 02, Decision and Review Application (July 1, 2005), *available at* http://www.takeovers.gov.au/display.asp?ContentID=956 [hereinafter "*Austral Coal Takeovers Panel Decision*"]; Glencore International AG v. Takeovers Panel [2006] FCA 274 (Mar. 22, 2006) [hereinafter "*Austral Coal Federal Court of Australia Decision*"].

64. *See, e.g.*, Arturo Bris, *Toeholds, Takeover Premium, and the Probability of Being Acquired*, 8 J CORP. FIN. 227 (2002); Sandra Betton & B. Espen Eckbo, *Toeholds, Bid Jumps, and Expected Payoffs in Takeovers*, 13 REV. FIN. STUD. 841 (2000).

explanations are concern about prompting a price run-up, which could increase total acquisition cost, and concern that target knowledge of the toehold may make bidder resistance more likely. An equity swap offers a quiet toehold that need not be disclosed. Nondisclosure might reduce market impact cost, or simply avoid bidder resistance. In Australia, for example, BHP Billiton, before announcing a 2004 bid for WMC, acquired a 4.3% toehold through equity swaps.[65] BHP disclosed its toehold before crossing the 5% threshold at which a direct share position had to be disclosed. Its reasons for acquiring swaps rather than shares are not known. Perhaps it wanted to preserve the possibility of acquiring more than 5% before disclosing its position.

D. Related Non-Host Assets

We consider here some complexities that can arise when related non-host assets form part of a shareholder's overall economic interest.

1. Mergers

One recurring situation involving related non-host assets is a proposed merger. We have already seen several examples, including Perry-Mylan, AXA-MONY, and Hewlett Packard-Compaq, where the empty voter had a limited or negative overall economic interest in the acquirer. But economic ownership in both bidder and target can also increase a shareholder's economic interest, and thus reduce the collective action problems that often lead to shareholder passivity when an acquirer proposes an overpriced acquisition.

Actions by hedge funds to oppose Deutsche Boerse's proposed acquisition of the London Stock Exchange (LSE) illustrate. In December 2004, Deutsche Boerse proposed buying the LSE.[66] In January 2005, two hedge funds (Children's Investment Fund and Atticus Capital), together holding 8% of Deutsche Boerse's shares, publicly opposed the bid as against shareholder interests. (We cannot resist noting that the head of Children's Investment Fund is a Perry alumnus.[67]) The acquisition was eventually abandoned. What connects this story to vote buying is that certain hedge funds—perhaps including these two funds—shorted a significant number of LSE shares soon after the opposition was announced. Let us

65. Andrew Trounson, *BHP Bid for the Long Haul—Xstrata Outgunned in Showdown for WMC*, Australian, Mar. 9, 2005, at 35; Bryan Frith, *Cunning Predators Hide Behind Swaps*, Australian, Mar. 11, 2005, at 18.

66. Our discussion relies on Norma Cohen and Patrick Jenkins, *D Borse Acts to Heal TCI Rift*, Fin. Times, Apr. 21, 2005, at 25; *Winners and Losers: CEO Werner Seifert Sheds Some Light on the Reasons Why Deutsche Borse Decided to Drop its £1.3 Billion Bid for the London Stock Exchange*, Guardian, Mar. 14, 2005, at 11; Norma Cohen, *Investors Warn D Borse Board*, Fin. Times, Feb. 22, 2005, at 21; William Hutchings, *Deutsche Boerse Affair Shows Way Ahead*, eFinancialNews.com, Jan. 23, 2005; *Seifert's Second Proposal*, Economist, Dec. 18, 2004; Silvia Ascarelli, *A Market Marriage in Europe? Deutsche Boerse's Courtship of London Exchange May Elicit a Rival*, Wall St. J., Dec. 14, 2004, at C18.

67. *See* Jason Singer, *Ivy Leave: Yale Parts Ways With Hedge Fund*, Wall St. J., Mar. 29, 2006, at C1.

assume that some hedge funds went long Deutsche Boerse and short LSE, thus betting that the acquisition would fail—causing Deutsche Boerse shares to rise and LSE shares to fall. The LSE short positions would increase the hedge funds' net economic interest in the Deutsche Boerse vote, and might make it cost-justified for them to undertake a public campaign against the acquisition.

However, other combined Deutsche Boerse-LSE positions could have the opposite effect. For example, merger arbitrageurs who follow the "classic" strategy of betting on completion of a stock-for-stock merger by going long the target and short the acquirer (the opposite of the posited CIF and Atticus strategy) have an incentive to support a merger, even if it was bad for the acquirer or the combined firms. Thus, ownership of related non-host assets could, at the same time, empower CIF and Atticus to pressure Deutsche Boerse to make a "good" decision, and empower classic merger arbitrageurs to support deal completion regardless of the merits.

In a merger situation, it is not much of a stretch to imagine a subterranean battle for votes among investors with differing overall economic interests. In such a battle, the voting outcome might not reflect the acquisition's expected value to the acquirer, the target, or both companies together. The outcomes in Henderson Investments and Sears Canada were apparently altered by new vote buying; vote buying may also have been outcome-determinative in AXA-MONY and Hewlett Packard-Compaq, though no one knows for sure (at least not publicly).

2. Indirect Hedges

Other plausible related non-host assets can exist, in addition to positions in the other party to a takeover bid. The essential characteristic of a related asset is that its value relate in some way to the value of host shares. Thus, an executive at Ford who is concerned about the future of Ford and other American car companies, might buy put options on shares of General Motors or a Ford supplier, rather than put options on Ford (which would raise legal and perception issues).[68]

E. The Extent of New Vote Buying

Table 2 lists all publicly disclosed (or in some cases rumored) decoupling examples that we have been able to find, in rough reverse chronological order. The list suggests the potential scale of decoupling, while the dates suggest its recent advent. Other evidence, including data on executive hedging and record date capture, suggest that the new vote buying is reasonably common.[69]

68. On the related question of whether executives can use such substitutes without running afoul of insider trading laws, see Ian Ayres & Joseph Bankman, *Substitutes for Insider Trading*, 54 Stan. L. Rev. 235 (2001).

69. *See* Hu & Black, *The New Vote Buying*, *supra* note 24, at 846–47.

Table 2. Decoupling Examples

This table lists, roughly in reverse chronological order, the known (or publicly rumored) instances of new vote buying we were able to collect. The list is surely partial: if readers know of instances not on this list, we would be grateful to learn of them.

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden (Morphable) Ownership	Coupled Asset or Related Non-Host Asset	Description	Source
2006	Sears Canada	Canada	hedge fund (Bill Ackman) and Scotiabank	X (by Scotiabank)	X (by Ackman's hedge fund: unsuccessful)	equity swap	See Part II.C	
2006	Henderson Investment	Hong Kong	hedge fund(s)	X	X (short position)	share borrowing + short sale	See Part II.B	
2005	Fiat	Italy	Agnelli family		X	equity swaps	See Part II.C	
2005	Austral Coal	Australia	Glencore		X	equity swaps	See Part IV.B	
2005	Fuji TV	Japan	Nippon Broadcasting		X	stock lending	Nippon lent its shares in Fuji TV to others as a defense to a takeover bid by Livedoor, producing a variant of hidden (morphable) ownership in which Nippon had economic ownership, but hoped to *deny* voting rights to Livedoor	70
2005	Deutsche Boerse	Germany	hedge funds	X		short sale of target shares	See Part II.D	
2005	Portman Mining	Australia	Seneca (hedge fund)		X	equity swaps	Seneca held 9% economic interest in Portman through equity swaps provided by CSFB.	71
2004–2005	WMC Resources	Australia	BHP Billiton		X	equity swaps	See Part II.C	

70. *See, e.g.*, Kyodo News Service, *Japan: Investment Firm becomes Fuji TV's Largest Shareholder*, BBC MONITORING MEDIA, Mar. 24, 2005; David Pilling, *White Knight New Villain of Fuji TV Saga*, FIN. TIMES, Mar. 28, 2005, at 1; Martin Foster, *Livedoor Suffers Blow in Bid*, DAILY DEAL, Mar. 25, 2005; *Softbank to Return Fuji Shares*, DAILY YOMIURI (TOKYO), Apr. 23, 2005, at 8; Michiyo Nakamoto, *Historic Battle Establishes Combat Rules*, FIN. TIMES, June 27, 2005, at 5 (FT Report); Nippon Broadcasting, *Softbank Investment End Fuji TV Stock Loan Deal*, AFX–ASIA, June 30, 2005. The defense was successful. Livedoor and Fuji TV agreed to a partnership, and Livedoor ended its effort to acquire Nippon. One borrower (Softbank) promptly returned the Fuji shares to Nippon; we have not found news reports discussing whether the other borrower (Daiwa Securities) also returned its borrowed shares.

71. *See* Bryan Frith, *Portman trading should be reviewed*, AUSTRALIAN, Mar. 4, 2005, at 22.

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden (Morphable) Ownership	Coupled Asset or Related Non-Host Asset	Description	Source
2004–2005	Mylan Laboratories	U.S.	Perry Corp. (hedge fund)	X		equity swaps	See Part II.B	
			Citadel (hedge fund) (possible)	X		unknown		
2004	DFS	U.K.	Polygon (hedge fund)		X	equity swaps	Polygon sought to influence DFS despite owning only one share of stock (it had 3% economic ownership through equity swaps).	72
2004	Alvis	U.K.	Hedge funds (helping BAe Systems to acquire Alvis)		X	equity swap	BAe Systems obtained commitments from hedge funds with equity swap positions in Alvis to either obtain shares or direct the voting of shares to support BAe's offer	73
2004	Marks & Spencer	U.K.	Hedge funds (helping Philip Green to acquire Marks & Spencer)		X	equity swap	Green announced support by 8.3% of target shares held by derivatives dealers as "matched shares" to support equity swaps	74
2004	Canary Wharf	U.K.	"Songbird" consortium (seeking to acquire Canary Wharf)		X	equity swaps	derivatives dealer UBS held 7.7% of Canary as matched shares to support equity swaps	75
2004	MONY Group	U.S.	holders and short sellers of AXA convertible bonds	X		convertible bonds of acquirer (AXA)	See Part II.D	

72. *See* Richard Fletcher, *US hedge fund builds up large stake in DFS*, SUNDAY TIMES (LONDON), Aug. 22, 2004.

73. *See* Panel on Takeovers and Mergers, *Consultation Paper Issued by the Code Committee of the Panel—Dealings in Derivatives and Options: Outline Proposals relating to Amendments Proposed to be Made to The Takeover Code and the SARS*, ¶ 3.3–3.4 (PCP 2005/1 Issued on Jan. 7, 2005), *available at* http://www.simmons-simmons.com/index.cfm?fuseaction=takeover.display&page=1868.

74. *See* U.K. Takeover Panel, *January 2005 Proposal*, *supra* note 73, at § 3.4(b); Jeremy Warner, *Outlook: Uncharted Waters*, INDEPENDENT, July 14, 2004.

75. *See, e.g.*, Martin Dickson, *The secret City battle over Canary Wharf*, FIN. TIMES, Apr. 24, 2004; Linda Saigol, *UBS wins Takeover Panel appeal over Canary Vote*, FIN. TIMES, Apr. 24, 2004.

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden (Morphable) Ownership	Coupled Asset or Related Non-Host Asset	Description	Source
2004	News Corp.	Australia & U.S.	Liberty Media	X	Hidden: yes Morphable: maybe	forward contract and equity swap	Liberty Media held voting and nonvoting News Corp. shares, also used derivatives to adjust its economic exposure	76
2002	P&O Princess	U.K.	Investors (favor Carnival bid for P&O Princess)	X	maybe	share borrowing	P&O shareholders who favored Carnival's bid reportedly borrowed shares in order to vote for acceptance	77
2002	Hewlett-Packard	U.S.	holders of Compaq shares (target of H-P merger bid)	X		target shares	See Part II.B	
2002	Coles Myer	Australia	Solomon Lew (proxy contestant)	X	no	options	See Part II.B	
2002	British Land	U.K.	Laxey Partners	X		share borrowing	See Part II.B	
2001	Rubicon	New Zealand	Perry Corp.		X	equity swaps	See Part II.C	
1997	John Fairfax Holdings	Australia	Brierley Investments			equity swaps	See Part II.C	

III. Current Ownership Disclosure Rules

A. General Considerations

We turn now to how current ownership disclosure rules treat the new vote buying. This Part III addresses the extent to which these rules require disclosure of empty voting or hidden ownership. Part IV presents our integrated disclosure reform proposal, which would require disclosure of both economic and voting

76. *See* Liberty Media Corporation, Schedule 13D as to The News Corporation Limited (Jan. 21, 2004), *available at* http://www.sec.gov/Archives/edgar/data/788509/000110465904001378/a04-1434_1sc13d.htm and (Amendment No. 1 to this Schedule (Nov. 12, 2004), *available at* http://www.sec.gov/Archives/edgar/data/788509/000104746904034156/a2146699zsc13da.htm; *Q3 2004 Liberty Media Group Earnings Conference Call—Final*, FD (Fair Disclosure) Business Wire, Nov. 9, 2004; US, *Liberty Media Corporation Announces Early Termination of Total Return Swap With Merrill Lynch,* PR Newswire (Dec. 20, 2004); Tim Burt, *Prince Pledges to Aid Murdoch*, Fin. Times, Nov. 18, 2004, at 32; Geraldine Fabrikant, *In Surprise, Liberty Media Fattens Stake in News Corp.*, N.Y. Times, Jan. 22, 2004, at C1; Geraldine Fabrikant, *Liberty Media Fuels Speculation By Adding to News Corp. Stake*, N.Y. Times, Jan. 23, 2004, at C3; Martin Peers, *News Corp.'s Net Increases by 27% on TV Strength—Liberty Media Gains Right to Boost Its Voting Stake in Murdoch-Led Concern*, Wall St. J., Nov. 4, 2004, at B3; Martin Peers, *News Corp. Offers About $5.7 Billion To Buy Rest of Fox*, Wall St. J., Jan. 11, 2005, at C4; *Why Liberty Halted Its 'Forward' Pass; Sale of 19 Million Shares Is Scrapped to Simply Structure, Show Faith in News*, Multichannel News, Sept. 26, 2005.

77. *See* Bank of England, Stock Lending and Repurchase Committee, Summary of Dec. 11, 2002 Meeting, *available at* http://www.bankofengland.co.uk/markets/gilts/slrcdec02.pdf.

ownership. Part V discusses additional possible steps for regulating empty voting. We are not yet ready to advocate taking any of these additional steps, but setting out a menu of regulatory choices may still prove helpful in the long run.

Currently there are five discrete ownership disclosure systems: for active 5% shareholders on Schedule 13D,[78] passive 5% shareholders on Schedule 13G,[79] institutional investors on Form 13F,[80] insiders and 10% shareholders under Section 16,[81] and mutual funds.[82] These systems, taken together, are bewilderingly complex. Different rules often apply in determining what triggers the disclosure requirements and what must be disclosed once the disclosure requirements have been triggered. Economically identical situations are often treated differently, depending on how an investor achieves a particular combination of voting and economic ownership. Positions involving OTC derivatives often escape disclosure, when an equivalent position involving exchange-traded derivatives would be disclosed. Ownership of call options sometimes requires disclosure, but (the nearly equivalent) sale of put options does not. And so on. A derivatives-savvy hedge fund can often avoid disclosure.

Table 3 summarizes the current ownership disclosure requirements. The complexity and illogic of the current rules is immediately apparent.

78. 17 C.F.R. § 240.13d-101 (2005).
79. 17 C.F.R. § 240.13d-102 (2005).
80. 17 C.F.R. §§ 240.13f-1, 249.325 (2005).
81. Exchange Act § 16 is codified as amended at 15 U.S.C. § 78p (2000 & Supp. III 2003).
82. *See infra* note 119.

Table 3. Current Ownership Disclosure Requirements Relating to New Vote Buying

This table summarizes how long positions in shares or equivalents, short positions in shares or equivalents, and stock lending and borrowing are treated under current U.S. ownership disclosure rules. The table addresses separately the use of long and short positions in shares and equivalents to *trigger* a reporting obligation, and the need to disclose these positions if a reporting obligation exists.

		Long Positions				**Short Positions**						**Stock Lending and Borrowing**	
		As Trigger		***If Filing Required***		***As Trigger***			***If Filing Required***				
Reporting Scheme	**Reporting Frequency**	Equity Swaps; other OTC Derivatives	Shares and Exchange-traded Derivatives	Equity Swaps; other OTC Derivatives	Shares and Exchange-traded Derivatives	Equity Swaps; other OTC Derivatives	Exchange-traded Derivatives	Short Sales	Equity Swaps; other OTC Derivatives	Exchange-traded Derivatives	Short Sales	Lending	Borrowing
13D	current	generally no	yes	partial	yes	no	yes	no	partial	yes	partial	unclear	yes
13G	annual	generally no	yes (if held on reporting date)	no	yes	no	yes (if held on reporting date)	no	no	yes	no	no	yes (if held on reporting date
13F	quarterly	status-based: $100M in 13F securities		no	partial	status-based: $100M in 13F securities			no	partial	no	no	
Section 16 (director or officer)	current	status-based		yes		status-based		banned by Section 16(c)	yes		banned by Section 16(c)	probably no	probably no
Section 16 (10% holder)		generally no	yes			no							yes (as trigger); probably no (in disclosure)
mutual funds	quarterly	yes		yes		yes			yes			no (except by implication from disclosure of short sales)	

B. Existing Disclosure Requirements

We review here the current disclosure requirements that affect the new vote buying. To avoid clutter that might obscure our main themes, we gloss over some complexities. Thus, our discussion should be understood as roughly but not wholly accurate. Outside investors, including hedge funds, are governed by large shareholder rules—any shareholder holding a 5% stake in a public company must make a Schedule 13D or 13G filing.[83] Institutional investors, including hedge funds, are also subject to status-based disclosure rules: an investment manager holding $100 million or more in U.S. equities must disclosure its holdings every quarter on Form 13F.[84] Corporate directors, officers, and 10% shareholders are also subject to separate disclosure of ownership on Forms 3, 4, or 5 under Section 16.[85] Finally, mutual funds must list all portfolio positions quarterly, and break down their holdings into various categories.[86]

1. Large Shareholder Disclosure (Schedules 13D and 13G)

a. Basic Requirements

Any person who "directly or indirectly" acquires "beneficial ownership" of more than 5% of a public company's shares is generally required to file Schedule 13D with the SEC within 10 days after crossing the 5% threshold.[87] Certain types of institutional investors who invest "passively" (in the ordinary course of business and without intent to influence control) and own between 5% and 20% of a company's shares can instead file a more abbreviated Schedule 13G (generally on February 15 of each year, reporting year-end positions with a 45-day lag).[88] Both Schedules are publicly available.

For both Schedules, disclosure is based on "beneficial ownership" of shares, as defined by Rule 13d-3. The focus is on sole or shared voting or investment power, which can be held "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise." Beneficial ownership of shares includes "the right to acquire beneficial ownership . . . within sixty days, including . . . through the exercise of any option [or] warrant." The SEC seeks to discourage

83. *See* Exchange Act § 13(d), (g) (codified as amended at 15 U.S.C. §§ 78m(d), 78m(g) (2000 & Supp. III 2003)); SEC Rules 13d-1–13d-7, 17 C.F.R.§§ 240.13d-1–13d-7 (2005); SEC Schedules 13D, 13G, 17 C.F.R. §§ 240.13d-101–102 (2005).

84. *See* Exchange Act § 13(f) (codified as amended at 15 U.S.C. § 78m(f) (2000 & Supp. III 2003)); SEC Rule 13f-1, 17 C.F.R. § 240.13f-1 (2005); *Form 13F*, *supra* note 16.

85. *See* Exchange Act § 16 (codified as amended at 15 U.S.C. § 78p (2000); SEC Rules 16a-1–16e-1, 17 C.F.R. § 240.16a-1–16e-1 (2005); SEC Form 3: SEC Initial Statement of Beneficial Ownership of Securities, *available at* http://www.sec.gov/about/forms/form3.pdf [hereinafter "*SEC Form 3*"], Form 4: Statement of Changes in Beneficial Ownership, *available at* http://www.sec.gov/about/forms/form4.pdf [hereinafter "*SEC Form 4*"], and Form 5: Annual Statement of Changes in Beneficial Ownership of Securities, *available at* http://www.sec.gov/about/forms/form5.pdf [hereinafter "*SEC Form 5*"], OMB Nos. 3235-0104, 3235-0287, 3235-0362.

86. *See infra* Part III.B.4.

87. Rule 13d-1(a), 17 C.F.R. §§ 240.13d-1(a) (2005).

88. Rule 13d-1(b), 17 C.F.R. § 240.13d-1(b) (2005). When ownership first exceeds 10%, Schedule 13G must be filed by the 10th day of the next month.

gaming by providing that any person who uses any "contract, arrangement, or device" to evade the 13(d) reporting requirements is deemed to be a beneficial owner.[89]

Both Schedules require disclosure of the number and percentage of the shares beneficially owned, and any purchases or sales within the past 60 days.[90] Item 6 of Schedule 13D—which has no counterpart in Schedule 13G—also requires disclosure of "any contracts, arrangements, understandings or relationships (legal or otherwise)" relating to any securities of the issuer[91] as well as filing of certain related "written agreements" as exhibits. The scope of the exhibit requirement is not entirely clear. Short positions, whether in shares or derivatives, do not trigger disclosure. If disclosure is triggered by a large long position, some disclosure is required for partially offsetting short positions.

How Schedules 13D and 13G treat share lending and borrowing is unclear. Borrowing (which provides voting power) would likely both count toward triggering disclosure and be disclosable on both forms. However, as a practical matter, record date capture without a control intent is unlikely to be captured by Schedule 13G, because few record dates will fall around the year-end reporting date. Share lending might be disclosable on Item 6 of Schedule 13D, but is likely not disclosable on Schedule 13G.

b. Application to Hidden Ownership

Consider now whether the 13D and 13G rules would capture hidden (morphable) ownership. We will use Perry-Rubicon as an example. Perry held just under 5% of Rubicon's shares, plus equity swaps conveying an additional 11% economic ownership. Its equity swaps, by themselves, seem unlikely to trigger disclosure. They were cash-settled, and thus did not convey the right to acquire shares. Perry's equity swap position might be caught by the "arrangement, understanding, or relationship (legal or otherwise)" language in Rule 13d-3. This would depend on whether Perry had a sufficiently firm expectation that it could terminate the swaps and obtain shares from the derivatives dealers at any time. On this point, there is no clear guidance in SEC rules or no-action letters. Practitioners at law firms prominent in the OTC derivatives market have stated that in their view, disclosure of cash-settled equity swaps is normally not required. A partner at Allen & Overy, the primary outside law firm of the International Swaps and Derivatives Association (the main trade association for the OTC derivatives industry), has so stated.[92] Similarly, partners at Cleary Gottlieb have written that "a long position under an

89. Rule 13d-3, 17 C.F.R. § 240.13d-3 (2005).

90. Schedule 13D, Item 5, 17 C.F.R. § 240.13d-101 (2005); Schedule 13G, Item 4, 17 C.F.R. § 240.13d-102 (2005).

91. Schedule 13D, Item 6, 17 C.F.R. § 240.13d-101 (2005).

92. Chin-chong Liew, *Disclosure Requirements for Purely Cash-Settled Derivatives*, HONG KONG LAWYER, June 2000, *available at* http://www.hk-lawyer.com/2000-6/June00-59.htm.

equity swap would generally not be treated as beneficial ownership" under Rule 13d-3.[93]

The non-disclosure of cash-settled equity swaps can be questioned, if one looks beyond the swap itself to the economic dynamic surrounding it. The derivatives dealer that enters into the swap will almost surely want to hedge its exposure. A principal way to hedge is to hold matched shares. This was especially likely in Perry-Rubicon because Perry initiated the swap by selling Rubicon shares to Deutsche Bank and UBS Warburg. Thus, there was an excellent chance that Perry could return to its dealers, pretty much whenever it chose, and exchange its swap position for shares, even without a prior discussion with its dealers.[94] Is this a sufficient "arrangement, understanding, or relationship (legal or otherwise)," to trigger disclosure, especially in light of the extension of beneficial ownership to any person who uses any "arrangement, or device" to evade reporting?

Perry claimed not under New Zealand's rules, which are similar to U.S. rules. It lost at trial and won on appeal. Glencore similarly lost a similar argument before the Australian Takeover Panel in 2005 under Australia's similar ownership disclosure rules,[95] but the Panel's decision was reversed on appeal by the Federal Court of Australia.[96]

c. Application to Empty Voting

Consider next how Schedules 13D and 13G affect empty voting, using Perry-Mylan as an example. If Perry held less than 5% of Mylan, disclosure would not be triggered. Perry chose, however, to acquire 9.9% of Mylan's shares. Had Schedule 13G been available, no disclosure of the hedges would have been needed, and the Schedule 13G filing could be delayed until Feb. 15 of the next year. Perry initially took the position that Schedule 13G was available, and filed a Schedule 13D only after Icahn filed his own Schedule 13D, indicating an intent to acquire control of Mylan, a step that Perry opposed.[97] Perry's view that its own intent to support the merger did not involve a control intent might be debatable. But assume a Schedule 13D filing was required. What did Perry have to disclose about the hedges that offset its direct economic ownership?

Not much, or so Perry and its counsel decided. Item 6 of Schedule 13D requires disclosure of "any contracts, arrangements, understandings or relationships" re-

93. 2 EDWARD F. GREENE, EDWARD J. ROSEN, LESLIE N. SILVERMAN, DANIEL A. BRAVERMAN & SEBASTIAN R. SPERBER, U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 13.02[2] n.25 (2004).

94. See the discussion of Perry-Rubicon in Part II.C *supra.* Access to the dealers' matched shares is not a certainty; the hedge fund in the Sears Canada situation, discussed in Part II.C *supra*, was surprised to find its dealer less accommodating than it had expected.

95. *See Austral Coal Takeovers Panel Decision*, *supra* note 63. The Takeovers Panel based this decision on the policy concerns underlying the large shareholder disclosure rules, rather than on the specific language of the statute.

96. *See Austral Coal Federal Court of Australia Decision*, *supra* note 63.

97. *See* Neil Whoriskey & Brandon W. Gardner, *Arbitrage in an M&A Context—Issues Raised by the* Mylan *Case*, M&A REPORT, Sept. 2005, at 15, *available at* http://www.cgsh.com/files/tbl_s47Details%5CFileUpload265%5C498%5CCGSH_MA_Newsletter_Sept2005.pdf.

lating to Mylan shares. Perry duly said that it had engaged in "security-based swap agreements" and other "hedging transactions" and that "to execute . . . certain hedging transactions," it had entered into stock loan transactions with Bear Stearns and Goldman, Sachs. But Perry disclosed neither the terms of the hedges nor the number of shares to which they pertained.

Consider finally the scenario in which an investor holds a stake in both acquirer and target, which affects its overall economic interest in the acquirer. Deutsche Boerse/LSE and HP-Compaq, discussed in Part II, provide examples. Assume that a hedge fund owns over 5% of a host company: must it disclose its position in the target's shares? Here the answer is clear—no disclosure is required by either Schedule 13D or 13G. For example, Item 6 of Schedule 13D requires disclosure of contracts or arrangements with respect to "any securities *of the issuer*" (emphasis added).

In sum, Schedules 13D and 13G provide only limited disclosure of the existence and nature of the new vote buying. One can quibble with level of detail that Perry provided, its initial decision that Schedule 13G was available, and its failure to attach the hedging agreements as exhibits to its 13D filing.[98] But from a policy perspective, picking at the language of disclosure rules that weren't written with empty voting in mind is beside the point. The real problem is that the 13D and 13G rules were written in the 1970s, when options markets were in their infancy and neither swaps nor other OTC derivatives existed.

2. Reporting by Institutional Money Managers (Form 13F)

The third ownership disclosure regime is under Section 13(f) of the Exchange Act ("Section 13(f)"). Institutional money managers must disclose their holdings at the end of each quarter by filing Form 13F with the SEC.[99] Form 13F, like Schedule 13G, is filed with a 45-day delay. For new vote buying, Form 13F offers little help. It requires disclosure of holdings of "section 13(f) securities" by every "institutional investment manager" who holds $100 million or more in these securities.[100] The term "institutional investment manager" is defined broadly to include (a) any person, other than a natural person, who invests in or buys or sells for its own account; and (b) any person, whether or not a natural person, who exercises investment discretion with respect to the account of any other person.[101] This captures hedge funds (whether located in the U.S. or offshore) but not Joe

98. Item 7 of Schedule 13D requires filing of "all written agreements, contracts, arrangements, understandings, plans or proposals relating to . . . (3) the transfer or voting of the securities, finder's fees, joint ventures, options, puts, calls, guarantees of loans, guarantees against loss or of profit, or the giving or withholding of any proxy as disclosed in Item 6." 17 C.F.R. § 240.13d-101 (2005). Perry's counsel presumably decided that its hedges were none of these.

99. The filings are publicly available. A manager may request confidential treatment, but only under narrow circumstances, and the SEC does not often grant such requests. *See Form 13F*, *supra* note 16, Instructions For Confidential Treatment Requests.

100. *See* Exchange Act §§ 13(f)(1), 13(f)(5)(A) (codified as amended at 15 U.S.C. §§ 78m(f)(1), (f)(5)(A) (2000 & Supp. III 2003)); Exchange Act Rule 13f-1, 17 C.F.R. § 240.13f-1 (2005).

101. *See* Exchange Act § 13(f)(5)(A) (codified as amended at 15 U.S.C. § 78m(f)(5)(A) (2000 & Supp. III 2003)).

Zillionaire, unless he exercises investment discretion over the accounts of others.[102] "Section 13(f) securities" are publicly traded U.S. equity securities included in the SEC's "Official List of Section 13(f) Securities." This list includes common shares and exchange-traded options.[103] Anything not on the list need not be disclosed. Form 13F is also quite narrow in what it calls for. The "Information Table" at its heart is simply a list of each security the managers owns, its CUSIP number (a standard means for identifying publicly traded securities), its type (for instance, shares, puts, or calls), and the number of securities held.[104]

Critically, Form 13F requires no disclosure for securities that are not publicly traded, even if they are economically equivalent to disclosable securities. For instance, holdings of exchange traded options are disclosable, but OTC option positions are not. Even for exchange-traded options, money managers need not report options they have *written* rather than *bought*. Long share positions are reported; short positions are not. Indeed, a manager who holds 1,000,000 shares and has separately sold 500,000 short will report owning 1,000,000 shares, and never mention the short position.[105] If shares have been lent, the loan is ignored. The lender reports owning the shares, while the borrower reports nothing.[106]

Form 13F requires reporting of voting power, and whether it is sole or shared. However, if a manager has voting authority over "routine" matters and no authority for "non-routine" matters, it reports as if it had no voting authority. Non-routine matters include a "contested election of directors, a merger or sale of all or substantially all assets, a charter amendment affecting shareholders' rights, and a change in fundamental investment policy" while routine matters "include" selection of an accountant, uncontested election of directors, and approval of an annual report.[107]

Consider now how 13F affects hidden (morphable) ownership positions. These positions commonly rely on OTC derivatives, which are not disclosed. Indeed, one reason why hedge funds hold equity swaps and other OTC derivatives rather than shares is to hide their ownership from public view.

Form 13F fares little better for empty voting. Empty voting through share borrowing will never be seen. If an investor holds shares directly, while hedging its economic ownership, the direct ownership will be reported, its empty character will not. Moreover, it is usually a simple matter to hide a voting stake altogether. All the investor need do is shed its direct holdings before quarter end. For example,

102. *See* Exchange Act § 13(f)(1) (codified as amended at 15 U.S.C. § 78m(f)(1) (2000 & Supp. III 2003)); Securities and Exchange Commission Division of Investment Management, Frequently Asked Questions About Form 13F (Question 4) (May 2005), *available at* http://www.sec.gov/divisions/investment/13ffaq.htm [hereinafter "*SEC 13F FAQ*"]. For an example of the use of Form 13F information to track hedge fund trading, see Markus K. Brunnermeier & Stefan Nagel, *Hedge Funds and the Technology Bubble* (working paper 2003), *available at* http://ssrn.com/abstract=423940.

103. See Exchange Act Rule 13f-1(c), 17 CFR. §240.13f-1; *SEC Form 13F FAQ*, *supra* note 102.

104. *See* Form 13F, *supra* note 16, Special Instructions 9–12.

105. *See, e.g.*, *SEC Form 13F FAQ*, *supra* note 102, Question 4 ("You should not report short positions on Form 13F. You also should not subtract your short position(s) in a security from your long position(s) in that same security; report only the long position.").

106. *SEC Form 13F FAQ*, *supra* note 102, Question 42.

107. Form 13F, *supra* note 16, Special Instruction 12(b)(viii).

a hedge fund could, in effect, exchange its shares for equivalent swaps before quarter end, and then unwind the swaps and require shares soon afterwards.

3. Insider and 10% Shareholder Disclosure (Section 16)

The fourth principal source of disclosure is Section 16, which covers officers, directors, and 10% shareholders of U.S. public companies.[108] Section 16 rarely covers outside shareholders, who avoid crossing the 10% threshold, partly because doing so triggers recapture of "short-swing profits" from buying and selling (or selling and buying) within a 6-month period. Avoiding coverage is straightforward. The 10% threshold is based on "beneficial ownership" in the 13D sense.[109] Thus, if a cash-settled equity swap lets a hedge fund avoid "beneficial ownership" for 13D purposes, this same swap should also let the hedge fund avoid Section 16 disclosure.

If disclosure is required, the positions to be disclosed are based on "beneficial ownership" in the Section 16 sense, and is reasonably extensive. The 13D definition of beneficial ownership focuses on voting power. In contrast, the Section 16 definition focuses on economic ownership.[110] The relevant forms (Forms 3, 4, and 5) require disclosure of most economic interests, regardless of their form. An initial filing must be made on Form 3 and changes reported on Form 4. Form 5 is an annual statement of changes. All Forms are publicly available. Form 3 must be filed with the SEC within 10 days after the event which triggers coverage.[111] Equity derivatives, whether exchange traded or OTC, must be disclosed. These include:

> any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security.[112]

This definition is quite broad. The derivative's value need not precisely track share value; disclosure is required as long as the derivative's value is "derived from the value of an equity security." There is an exception for "broad-based" index options, futures, and market baskets of stocks.[113] By implication, derivatives whose value is based on a narrow index are covered. Thus, some related *non-host* assets are covered by Section 16—albeit with ambiguity about which ones. There is no disclosure of short sales of shares, but no need for any, because short sales

108. *See* Rules 16a-1(a); 16a-2, 17 C.F.R. §§ 240.16a-1(a), 16a-2 (2005).

109. Rule 16a-1(a), 17 C.F.R. § 240.16a-1(a) (2005). Registered broker-dealers, banks, and certain other persons are exempt so long as they hold shares without the purpose or effect of changing or influencing control of the issuer or entering into an arrangement that would violate the anti-gaming provisions of Rule 13d-3(b), 17 C.F.R. § 240.13d-3(b) (2005).

110. Rule 16a-(2), 17 C.F.R. § 240.16a-2 (2005). For non-experts in securities law, yes, the SEC has indeed defined the same term—beneficial ownership—in two different ways, once under Exchange Act § 13(d) (codified as amended at 15 U.S.C. § 78m(d) (2000 & Supp. III 2003)) and once under § 16(b) (codified as amended at 15 U.S.C. § 78p(b) (2000 & Supp. III 2003)).

111. Rule 16a-3, 17 C.F.R. § 240.16a-3 (2005); *SEC Form 3*, *supra* note 85, General Instruction 3.

112. Rule 16a-1(c), 17 C.F.R. § 240.16a-1(c) (2005).

113. Exchange Act Rule 16a-1(c)(4), 17 C.F.R. § 240.16a-1(c)(4) (2005).

are banned outright by Section 16(c). The information required for each derivative is also extensive, and includes the title, exercise or conversion price, date exercisable, expiration date, and the title and amount of securities underlying the derivative security.[114] Changes in ownership are reported on Form 4 using specific transaction codes. For instance, "S" indicates a sale, "C" indicates conversion, "O" indicates exercise of an out-of-the-money derivative, "X" indicates exercise of an in-the-money or at-the-money security, "K" indicates an equity swap or similar security.[115]

Because Section 16 disclosure focuses on economic ownership, it is much less developed for voting ownership without economic ownership. It seems likely that few Section 16 filers report share borrowing or lending.[116] The SEC does not directly require this, there is no relevant transaction code, and we have not found any SEC or practitioner guidance even discussing this question. Economic ownership, the focus of Section 16, is not significantly changed by lending or borrowing, and voting rights do not easily fall within the term "pecuniary interests" under Section 16. In the parallel situation of a voting trust which has voting power but no economic ownership, the trust does not report share ownership.[117]

For hidden (morphable) ownership, then, Section 16 disclosure does a good job. For empty voting, disclosure likely depends on how the empty voter acquires its votes. Shares hedged with derivatives would be disclosed; share borrowing likely would not be.

4. Mutual Fund Reporting

The final set of reporting rules applies to mutual funds, which report to the SEC quarterly on their portfolio holdings (the filing is public), and provide a summary list semiannually to investors.[118] Disclosure focuses on economic ownership and covers both long and short positions. For options, disclosure includes value, exercise price, and maturity date. There are no rules on what details to report for equity swaps and other OTC derivatives, but our spot check of several

114. *SEC Form 3*, *supra* note 85, General Instruction 5(c)(iii).

115. *SEC Form 4*, *supra* note 85, General Instructions 1(a), 4(a), 8.

116. Share borrowings would, however, clearly count toward triggering disclosure by 10% shareholders, which is governed by the separate Section 13(d) rules.

117. *See, e.g.*, 16 ARNOLD S. JACOBS, SECTION 16 OF THE SECURITIES EXCHANGE ACT § 7.31 (2005). The lender's tax position does change slightly, due to tax differences between dividends and payments by the borrower in lieu of dividends. *Cf. infra* note 171 (on another aspect of such tax differences). However, these seem too thin a reed on which to hang a disclosure obligation, especially since this difference has been significant only since the 2003 reduction in the tax rate on dividends.

118. The basic forms for mutual fund portfolio disclosure are Forms N-1A, N-CSR, and N-Q. *See* Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, SEC Rel. No. 33-8393 (Feb. 27, 2004), 69 Fed. Reg. 11244, 11254–57 (Mar. 9, 2004) [hereinafter "*SEC Mutual Fund Reports Adopting Release*"]; Form N-1A, Registration Statement Under the Securities Act of 1933, Items 22(b)-(c) (discussing annual and semiannual reports), *available at* http://www.sec.gov/about/forms/formn-1a.pdf; Form N-CSR, Certified Shareholder Report of Registered Management Investment Companies, Item 6 (Schedule of Investments), *available at* http://www.sec.gov/about/forms/formn-csr.pdf; Form N-Q, Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company, *available at* http://www.sec.gov/about/forms/formn-q.pdf.

disclosure filings suggests that disclosure of counterparties and certain quantitative information such as notional amounts is common. There is no requirement to disclose share lending or non-short-sale-related borrowing.[119]

Thus, while the details are different, mutual fund reporting is similar to insider Section 16 reporting in: (i) its focus on economic ownership; (ii) its coverage of all forms of economic ownership, both long and short; and (iii) its failure to cover share lending and non-short-sale-related borrowing. Both systems thus cover hidden (morphable) ownership reasonably well, as well as some empty voting. However, mutual fund disclosure captures only quarter-end positions.

IV. A Proposal for Integrated Ownership Disclosure

A. General Considerations

As Part III has shown, the current ownership disclosure rules are highly complex, treat substantively identical positions inconsistently, both across and within disclosure regimes, and do not effectively address either empty voting or hidden (morphable) ownership. In big picture, current 13D and 13G disclosures turn largely on voting ownership while Section 16 and mutual fund disclosures focus on economic ownership. Form 13F disclosure covers only publicly-traded shares and long positions in exchange-traded derivatives. None of the disclosure regimes effectively addresses share borrowing and lending. Some of the differences between these sets of rules may have once made sense. Some omissions may once have been unimportant. But in a world of easy decoupling and massive OTC derivatives and share lending markets, these differences and omissions make sense no longer.

In this Part IV, we offer an "integrated ownership disclosure" reform proposal that would provide decent although still imperfect disclosure of both empty voting and hidden ownership, while greatly simplifying the current ownership disclosure rules. Our proposal builds on existing disclosure technology and requires only information readily accessible to investors. For the most part, we would simply extend existing disclosure requirements for insiders and mutual funds to a broader class of reporting persons. Thus, additional compliance costs should be limited, and will be offset for many reporting persons by adopting a single set of rules for what must be reported. We expect, but cannot prove, that overall reporting costs would decline.

We believe the new information will be useful to investors, as well as to corporations, judges, regulators, and legislators as they assess how else to respond to new vote buying. But even if our proposal had no other value, simpler disclo-

119. Mutual funds usually list the securities that they have lent in their schedule of investments with a footnote saying that "[a]ll or a portion of this security is on loan." Susan C. Peters, *Accounting Treatment of Loans of Securities*, in Securities Finance: Securities Lending and Repurchase Agreements 210 (Frank J. Fabozzi & Steven V. Mann eds., 2005). Mutual fund balance sheets disclose the total value of securities on loan. *Id.* Mutual funds must disclose any short positions; implicit in this disclosure is that the fund borrowed the shares that it then sold short.

sure—largely integrating what are now five discrete ownership disclosure systems—would likely be worthwhile.

Our proposal would: (i) move toward common standards for triggering disclosure and for disclosing positions once disclosure is triggered; (ii) provide a single set of rules for which positions to disclose and how to disclose them; (iii) require disclosure of both voting and economic ownership, however arising; and (iv) require symmetric disclosure of long and short economic ownership. We mostly leave for another day disclosure of related non-host assets. However, our proposals would often require disclosure of holdings in both acquirers and targets, which is one important instance of related non-host assets.

Our disclosure proposal should capture empty voting and hidden (morphable) ownership reasonably well for current Schedule 13D and Section 16 filers, who must report ownership and ownership changes promptly. Disclosure will be patchier for other filers due to the periodic nature of the reporting requirements, which let filers sell down their positions before the filing date. To capture significant empty voting by periodic filers, we would require disclosure of instances in which they voted when holding voting ownership that exceeded economic ownership by more than a threshold percentage (such as 0.5% or 1% of a company's shares). This will ensure that empty voting episodes such as Henderson Investments or Sears Canada are disclosed eventually.

In offering these proposals, we do not reassess here the current disclosure thresholds, disclosure frequencies, and delay periods, nor, to any significant extent, which investors must disclose their positions. Implicitly, then, we assume that there is rough economic or political logic supporting the current rules. We believe, however, that whatever the thresholds and delay periods may be, ownership disclosure rules should be internally coherent.

We recognize that ownership disclosure has both benefits and costs.[120] On the benefit side, share pricing is likely to be more efficient if investors know what major investors are doing and have advance notice of possible changes in control. Moreover, price-relevant information about securities often has greater private than social value. Requiring disclosure can reduce costly, often duplicative private search for it. On the cost side, private search for information can enhance share pricing efficiency, and the corporate control market is animated in part by private returns to search. Outside investors must receive some reward for searching for mispriced shares and mismanaged firms. Real-time disclosure would likely reduce the return to search. The current system, with near-real-time disclosure by insiders and large active shareholders (13D filers), but delayed disclosure by other shareholders, could well strike a decent balance among these competing concerns.

Beyond their potential economic logic, ownership disclosure rules reflect the intuition that investors want to know who a company's major shareholders are and whether those shareholders are buying or selling, and that company insiders should have an opportunity to respond to takeover attempts. Moreover, the his-

120. For more extended discussion of the benefits and costs of disclosure, see Hu & Black, *Hedge Funds and Empty Voting*, *supra* note 24, Part 4.3.

tory of ownership disclosure, in the U.S. and elsewhere, suggests that hidden control of major companies will not be politically acceptable for long, nor will secret contests for control. So disclosure of major positions there will be. Our aim is to make that disclosure coherent, simple, and therefore relatively low-cost.

Our proposed reforms build largely on the Section 16 rules. We would extend Section 16-type disclosure of economic ownership to institutions and other shareholders who now report on Form 13F and Schedules 13D and 13G. Short sales of shares would be disclosed in a manner similar to long positions, with a possible exception for "pure" short sales, discussed below. We would modestly expand the institutions who report on Schedule 13F by counting any economic ownership of equity securities or equity derivatives, long or short (on a gross basis) and exchange-traded or OTC, toward the 13D, 13F, and 13G triggering thresholds. For banks, broker-dealers and others who both hold proprietary positions and positions managed for clients, we would require separate reporting of each; subject perhaps to limited exceptions for short-term positions held in connection with market-making.

We would also require more complete disclosure of share lending, share borrowing, and voting ownership unaccompanied by economic ownership. Share lenders would report their loans; share borrowers would report borrowings and whether they retained the borrowed shares or sold them short. Money managers who have voting discretion for routine but not non-routine matters would so indicate.

We propose symmetric disclosure of positive and negative economic ownership. Whether a large "pure" short economic position, defined as negative economic ownership with no accompanying voting ownership, should require disclosure is, we believe, a very close question. Our proposal opts for simplicity and symmetry in providing that these short positions should be disclosed and count toward triggering a filing requirement.[121]

Regulators will need to develop guidelines for reporting derivative positions that are not addressed by the current Section 16 and mutual fund rules. As a lodestar principle, we believe that disclosure should allow a derivatives dealer, with access to market information on volatility and other pricing parameters, to estimate the derivative's value and its delta (how that value depends on share price). The reporting person need not provide the model it uses to value the derivative (that may be proprietary), only the raw material. For instance, for a typical OTC put option, disclosure would include the core contractual terms—the strike price, expiration date, and number of shares, the counterparty, and

121. The principal arguments for disclosure of pure short positions are the value of simplicity and symmetry, the practical difficulty in drafting an exception that is limited to a short position with no de facto voting rights, reduced gaming risk, and the value to investors of fuller knowledge of other investors' positions. The principal arguments against disclosure are that short selling is a valuable policing mechanism for share prices, our markets and regulatory systems already burden short sellers in various ways, and disclosure would add to these burdens. On how U.S. tax and regulatory rules raise the cost of short selling, see Michael R. Powers, David M. Schizer & Martin Shubik, *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 TAX L. REV. 233 (2004).

whether the option was European style (exercisable only at expiration) or American style (exercisable at any time). This principles-based approach should be more robust to financial innovation than a traditional classification-based (i.e., "cubbyhole") approach such as that used in the 13F rules.[122]

These proposals would expand disclosure, but would also integrate and substantially simplify the current disclosure regime. Economically equivalent positions would be treated consistently. The distinction between positions that trigger disclosure and positions that must be reported once disclosure is triggered, would disappear.

Our proposals are consistent with recent regulatory changes made in the U.K. and Hong Kong in response to new vote buying. In November 2005, the U.K. began requiring large shareholder reporting by persons who have long economic ownership through derivative positions.[123] In 2003, Hong Kong similarly extended large shareholder disclosure to persons with both long and short equity derivatives positions.[124] The 2006 Henderson Investment incident, discussed in Part II.C, may prompt Hong Kong to take further action.[125] The most important difference between the U.K. and Hong Kong approaches is that Hong Kong does (as we do), while the U.K. does not, require disclosure of a *pure short* economic position.

Disclosure rules also need to be enforced. At present, there is some enforcement of Section 13(d) and Section 16 disclosure, but apparently minimal enforcement of Form 13F.[126]

Table 4 summarizes our integrated ownership disclosure proposal. Comparing Table 4 to Table 3 shows the significant simplification of the current rules.

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122. For analyses of how financial innovation subverts traditional classification-based regulation, see Hu, *Misunderstood Derivatives*, *supra* note 27; Henry T. C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989) [hereinafter "Hu, *Regulatory Paradigm*"]; Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319 (1991) [hereinafter "Kleinbard, *Equity Derivatives*"].

123. Panel Executive (Panel on Takeovers and Mergers), *Summary of Changes to the Takeover Code* (Oct. 2005), *available at* http://www.thetakeoverpanel.org.uk/forms/summary%20of%207%2011%20changes.pdf; Panel on Takeovers and Mergers, *Dealings in Derivatives and Options: Statement by the Code Committee of the Panel Following the External Consultation Processes on Disclosure Issues in PCP 2005/1 and PCP 2005/2* (Aug. 5, 2005), *available at* http://www.thetakeoverpanel.org.uk/new/statements/DATA/2005/2005-34.pdf; Panel on Takeovers and Mergers, *Consultation Paper Issued by the Code Committeee of the Panel—Dealings in Derivatives and Options: Outline Proposals relating to Amendments Proposed to Be Made to The Takeover Code and the SARS* (PPCP 2005/1 Issued on Jan. 7, 2005), *available at* http://www.thetakeoverpanel.org.uk/new/consultation/DATA/PCP200501.pdf.

124. Hong Kong Securities and Futures Commission, *Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance* (Jan. 2005), *available at* http://www.sfc.hk/sfc/notes/consult/EN/apps/som/direviewconsult.nsf/content/Download/1/$FILE/Part%20XV%20Consultation%20Paper%20200105%20-%20English.pdf; Hong Kong Securities and Futures Commission, *Outline of Part XV of the Securities and Futures Ordinance (Cap. 571)—Disclosure of Interests* (Aug. 6, 2003), *available at* http://eapp01.sfc.hk/apps/cc/RegulatoryHandbook.nsf/lkupMainAllDoc/H339/$FILE/en_sfc_outline.pdf.

125. *See, e.g.*, Cheng, *supra* note 52.

126. On Form 13F enforcement, see James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 445–48 (2005).

Table 4. Proposal for More Integrated Ownership Disclosure

This table summarizes the disclosure changes we propose, in a format similar to Table 3, which summarizes current ownership rules. The table addresses separately the use of long and short positions in shares and equivalents to trigger a reporting obligation, and the duty to disclose them once the reporting obligation has been triggered. For stock lending and borrowing, borrowing is relevant both for triggering disclosure (except for status-based filers) and for disclosure if a filing is required.

Proposed Disclosure Requirement	Reporting Frequency (Same as Current Law)	Long Positions (Shares, Equity Swaps, other OTC and Exchange-traded Derivatives)		Short Positions				Share Lending and Borrowing		Empty Voting (over Threshold Level, such as 0.5% of Company's shares)
		As trigger	If filing required	As trigger		If filing required		Lending	Borrowing	
				Equity Swaps, other OTC and Exchange-traded Derivatives	Short Sales	Equity Swaps, other OTC and Exchange-traded Derivatives	Short Sales			
13D	current	yes	yes	yes		yes		yes		yes
13G	annual	yes (if held on reporting date)	yes	yes (if held on reporting date)		yes		yes (if held on reporting date)		yes
13F	quarterly	status-based: $100M in economic ownership of equities and equity derivatives	yes	status-based: $100M in economic ownership of equities and equity derivatives		yes		yes		yes
Section 16 (director or officer)	current	status-based	yes	status-based	banned by Section 16(c)	yes	banned by Section 16(c)	yes		yes
Section 16 (10% holder)		yes		yes						
mutual Funds	quarterly	yes	yes	yes		yes		yes		yes

B. Large Shareholder Disclosure (Schedules 13D and 13G)

Currently, 13D and 13G disclosure focuses on voting ownership. Our proposed extension is simple: filers should report both voting and economic ownership and either form of ownership can trigger the reporting obligation. The Section 16 concept of economic ownership can be carried over to Schedules 13D and 13G. We would expand current Section 16 reporting to include stock borrowing and lending positions, since these positions affect voting ownership. Each position would be separately disclosed using transaction codes adapted from Section 16 reporting, including new codes for borrowing and lending. Schedule 13D filers would attach any contracts that convey or relate to their economic or voting ownership. We would also modestly move the line between 13D and 13G reporting, which currently turns on control intent, and require 13D reporting for positions held with a view to affecting a shareholder vote, even if the vote does not affect control.

To take Perry's position in Mylan as an example, Perry, once it passed 5% ownership of Mylan, would report on Schedule 13D because it sought to influence Mylan's vote on acquiring King. It would separately report each position conveying positive or negative economic or voting ownership, and attach related contracts as exhibits. Schedule 13G reporting would be similar to Schedule 13D reporting, but without exhibits. As at present, it would generally be due annually and include only year-end holdings. This will let some positions go unreported, but most institutional filers will have to report their positions quarterly on Schedule 13F.

In determining whether the 5% reporting threshold has been crossed, we would not allow netting of long and short positions. An example can show why. Assume that a hedge fund takes a 10% net short position and also enters into an equity swap conveying a 6% long position, so that its net short position is 4%. With netting, no filing would be required. But we would want the hedge fund to disclose its position. It would like to see the company's share price drop because its overall position is net short, and likely has de facto access to 6% voting rights if a shareholder vote arises.

For some derivative positions, questions will arise as to how to measure effective economic exposure. An equity swap conveying the economic return on 1,000,000 shares should count as economic ownership of 1,000,000 shares. That is simple enough. But how about a call option? The option holder's economic exposure depends on the share price. In derivatives terminology, δ (delta) is the change in option value for a small change in the price of the underlying asset.[127] If shares go up by $1, a call option with $\delta = 0.4$ will increase in value by $0.40. A call option's δ, however, changes as share price changes. How should this position be reported?

127. More technically, delta is the partial derivative of option price with respect to the price of the underlying asset. *See* E. Briys, M. Bellalh, H.M. Mai, F. De Varenne, Options, Futures, and Exotic Derivatives 124 (1998).

We believe that reporting the precise economic exposure for call options and other derivatives with deltas that vary with share price or other factors would add undue complexity and cost. We propose a cruder approach. Under current Rule 13d-3, option holders report the number of shares that would be acquired on exercise of the option, which is equivalent to assuming $\delta = 1$. We believe the number of "matched shares" for a derivative position should be computed in parallel fashion. Hong Kong uses a similar approach and its experience can be instructive.[128]

C. Institutional Money Managers and Mutual Funds

We propose that 13F disclosure should use the same format and contain the same information as revised Schedules 13D and 13G. The principal difference would be the trigger for reporting. We would change the threshold from $100 million in Section 13(f) securities to $100 million in economic ownership of U.S. equity securities (including equity derivatives). Otherwise, an institution could avoid disclosure by holding equity derivatives and keeping its direct equity holdings under $100 million.

Cost concerns are more important for Form 13F reports than for Schedules 13D and 13G because almost every institutional investment manager has to file Form 13F on a quarterly basis, as to all positions held. In contrast, Schedules 13D and 13G apply to a much smaller number of persons and positions. However, institutional money managers should have ready access to the basic information we propose to collect. Some hedge funds, for example currently provide quite detailed reports to investors.[129] Thus, there will be a one-time cost in revising internal reports to match the new reporting format, but ongoing filing cost should be similar to current cost, and similar to the costs that mutual funds now incur, without howls of outrage at compliance cost.

These changes to Form 13F would result in mutual fund advisory firms that manage a number of funds (such as Fidelity and Vanguard) providing greater information on the aggregate holdings of the funds they manage. Individual mutual funds would continue to provide fund-specific disclosures, much as they do currently. Both advisory firms and individual funds would be subject to the new empty voting disclosure rules we will address in Part IV.D.

The 13F and mutual fund disclosure is quarterly, and thus will not reach all instances of new vote buying. We also would not change the current reporting delays, in which 13F, 13G, and mutual fund reports are due some time after the end of the reporting period. The current reporting speeds and frequencies seem to us to offer an acceptable tradeoff between disclosure completeness and cost. The disclosures should offer an overall picture of the extent of new vote buying, even if they do not capture all instances.

128. *See* Hong Kong SFC, *Part XV Outline*, *supra* note 124, at 2.5 (section entitled "How many shares am I taken to be interested in if I hold equity derivatives?").

129. For a discussion of so-called "risk reporting" to hedge fund investors, see Leslie Rahl, Hedge Fund Transparency—Unraveling the Complex and Controversial Debate 65–81 (2003).

An important fringe benefit of our proposal is that Form 13F reporting covers a large fraction of the universe of stock lenders and borrowers. Currently, stock lending data is sparse. Even the aggregate size of the market can only be estimated.[130] The largest borrowers of stocks are prime brokerage firms; the largest lenders are major institutions. Beyond that, little is known, beyond individual anecdotes.[131] Simply aggregating 13F reports of lending and borrowing will provide valuable data, both in the aggregate and for particular firms.

The primary cost to investors will be indirect, from disclosing trading positions that are currently concealed. Yet, to some extent, we have already crossed the bridge. The intent of Form 13F was to require institutional money managers to disclose their equity holdings, with a delay to reduce the competitive impact of disclosure. Changes in the derivative markets have undermined the completeness of reporting but, as discussed earlier, we do not believe that the basic tradeoff between the value of disclosure to other investors and the value of competitive secrecy was seriously misdrawn.

D. Disclosure of Empty Voting

Our proposed stock lending and borrowing disclosure will provide a good aggregate picture of the stock lending market. But without more, periodic filers (i.e., mutual funds and those filing on Schedule 13G or Form 13F) could avoid disclosing most empty voting positions that are in place for a short period around that record date. For instance, consider an institution using record date capture; it could borrow up to 5% of a company's shares, vote them, reverse the borrowing before the quarter ends, and report nothing.

To address empty voting by periodic filers, we propose that these filers separately report any occasions where they cast votes which substantially exceed their economic ownership. To limit the reporting burden for filers who engage in ordinary hedging activities, we would require disclosure if a filer held voting ownership that exceeded economic ownership by at least 0.5% (or some other threshold amount) of the outstanding shares on a record date for a shareholder meeting. We would rely on the crude rules discussed above to measure economic ownership. Reporting would be on the usual forms, and thus would occur some time after the vote.

Consider the MONY-AXA merger as an example. Suppose that a hedge fund holds AXA convertible bonds, wants the merger to be completed, borrows 4% of MONY's shares shortly before the record date, votes for the merger, and reverses the borrowing soon afterwards. The hedge fund would report, in its next 13F

130. Thus, one recent estimate of the size of the U.S. institutional securities lending market drew on a combination of the firm's own internal client surveys and Federal Reserve statistics. *See* Phyllis Plitch, *Funds' Lending Sparks' 'Short' Debate*, Wall St. J., May 25, 2005, at B2D; *cf.* Dan Barnes, *Learning the Cost of Stock Lending*, Banker, May 2005, at 62 (the size of the global securities lending market is "fairly unclear").

131. *See* Jeffrey Cohen, David Haushalter & Adam V. Reed, *Mechanics of the Equity Lending Market*, in Short Selling: Strategies, Risks, and Rewards 13–14 (Frank J. Fabozzi ed., 2004).

filing, that it had borrowed and voted the MONY shares, what issues it had voted on, how it had voted, and relevant dates (for borrowing, voting, and position reversal). It would also report its economic ownership at the time of MONY shares and any related non-host assets (in this case, the AXA bonds).

This empty voting disclosure will apply only to institutions that engage in large-scale vote capture. These are likely a small faction of the universe of 13G, 13F, and mutual fund filers. If vote capture is widespread, the filing burden will be higher, but so will be the need for the information.

E. Summary

As a response to hidden (morphable) ownership, the disclosure enhancements we propose above may well be sufficient. For empty voting, disclosure will be valuable, and may reduce the incidence of empty voting. Even hedge funds may be less likely to do publicly what they might do in the dark. Insiders might hesitate as well. Derivatives dealers could take "reputational risk" into account in deciding whether to facilitate a client's empty voting.

Disclosure should also provide the information base needed to assess the need for additional reforms to address empty voting. At the same time, much of the disclosure will be delayed, which limits its value for a contest at an individual company. It will often be possible to reconstruct instances in which vote buying may have affected voting outcomes, but usually too late to alter those outcomes. Delayed reporting is a tradeoff of disclosure cost against timeliness. If empty voting proves widespread, it could make sense to require periodic filers to provide "real-time" reports of significant empty voting positions.

The new information will also prove useful for efforts at international coordination, which is important for any regulatory response. The need for international coordination has been recognized in a current private effort to address new vote buying undertaken by the International Corporate Governance Network (ICGN), a group of major institutional investors from the U.S. (including CalPERS), U.K. (including Hermes), France (including Credit Agricole), and elsewhere.[132]

V. Toward Additional Responses to Empty Voting

A. General Considerations

We discuss in our companion works the theory and evidence bearing on the benefits and costs of linking shares to votes and on how a market for votes, decoupled from shares, might operate.[133] There are circumstances in which such

132. *See* International Corporate Governance Network—Securities Lending Committee, *ICGN Stock Lending Code of Best Practice* (2005) [hereinafter "ICGN, *Draft Stock Lending Code*"], *available at* http://www.icgn.org/organisation/documents/slc/code_final.pdf; Lintstock, *Share lending vis-à-vis voting—A report commissioned by the International Corporate Governance Network*, at 3 & 22 (May 28, 2004) [hereinafter "Lintstock, *Share Lending Survey*"], *available at* http://www.icgn.org/documents/share_lending_report_may2004.pdf.

133. *See* Hu & Black, *New Vote Buying*, *supra* note 24; Hu & Black, *Hedge Funds and Empty Voting*, *supra* note 24.

a market could be problematic, and circumstances in which it could enhance shareholder oversight of managers. For this and other reasons, including the difficulty in regulating an activity that can take many forms, about which little is yet known, we consider it premature to adopt additional rules to address empty voting.

Still, some simple examples can illustrate why it is likely that additional regulation will be needed. For takeover bids, an unregulated market for shares, coupled with votes, has well-known problems, driven by the high value of the marginal shares that just convey control, and the lower value of minority shares once control is assured. These problems have led to regulation of takeover bids, including a minimum offer period and a ban on two-tier offers. Similar problems would afflict a proxy fight waged by buying votes decoupled from shares. Thus, an unregulated market for votes seems unlikely to work well.

For record date capture, consider the Henderson Investments scenario. A hedge fund borrowed shares, voted them against an apparently beneficial transaction, and then sold them short, profiting while defeating an apparently beneficial transaction. Disclosure would not change the hedge fund's ability to profit at other shareholders' expense. Or consider Scotiabank's decision to vote the Sears Canada shares, held to support an equity swap, in favor of Sears Holdings' buyout offer.[134] It is arguable that, Scotiabank was an empty voter, akin to a nominal holder, while the hedge fund was the real economic owner. Perhaps the wrong party voted.

We therefore develop below a menu of regulatory options for addressing empty voting, and say a bit about their merits. There are three families of additional strategies. The most obvious strategies focus directly on voting rights (Section B). A second family focuses on improving an aging "voting architecture" (Section C). A third family involves regulatory interventions that affect supply and demand forces in the markets that support decoupling (Section D). We make no claim that particular rules we discuss are desirable, only that they are possible.

A further issue, which we do not detail here, is the locus of regulation. In particular, federal securities law focuses on disclosure. The SEC likely cannot, within its current statutory authority, directly regulate empty voting. Doing so would likely affect the "internal affairs" of corporations, traditionally governed by state law.[135] Moreover, especially in an area where the right response is uncertain, a federal response could lock in overregulation—as some scholars suggest may be the case with the Sarbanes-Oxley Act.[136] Thus, there could be reason to prefer responses that do not expand the SEC's regulatory reach.

134. Scotiabank apparently is claiming that the shares it pledged were not the "matched shares" supporting the swap. *See* Eisinger, *supra* note 59 (noting that shares are fungible).

135. *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (invalidating SEC's effort to ban dual-class recapitalizations); Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U.L.Q. 565 (1991) (discussing said effort).

136. *See, e.g.*, Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US* (working paper 2006), *available at* http://ssrn.com/abstract=876624; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

B. Strategies Focused on Voting Rights

1. Direct Limits on Voting Rights

One way to address empty voting is to limit the voting rights of shareholders who hold greater voting than economic ownership. Thus, in a recent article, Professors Martin and Partnoy suggest that "shareholders with substantial short positions should not be entitled to vote" and that "corporations and their regulators should strongly consider taking away the votes of [shareholders who are also] options buyers and sellers."[137]

In the extreme case of negative economic ownership, this could be the right answer. But even here, the technology for enforcing such a rule is not obvious. To be effective, a rule must address the many ways to decouple votes from economic ownership. Martin and Partnoy address only short sales and option positions and do not offer guidelines for implementation. They do not discuss other decoupling techniques—including record date capture and hedging with equity swaps.[138] In addition, new strategies will no doubt emerge as financial innovation continues. The innovation process can easily undermine classification-based regulatory approaches such as theirs.

An additional problem with limiting voting rights is determining when a single "investor" holds equivalent economic and voting ownership. Say, for instance, that a fund management firm runs both a conventional, "long-only" mutual fund that holds General Motors shares, and a hedge fund, managed by a different portfolio manager, which is short General Motors. Should the conventional mutual fund lose its votes because of the hedge fund's short position? Should it matter whether the fund management firm centralizes its voting decisions, or delegates them to individual fund managers?

Bringing related non-host assets into a calculus of overall economic interests raises further complexities. Consider the AXA-MONY transaction, discussed in Part II.B. The problem was not that holders of AXA convertible bonds had greater voting than economic interest in MONY, but instead that they had an orthogonal interest in the AXA bonds, which was their primary concern.

Once one moves from a simple, rarely triggered on-off switch (Does an investor have negative economic ownership, or perhaps negative overall economic interest?) to a general rule that limits voting rights when votes would otherwise exceed economic ownership, the technical difficulties in measuring economic ownership become fearsome. One must grapple with complex derivative positions, in which economic exposure varies with share price. In developing the integrated disclosure proposal presented in Part IV, we initially attempted to invent a workable scheme for numerical disclosure of economic ownership for positions with deltas different than one. The effort became absurdly complex, and we gave it up as misguided. Substantive limits on voting rights when an investor holds related non-host assets would raise further complications.

137. Martin & Partnoy, *supra* note 25, at 794.

138. In effect, Martin and Partnoy deal with limited aspects of what we refer to as empty voting, and do not address hidden (morphable) ownership, the other half of the new vote buying.

Moreover, vote buying can sometimes move votes from passive or ignorant investors to investors who can cast informed votes. Insiders who hold partly hedged positions still have incentives to vote in ways that increase firm value. The proportions of "good" and "bad" empty voting are currently unknown.

In the end, a combination of factual uncertainty about when and how new vote buying occurs, how often it is beneficial or harmful, and concerns about how one might draft and enforce a rule that limits voting rights and thus requires measuring economic ownership with reasonable precision, persuade us to err on the side of caution. At this point, we are ready neither to recommend limiting voting rights when they would otherwise substantially exceed economic ownership, nor to argue that such a rule would be a serious error. Our disclosure proposal may provide the knowledge needed to draft a workable rule. It will also help courts assess whether to limit voting rights on a case-by-case basis.

2. Voting By Record Owners: Extension to Equity Swaps

Empty voting by shareholders with zero economic ownership deserves special attention, because it is common and, in part, already regulated. Our system of record ownership already decouples economic ownership from formal voting rights. The record owner is typically at least two persons removed from the economic owner of the shares.[139] Shares held in "street name" are generally held "of record" by Depository Trust Company or another securities depository, which holds the shares on behalf of another intermediary (such as a broker-dealer or bank), which holds the shares for economic owners. Our legal system has responded by partly recoupling voting and economic ownership. Depositories pass voting rights to their bank and broker clients, who must request voting instructions from economic owners. If the customer does not provide instructions, New York Stock Exchange (NYSE) Rule 452 allows a bank or broker to vote on routine matters, but not on a contested matter or on a merger or similar transaction which may substantially affect the value of the shares.[140]

These rules on when record owners can vote provide precedent for an effort to reconnect voting rights to economic ownership, when technology has severed them. Consider, for example, a derivatives dealer who holds shares to hedge a short equity swap position. As we discuss in Part II, the dealer will often either unwind the swap so that the holder of the long position can vote, or simply vote as the holder directs. This market convention reconnects voting and economic ownership in a manner similar to the rules governing record owners. In this situation, we should require disclosure of ownership that is currently hidden, but recognize that the market is generally placing voting rights where they ought to

139. On the current system and its origins, see, e.g., Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, SEC Rel. No. 34-50758, 69 Fed. Reg. 70852, 70852 nn. 1–2, 70853 n. 21 (Dec. 7, 2004); MICHAEL T. REDDY, SECURITIES OPERATIONS—A GUIDE TO OPERATIONS AND INFORMATION SYSTEMS IN THE SECURITIES INDUSTRY 127–64 (2d ed. 1995).

140. NYSE RULE 452. *See generally* Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, *Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109 (2003).

be. One might also extend current rules governing record owners to dealers who hold matched shares to hedge short equity swap positions.

3. Corporation Opt-In

An obvious alternative to mandatory limits on voting rights would be to let corporations decide for themselves whether to require a link between economic and voting ownership.[141] Corporations could potentially do so through a board-adopted bylaw or a charter amendment.

Corporate opt-ins, such as only allowing shareholders with positive net economic ownership to vote or limiting votes to the amount of economic ownership, have the attractive feature of allowing corporations to experiment with different solutions. Still, they are subject to many of the measurement concerns we raised above. Opt-ins also raise additional concerns. A board-adopted bylaw can easily be structured to entrench insiders. It also is not clear whether board-adopted bylaws that restrict voting rights would be valid, given that corporate law currently grant voting rights to record owners, whether or not they are economic owners. Moreover, case law promises close scrutiny of unilateral board actions affecting shareholders.[142]

A charter amendment is more likely to be valid. Delaware section 212(a) states that "unless otherwise provided in the certificate of incorporation" and subject to certain record date limitations, "each stockholder shall be entitled to 1 vote for each share of capital stock."[143] The one share-one vote rule is merely a default rule and the corporation is not explicitly constrained in how it departs from this rule. Moreover, the most closely relevant case, *Williams v. Geier,* suggests that a charter amendment affecting voting rights will receive deferential business judgment review.[144] However, stock exchange rules that limit dual-class recapitalizations could block some charter amendments. Consider, for example, a time-phased voting plan, similar to the one approved in *Williams v. Geier*, which limits the voting rights of short-term shareholders. This would likely run afoul of NYSE rules, which state that voting rights cannot be "disparately reduced or restricted through any corporate action or issuance" and offers as examples "time phased voting plans" and "capped voting rights plans."[145]

Some vote-limiting strategies could also run afoul of the federal proxy rules. Consider, for example, a charter provision requiring a shareholder to attest that

141. We first raised the idea of an opt-in approach in the initial 2005 draft of this article. *See supra* note 24.

142. The Delaware Supreme Court has stated that Delaware courts "have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders, especially in an election of directors." MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003).

143. DEL. CODE ANN. tit. 8, § 212(a) (2001 & Supp. 2004).

144. Williams v. Geier, 671 A.2d 1368 (Del. 1996). This case involved "time-phased" voting rights, in which shareholders who held shares for three years had 10 votes per share, while other shareholders had only one vote per share.

145. New York Stock Exchange, *Voting Rights*, LISTED COMPANY MANUAL, ¶ 313.00(A) (Oct. 10, 1998).

he has economic ownership "substantially equal" to the number of votes he proposes to cast. Given the SEC's broad power under Exchange Act section 14(a) to regulate the proxy process, such a provision would probably require SEC assent.[146]

Assuming that a charter amendment is permitted under current law, there remains the policy question: To what extent *should* companies be able to limit voting rights through charter amendments? The core problem is that for shareholders, voting rights are collectively valuable but individually worth little. Thus shareholders can sometimes be persuaded, as in the dual class recapitalizations of the 1980s, to part with these rights for little consideration.

There is usually a presumption that a charter provision adopted before a company goes public is probably not seriously inefficient, because if it is, the insiders should receive a lower price for their shares. This market price response presumably explains why most companies go public with a one share, one vote structure. Scholars debate, however, the extent to which IPO pricing is efficient for more subtle variations in shareholder rights.[147] Those doubts would likely include charter provisions that respond to empty voting. In addition, the usual arguments for the efficiency of corporate choice are weaker for midstream charter amendments, which can entrench management and can sometimes succeed despite reducing share value.[148] Companies might well opt for midstream amendments that allow vote buying techniques used by insiders while blocking techniques used by outsiders. Time-phased voting is a good example of a rule that limits vote buying but also entrenches insiders.

Thus, the "company choice" approach needs to be cabined. Yet it seems premature to assess how without knowing either the dimensions of empty voting or how companies might respond. Some possible charter amendments might be unobjectionable. Others might be acceptable at the IPO stage, but problematic midstream. The initial need is still for disclosure, to provide a base of knowledge against which potential charter amendments can be judged.

4. State Corporate Law

A separate question from whether companies can use charter amendments to limit vote buying by outside shareholders is whether corporate law limits vote buying by insiders. There are no direct legal constraints.[149] Insiders, however,

146. Exchange Act § 14(a) (codified as amended at 15 U.S.C. § 78n(a) (2000 & Supp. III 2003)).

147. *See, e.g.*, Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L., ECON. & ORGANIZATION 83 (2001).

148. *See* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U.L. REV. 542 (1990).

149. In the Introduction, we sketched why traditional vote buying doctrine does not cover empty voting through the two-step process of purchasing shares and then hedging economic ownership. A new vote buyer using record date capture can generally also avoid being constrained by existing case law. The borrowed shares convey full economic and voting ownership. This is customarily coupled with the right of either the borrower or the lender to reverse the transaction on demand and, while the loan is outstanding, the borrower paying to the lender the cash return on the shares plus an agreed upon borrowing charge. No individual piece of this arrangement is seen as problematic under current doctrine.

might be constrained by fiduciary duty. At one extreme, given the rigor with which courts police shareholder elections, company officers or directors would likely breach their duty of loyalty if they used corporate funds or the promise of future business to procure votes. In the *Hewlett v. Hewlett-Packard* proxy fight case, for example, Walter Hewlett claimed that HP management had procured a favorable vote by Deutsche Bank through promises or threats related to future business dealings between the two companies. HP defended on the grounds that it had persuaded Deutsche Bank to support the merger on the merits, and effectively conceded that procuring votes through a promise or threat would be improper.[150] Suppose, instead, that HP management had engaged in new vote buying to swing the outcome. There would be no identifiable transfer of voting rights, and hence no classic vote buying, but the breach of fiduciary duty would be the same, and the courts would likely disallow the procured votes.

However, other efforts at new vote buying could be hard for courts to reach under current doctrine. Consider, for example, a company founder who hedges his economic ownership. Corporate law neither requires disclosure of the hedging nor questions the founder's exercise of voting rights. Disclosure comes from Section 16 rules. Managers could also acquire votes while hedging their economic interest, if they did so for the long term, rather than to influence a particular vote.

If empty voting is potentially outcome-determinative, judges will likely face pressure to update current vote-buying doctrine, which addresses only explicit transfers of voting rights by a vote seller. They may also have to examine a new vote buyer's transfer of economic ownership. They might well disallow voting by an empty voter such as Perry, or the hedge fund in Henderson Investments, with negative economic interest. This situation is analogous to voting by directors whose personal interests conflict with the corporation's interests.[151] In both situations, the usual presumption that the voter will seek to increase shareholder wealth is thrown into doubt. Zero or negative economic interest aside, it seems premature to speculate as to how courts should address empty voting, given the multiple factual contexts in which it can be used.

Another possible response is to reduce the importance accorded to shareholder votes as a guide to shareholder preferences. Ronald Gilson and Alan Schwartz have argued that elections are inferior to tendering decisions as a guide to shareholder preferences in a control battle.[152] The potential for empty voting strengthens their case. When some directors are conflicted, the Delaware courts channel decision-making to non-conflicted directors. Similarly, if some shareholders hold more votes than economic ownership, judges can give less deference to a voting

150. *See* Hewlett v. Hewlett-Packard Co., No. Civ. A. 19513-NC, 2002 WL 818091, at *9 (Del. Ch. Ap. 30, 2002) (finding that "no one from HP used any threats or inducements regarding future business relationships").

151. *See* Warner Fuller, *Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors*, 26 WASH. U.L.Q. 189 (1941); *cf.* Golden Rod Mining Co. v. Bukvich, 92 P. 2d 316 (Mont. 1939) (involving an outside director who was a competitor).

152. Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, 2 THEORETICAL INQUIRIES IN LAW 783 (2001).

outcome influenced by the votes of these shareholders. The degree of deference could change both for control contests and for shareholder proposals, for which an open question is how much attention a board should pay to a nonbinding shareholder proposal that receives majority shareholder support.[153]

C. Strategies Focused on Voting Architecture

The new vote buying has put stress on an aging "voting architecture," developed before the emergence of OTC equity derivatives and large-scale stock lending. One result is that even large institutional investors often misunderstand how share lending affects their voting rights. There are also mechanical problems; the simple act of properly counting votes would often fail if all shareholders entitled to vote did so.

Many institutional investors lend through agents and do not keep careful track of which shares have been lent.[154] For example, in 2004, the International Corporate Governance Network (ICGN) circulated among its members a questionnaire on their securities lending practices.[155] Of the 39 institutions which responded (including pension funds, mutual funds, banks, insurance companies, and other asset managers), 31 had lent shares. Most relied on agents and half reported that the agent could lend without the respondent's knowledge. A substantial majority (21 of 31) "[r]arely, only in special circumstances" recalled shares in order to vote them; moreover, attempts to recall shares for voting purposes sometimes failed.

Another recent analysis found similar results. In 2005, the Shareholder Voting Working Group—a financial industry group convened to improve the voting process in the United Kingdom—issued a report stating that some fund managers were not aware that their shares had been lent.[156] This was the case both for institutions that lent through agents and institutions that ran their own lending programs; because lending departments often do not report loans to portfolio managers. Some institutions were not even aware that lent shares cannot be voted. Working Group head Paul Myners stated that "[i]t is not well enough understood that the vote goes with the share."[157]

Fuller information may change lender behavior. CalPERS, a major lender which earns about $110 million a year from this activity, illustrates. Beginning in 2003,

153. *See, e.g.*, Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 Bus. Law. 23 (2004).

154. *See, e.g.*, Kit Bingham, *Myners rejects calls for curbs on stock lending*, eFinancialNews.com, Mar. 20, 2005 ("most portfolio managers are unaware that their shares have been lent"); Martin Dickson, *Myners' whiffometer*, Fin. Times, Mar. 15, 2005, at 22 ("some fund managers may not be aware that the shares have been lent, since the beneficial owners may contract directly with custodians to lend").

155. *See* Lintstock, *Share lending vis-à-vis voting—A report commissioned by the International Corporate Governance Network* (May 28, 2004), *available at* http://www.icgn.org/documents/share_lending_report_may2004.pdf.

156. Paul Myners, Review of the Impediments to Voting UK Shares 4–5, 11 (2005), *available at* http://www.investmentuk.org/press/2005/20050314-01.pdf.

157. Kit Bingham, *Concern Grows Over Borrowed Votes*, eFinancialNews.com, May 8, 2005.

CalPERS has sought to balance the income it receives from securities lending with its "shareholder responsibility" to vote shares. CalPERS currently will not lend shares of certain companies around voting record dates and claims that it will only lend shares to "those who have a legitimate right to the proxy as a benefit of true ownership."[158]

Institutional investors will vary in their interest in preserving voting rights. Any one investor can profit from lending, while its vote probably won't matter. Some institutional investors enter into "exclusives"—arrangements in which a lender makes some or all of its portfolio available to a particular borrower—usually with no exception for record dates and little consideration of the borrower's goals.[159] On the other hand, some institutional investors (such as Europe's largest pension fund) have decided to stop lending shares despite the impact on their returns.[160]

For annual meetings, a lender's effort to decide whether to hold shares and itself vote faces a technical problem. The record date will usually have passed before the company distributes its proxy statement. Hence, on the record date, investors may not know what is on the agenda (beyond the customary need to elect directors and approve the auditor). One could address this problem by requiring companies to disclose the expected voting agenda when they announce record dates. To be sure, however, this same information could encourage record date capture.

A further step for stock lenders, beyond knowing that they have lent shares and cannot vote, is knowing to whom they have lent. This too is not common. Lenders often lend through agents, or lend to broker-dealers who act on behalf of clients who are unknown to the lender. Efforts are currently under way to require U.S. banks or broker-dealers that arrange securities loans to advise the *borrower* of the *lender's* identity. The goal is to allow the borrower to assess the lender's credit risk, since the lender holds the borrower's collateral.[161] These efforts do not yet contemplate advising the lender of the borrower's identity.

Another concern is mechanical problems associated with voting.[162] Growth in short selling and stock lending are fostering an increasingly serious "over-voting"

158. *See* CalPERS, *Securities Lending as It Relates to Proxy Voting* (report prepared by CalPERS staff in response to May 16, 2005 Investment Committee meeting), *available at* http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200506/item08a-03.pdf. We confess to being unsure how CalPERS will decide which borrowers are legitimate and which are not.

159. *See* Gene Picone & Paul Wilson, *Lending Arrangements—Exclusive Risks, Exclusive Rewards*, GLOBAL INVESTOR, Mar. 2005, at 1, 1–2.

160. See, e.g., *Super-hero or Super-villain? Is Securities Lending Unpatriotic and Detrimental to the Market, or Does It Improve Liquidity and Efficiency?*, BANKER, Nov. 1, 2002.

161. *See DTC Begins Testing for Agency Lending Disclosure*, BUSINESS WIRE, June 29, 2005; Shane Kite, *Deadline Looms for Securities Lenders-Two-year Agency Disclosure Initiative Still Trying to Fill Membership Gaps*, SEC. INDUSTRY NEWS, Mar. 15, 2006; Department of the Treasury, Financial Crimes Enforcement Network, Frequently Asked Questions—Customer Identification Program Responsibilities Under the Agency Lending Disclosure Initiative (Apr. 25, 2006), *available at* http://www.fincen.gov/cip_faq.html.

162. For an introduction to over-voting issues, see Martin & Partnoy, *supra* note 25; Chris Kentouris, *Decisive Moment on Proxy Miscounts*, SEC. INDUSTRY NEWS, Dec. 31, 2004; Robert C. Apfel, John E. Parsons, G. William Schwert, & Geoffrey S. Stewart, *Short Sales, Damages, and Class Certification in 10b-5 Actions*, Univ. of Rochester, Simon School of Business Administration, Bradley Policy Research

problem, which arises as follows. Currently, brokers who hold shares in street name must vote in accordance with their clients' instructions. Suppose that a broker holds 2 million shares in a pooled account on behalf of margin customers, lends 1 million shares, and receives voting instructions from holders of 1.5 million shares. There is no coherent way of ensuring that such a broker will cast only 1 million votes, nor for companies to decide what to do if a broker votes too many shares, nor for the broker to decide whose voting instructions count if it casts only 1 million votes. Instead, brokers and companies follow ad hoc procedures, with uncertain impact on proxy fights. The New York Stock Exchange issued a warning on over-voting in 2004.[163] Over-voting has been an issue in at least two lawsuits over the results of a proxy fight.[164] The Securities Transfer Association, a trade group for transfer agents, reviewed 341 shareholder votes in corporate contests in 2005—and found over-voting in all 341 cases.[165] One company specializing in the oversight of shareholder elections recently said that "[a] lot of the time we have no idea who's entitled to vote and who isn't" and called the situation an "abomination."[166]

The current formally correct response to overvoting is to limit the broker in our example to 1 million votes (presumably cast in proportion to the voting instructions the broker receives). But this would disenfranchise individual shareholders and *increase* the disparity between economic ownership and voting rights. What might contribute to a better solution would be a change in business practice in which economic owners could decide whether to allow their shares to be lent around record dates, or in which stock lenders could elect to retain voting rights. If some lenders retain voting rights, borrowers who need these voting rights would have to borrow from lenders who were willing to part with them, presumably at higher cost.

In sum, the current ways in which share lending affects voting need to be updated, both to ensure that those with voting rights can exercise them and to provide lenders and borrowers with the information they need to decide what to do with their voting rights.

D. Strategies Focused on Supply and Demand Forces in the Markets on Which the New Vote Buying Relies

A third family of regulatory interventions would focus on the supply and demand forces in the markets that support new vote buying, especially the share

Center Financial Research and Policy Working Paper No. FR 01-19 (July 2001), *available at* http://ssrn.com/abstract = 285768.

163. *See* Kentouris, *supra* note 162.

164. *See* Seidman and Associates, L.L.C. v. G.A. Financial, Inc., 837 A.2d 21 (Del. Ch. 2003) (court upholds decision by election inspector to disallow all 232,000 votes cast by a broker dealer who had overvoted by less than 1,000 votes); Apfel et al., *supra* note 162 (discussing a proxy contest at Integrated Circuit Systems and associated voting actions taken by brokers).

165. Bob Drummond, *One Share, One Vote: Short Selling Short-circuits the System*, Int'l Herald Trib., Mar. 1, 2006, at 20.

166. *Id.* (quoting Thomas Montrone, CEO of Registrar & Transfer).

lending market. On the "supply" side, one could regulate share lenders, lending intermediaries, and derivatives dealers. On the "demand" side, one could regulate the purposes for which hedge funds and other investors could acquire voting rights decoupled from economic ownership. The primary actors here would be the SEC, the Federal Reserve Board, the U.S. Department of Labor, and other federal authorities.

1. Encouraging Institutional Shareholders to Vote on Important Matters

One approach would be to encourage institutional shareholders to vote on important matters. Voting could be made part of their obligation to their clients, perhaps with an exception for routine matters. Regulators have already gone partway down this path for mutual funds and pension funds. An SEC guideline for mutual funds states that:

> We would not object if voting rights pass with the lending of securities. However, this does not relieve the directors of a fund of their fiduciary obligation to vote proxies. If the fund management has knowledge that a material event will occur affecting an investment on loan, the directors would be obligated to call such loan in time to vote the proxies.[167]

We are not aware, however, of SEC efforts to enforce this soft guidance. It has little bite for annual meetings, for the technical reason noted above—the record date has typically passed before the company distributes its proxy statement, thus informing shareholders about the voting agenda. Moreover, the SEC's controversial 2003 rules requiring mutual funds and investment advisers to disclose their voting practices are silent on stock lending. The adopting release states that mutual funds and investment advisers can choose not to vote if the costs of doing so outweigh the benefits, and offers examples involving voting of foreign shares.[168]

The Department of Labor (DoL), which regulates pension plans subject to ERISA (basically, company pension plans but not public sector pension plans), has adopted a similar approach. Interpretive Bulletin 94-2 encourages but does not require voting. For shares of foreign corporations, the Department interprets ERISA fiduciary duties:

> to require the responsible plan fiduciary to weigh the costs and benefits of voting on proxy proposals relating to foreign securities and make an informed decision with

167. *See, e.g.*, State Street Bank & Trust Company, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4607 (Sept. 29, 1972); *cf.* Susan C. Peters, *Accounting Treatment of Loans of Securities*, in SECURITIES FINANCE: SECURITIES LENDING AND REPURCHASE AGREEMENTS 209 (Frank J. Fabozzi & Steven M. Mann eds., 2005) (mutual funds "must have the ability to recall any security on loan to vote on a material event proxy").

168. *See* Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Investment Companies, SEC Rel. No. 33-8188 (Jan. 31, 2003); Proxy Voting by Investment Advisers, SEC Rel. No. IA-2106 (Jan. 31, 2003). On the circumstances when investment advisors need not vote, see Rel. No. IA-2106, *supra*, at § II(A)(2)(a) & n. 3.

> respect to whether voting a given proxy proposal is prudent and solely in the interest of the plan's participants and beneficiaries.[169]

A similar analysis presumably would apply to voting shares in U.S. companies.

At the same time, the DoL appears to expect that ERISA plan trustees will recall lent shares in order to cast important votes. In a 1979 advisory opinion on share lending, the Department stated:

> a breach of fiduciary responsibility . . . might result if the plan trustees do not terminate the loan in time to vote proxies in the event of an occurrence affecting the plan's interest in the security.[170]

It is not hard to imagine the SEC, the DoL, or other regulators strengthening this sort of informal guidance, and extending to other classes of institutional investors a requirement to recall lent shares in order to cast important votes. Regulators might also require institutions to disclose when they have lent shares rather than voting them. Some might find it embarrassing to have to disclose that they routinely lend shares around record dates.

2. Safe Harbor for Voting Instead of Lending Shares

A more modest step would address the dilemma faced by an institutional investor which must decide whether to lend or vote shares. Any one institution's vote is unlikely to affect the outcome, so lending will often be privately optimal. Yet collectively, institutional voting can benefit all shareholders. This externality will produce too much lending and too little voting. The SEC and DoL positions on share lending, discussed above, likely provide a quasi-safe harbor in terms of fiduciary challenges. If one's regulator is urging one to vote, it is hard for clients to object to a decision to do so. Still, there could be value in a safe harbor for all institutions which vote shares rather than lend them around a record date.

3. Reducing the Attractiveness of Lending Shares and Providing Equity Derivatives

There are also a variety of tax and regulatory changes that could be deployed to make share lending less attractive to lenders, or to make equity swaps less attractive to derivatives dealers. One set of changes could focus on the fact that if a mutual fund lends shares and receives a dividend-equivalent payment, the dividend would have qualified for a reduced 15% tax rate; but the substitute payment does not.[171] A similar tax issue arises for lending by broker-dealers. If a

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169. *See* Department of Labor, Interpretive Bulletin 94-2 (July 29, 1994); *cf.* Clifford E. Kirsch, *Proxy Voting*, in MUTUAL FUND REGULATION § 11.4 (Clifford E. Kirsch ed., 2d ed. 2005) (describing DoL's approach to proxy voting).

170. Department of Labor—Pension & Welfare Benefit Programs, Opinion 79-11A, 1979 ERISA LEXIS 81 (Feb. 23, 1979).

171. For discussion of how these tax considerations may cause stock lending to flow from mutual funds to (tax-exempt) pension funds, see Phyllis Feinberg, *Reduced Supply: New Law to Slow Mutual Funds' Securities Lending: Pension Fund Programs Stand to Receive Benefits of Recently Passed Dividend Tax Cut*, PENSIONS & INVESTMENTS, Sept. 1, 2003, at 6.

broker lends customer shares and receives dividend-equivalent payments, the broker keeps the loan proceeds, while the customer receives "payments in lieu of dividends," which are taxed as ordinary income. These tax consequences should reduce the attractiveness of stock lending. For example, unless compensated for these tax consequences (which is not the current industry practice), investors could open cash accounts (from which shares cannot be lent) rather than margin accounts.

Many mutual fund investors and margin account holders are probably not aware of the tax consequences of share lending. Broker-dealers must disclose annually to their customers the portion of investment income that qualifies for the dividend tax rate, but not the reasons why. One can imagine better disclosure, for example, a statement that "we earned $X last year by lending shares from your account; this increased your ordinary income by an estimated $Y."

Other steps could affect the attractiveness of share lending and equity derivatives activities. Broker-dealers could be required periodically to obtain customer consent to lend shares held in margin accounts.[172] Pension funds and banks are already subject to constraints on their securities lending activities; these could be revisited.[173] Capital adequacy and general safety and soundness requirements applicable to commercial and investment banks provide additional regulatory levers. We make no claim that particular tax or regulatory tweaks are desirable, only that they are possible.

4. Imposing Responsibilities on Share Lenders and Derivatives Providers

Another possible approach would require share lenders and equity swap providers to know their clients, and how their clients will use the share borrowing or swap. In the Enron disaster, banks offered Enron a variety of financial products that helped Enron present a misleading financial picture to the public. One consequence has been multibillion dollar payments by major banks to settle class action lawsuits. Another is that regulators now expect financial institutions to do more to investigate their clients' use of financial products to game disclosure or tax rules.[174] The SEC, the Federal Reserve Board, and the Office of the Comptroller of the Currency have issued a joint statement warning financial institutions against creating complex financial products that let their customers artificially alter their

172. Rule 15c3-3(b)(3), 17 C.F.R. § 240.15c3-3(b)(3) (2005), specifies that the broker's borrowing of securities from its margin customer be pursuant to a written agreement that meets certain criteria; there is no requirement that the agreement be periodically renewed, or that the customer approve individual loans. *See* Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069 (2002).

173. For details on these constraints, see Hu & Black, *New Vote Buying*, *supra* note 24, at 903–04.

174. *See* In the Matter of Citigroup, Inc. SEC Rel. No. 34-48230, 2003 SEC LEXIS 1778 (July 28, 2003); In the Matter of J.P. Morgan Chase & Co., Lit. Rel. No. 18252 2003 SEC LEXIS 1775 (July 28, 2003).

public financial statements or evade taxes.[175] Regulators could take a similar interest in investment banks' creation of instruments designed to facilitate empty voting or evade ownership disclosure rules.

In one respect, current rules already limit the purposes for which shares may be lent. Under Federal Reserve Regulation T, broker-dealers who have material dealings with the general public are exempt from the usual margin rules that limit borrowing to acquire securities. Other broker-dealers enjoy a more limited "permitted purpose" exemption. They may "borrow or lend securities in case of short sales, failure to receive securities required to be delivered, or similar situations."[176] Under the "permitted purposes" exemption, broker-dealers are required to make a good faith effort to determine the borrower's purpose and cannot lend shares for voting purposes.[177] All the Federal Reserve need do to greatly limit record date capture is to either extend the permitted purpose approach to all broker-dealers or make share lending for vote capture purposes an illicit purpose for otherwise exempt broker-dealers. Such a ban on share lending to permit record date capture is already the informal norm in the U.K.[178]

A similar "know your customer's purpose" approach could affect the market for some other forms of vote buying. Suppose that a hedge fund comes to a derivatives dealer, seeking simultaneously to buy shares and hedge its economic exposure, ending up with pure votes. One could establish a presumption that the hedge fund's goal is empty voting, and bar dealers from entering into these swaps.

5. The Demand Side: Executive Hedging

The demand for vote buying and the products it depends on can be affected by techniques similar to some of those discussed above for the supply side. We offer here one example, involving executive hedging, which usually leaves executives with more voting power than economic interest. One could make this "lite voting" less attractive by increasing the tax consequences of hedging. By hedging, the executive has effectively sold a portion of his shares. Internal Revenue Code section 1259 taxes, as constructive sales, a limited set of hedges.[179] For example, an equity swap that offsets "substantially all" economic exposure would trigger taxation. Section 1259 is easy to avoid: standard zero-cost collars do not trigger

175. *See* Securities and Exchange Commission, Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, SEC Rel. No. 34-49695, 2004 SEC LEXIS 1017 (May 13, 2004); Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28326 (May 16, 2006).

176. *See* Regulation T, 12 C.F.R. pt 220 (2006), especially 12 C.F.R. § 220.2 (2006) ("exempted borrower" exemption for major broker-dealers); 12 C.F.R. § 220.10(c) (2006) ("permitted purpose" exemption for other broker-dealers).

177. *See* Federal Reserve Board Rulings and Staff Opinions Interpreting Regulation T, 5-615.01, FRRS 5-615.01 (July 6, 1984) (regarding analogous situation of record date capture to let borrowers take advantage of company dividend reinvestment plans).

178. *See* Myners, *supra* note 156, at 13; Bank of England, Securities Borrowing and Lending Code of Guidance, at 17 (2004), *available at* http://www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf (stating that there is "consensus in the market" that securities "should not be borrowed solely for the purposes of exercising the voting rights at [a shareholder meeting]").

179. 26 U.S.C.A. § 1259 (2002 & Supp. 2006).

it, nor would a swap that offset most, but not "substantially all" of an executive's economic exposure.[180] While it may be hard to develop an administrable rule that could not be easily gamed, one could try to move to a more easily triggered standard.

VI. Conclusion

The shareholder vote is a central means by which corporate governance systems constrain managers' discretion over other people's money. The vitality of that constraint, however, depends on a connection between votes and economic interest.

Financial innovation now allows large scale, low cost, often undisclosed decoupling of voting rights from economic ownership. This decoupling—the new vote buying—comes in two main forms, which we call empty voting (more votes than economic ownership) and hidden (morphable) ownership (undisclosed economic ownership accompanied by informal voting rights). The modern derivative, heretofore largely a risk management tool and an investment vehicle for investors and firms, can also affect voting outcomes. OTC derivatives, developed to trade risk, turn out to be well adapted for trading votes. A now-massive share lending market serves the needs of both short-sellers and empty voters.

Hedge funds have been among the pioneers in both forms of the new vote buying. Insiders have also used decoupling strategies to retain votes while shedding economic exposure. In the past several years, decoupling has played an increasing role in corporate governance worldwide. We have found more than twenty publicly known or rumored examples, almost all since 2002. Several involve empty voting by investors with negative economic interests, who would profit if the companies' share prices go down. Additional uses of decoupling have surely remained hidden.

Not all vote buying is bad. Some could move votes from less informed to better informed investors, and strengthen shareholder oversight. Still, unless there are ways to separate good vote buying from bad, and allow only the former, the new vote buying, as we call it, can potentially undermine the coupling between voting and ownership. Voting outcomes might be determined by hidden warfare among company insiders and major investors, each employing vote morphing and other financial innovations to swing a voting contest. Voting results are now increasingly close, a corollary to voting becoming an increasingly significant aspect of corporate governance. Winning a close vote could sometimes turn on cleverness in decoupling, rather than the merits of each side's position.

While the potential corporate governance threat posed by the new vote buying is serious, the extent and nature of the new vote buying is unknown. In addition, any regulatory response to decoupling must attend to potential effects on derivatives and short-selling. Derivatives serve good purposes, as well as ill. Short

180. *See, e.g.*, Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. Rev. 431 (2005); Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 Tax L. Rev. 503, 532–33 (2004) (noting that a "very limited number of taxpayers" pay tax under § 1259).

sellers play a valuable role in securities markets, and depend on the same share lending market that facilitates the new vote buying.

The first step is to better understand the new vote buying through enhanced disclosure. Empty voting and hidden (morphable) ownership should, we believe, be exposed to public view. This article's "integrated ownership disclosure" proposal would partially integrate and greatly simplify the five existing ownership disclosure regimes. The proposal is practical and indeed may reduce the direct costs of regulatory compliance. Indeed, we believe that our integrated ownership disclosure proposal is worth considering for its simplicity and internal consistency alone, even apart from its value in relation to new vote buying.

Disclosure may be a sufficient response to hidden (morphable) ownership. For empty voting, it will likely be only a first step, but a sufficient step to give regulators, judges, companies, and investors a good view of the nature and scale of this new activity. Eventually—perhaps soon—other responses to empty voting may be needed. One family of responses would involve focusing on voting rights themselves. Corporations can, for instance, amend their charters to condition voting rights of major shareholders on economic ownership. Other families of responses focus on voting mechanics and on the supply and demand forces in the OTC derivatives and share lending markets, on which the new vote buying relies.

Which additional reforms should be adopted, we cannot yet say. That will depend on information as yet unknown, which our disclosure rules are designed to collect. We do know that existing legal and economic theories of the public corporation depend on a link between voting rights and economic ownership that can no longer be relied on.

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