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THE NEW VOTE BUYING:
EMPTY VOTING AND HIDDEN
(MORPHABLE) OWNERSHIP

HENRY T. C. HU
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THE NEW VOTE BUYING: EMPTY VOTING AND HIDDEN (MORPHABLE) OWNERSHIP*

HENRY T. C. HU** & BERNARD BLACK***

ABSTRACT

Corporate law generally makes voting power proportional to economic ownership. This serves several goals. Economic ownership gives shareholders an incentive to exercise voting power well. The coupling of votes and shares makes possible the market for corporate control. The power of economic owners to elect directors is also a core basis for the legitimacy of managerial authority. Both theory and evidence generally support the importance of linking votes to economic interest. Yet the derivatives revolution and other capital markets developments now allow both outside investors and insiders to readily decouple economic ownership of shares from voting rights. This decoupling, which we call the

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“new vote buying,” has emerged as a worldwide issue in the past several years. It is largely hidden from public view and mostly 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.” In an extreme situation, a vote holder can have a negative economic interest and, thus, an incentive to vote in ways that reduce the company’s share price. Sometimes investors 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 situation “hidden (morphable) ownership” because the economic ownership and (de facto) voting ownership are often not disclosed.

This Article analyzes the new vote buying and its potential benefits and costs. We set out the functional elements of the new vote buying and develop a taxonomy of decoupling strategies. We also propose a near-term disclosure-based response and outline a menu of longer-term regulatory choices. Our disclosure proposal would simplify and partially integrate five existing, inconsistent 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 discuss strategies focused on voting rights, voting architecture, and supply and demand forces in the markets on which the new vote buying relies.

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I. INTRODUCTION

The vote is the core source of shareholder power. The standard contractarian theory of the corporation supports assigning voting rights to common shareholders in proportion to share ownership. Doing so places the power to oversee company managers in the hands of residual owners, who have an incentive to exercise that power to increase firm value; the more shares owned, the greater the incentive and thus the greater the number of votes.¹ Linking shares to votes also facilitates the operation of the market for corporate control. Empirical evidence supports the concern with a disparity between insiders' voting power and economic interest by

1. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 63, 67 (1991) (“[W]hy do shareholders alone have voting rights? . . . The reason is that shareholders are the residual claimants to the firm’s income.”).

showing that such a disparity predicts reduced firm value.² Beyond this instrumental role of voting, shareholder voting is a core ideological basis for managerial authority, legitimating managers' exercise of authority over property the managers do not own.³

Yet 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 share lending market, are making it easier and cheaper to decouple economic ownership from voting power.⁴ Hedge funds and company insiders are taking advantage of this new opportunity. Sometimes, they hold more votes than shares—a pattern we call "empty voting" because the votes have been emptied of an accompanying economic stake. 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 or insiders can also have economic ownership that exceeds their apparent voting rights. The investors or insiders often have informal access to voting rights, which they typically exercise by either acquiring formal voting rights from an intermediary (usually a derivatives dealer) or instructing the intermediary on how to vote the company's shares. This ownership is typically not disclosed under large shareholder disclosure rules.⁵ These rules focus on voting power rather than economic interest, and do not clearly require disclosure of the informal voting power that often exists. The informal, "morphable" nature of these voting rights allows

2. See, e.g., Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81 (2000); Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-class Firms in the United States* (Rodney L. White Ctr. for Fin. Research, Working Paper No. 12-04, 2006), available at <http://ssrn.com/abstract=562511>.

3. See, e.g., *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (asserting that voting rights are "critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own"). Cf. *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

4. For broader discussions of the challenges that derivatives and modern financial innovations pose to corporate governance principles, see, for example, Henry T. C. Hu, *Behind the Corporate Hedge: Information and the Limits of "Shareholder Wealth Maximization,"* J. APPLIED CORP. FIN., Fall 1996, at 39 [hereinafter Hu, *Behind the Corporate Hedge*], and 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*]. On the distinction between OTC and exchange-traded derivatives, see, for example, 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*].

5. We discuss the current ownership disclosure rules *infra* in Part IV.B.

investors to plausibly deny the voting power that would trigger disclosure. We use the term “hidden ownership” to refer to the undisclosed economic ownership, and the term “hidden (morphable) ownership” to refer to the combination of undisclosed economic ownership plus probable informal voting power.

We refer to empty voting and hidden (morphable) ownership together as “the new vote buying” or simply as “decoupling.” In the last few years, the new vote buying has affected takeover battles and control of public companies in (at least) Australia, Canada, Germany, Hong Kong, Italy, Japan, New Zealand, the United Kingdom, and the United States.

There are a number of ways to decouple votes from economic ownership. One method relies on the share lending market, which lets one investor “borrow” shares from another. Under standard lending arrangements, the borrower has voting rights but no economic ownership, while the lender has economic ownership without voting rights. A second approach employs an equity swap, in which the person with the long equity side (the “equity leg”) of the swap acquires economic ownership of shares (but not voting rights) from the short side (the “interest leg”). The short side often hedges its economic risk by holding shares, thus ending up with votes but no net economic ownership. Other decoupling strategies are also possible, such as relying on put and call options or, where they exist, single-stock futures.

A recent public instance of empty voting illustrates the potential risks from empty voting. Perry Corp., a hedge fund, owned 7 million shares of King Pharmaceuticals.⁶ In late 2004, Mylan Laboratories agreed to buy King in a stock-for-stock merger at a substantial premium, but 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 Perry fully hedged the market risk associated with its Mylan shares. Perry thus had **9.9% voting ownership** and **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.

Empty voting can also be used to multiply the voting power of an existing long ownership position. For example, a shareholder can borrow shares just before the record date for a shareholder vote, and then reverse

6. We discuss this example and provide citations *infra* in Part II.B.

the transaction afterward. The first publicly reported instance of this “record date capture” strategy occurred in the United Kingdom in 2002.⁷ Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a property company. At the annual general meeting, Laxey voted over 9% of British Land’s shares to support a proposal to dismember British Land. Just before the record date, Laxey had borrowed almost 42 million shares.

Empty voting by institutions is a close cousin to widely used techniques, such as zero-cost collars and variable prepaid forwards, by which managers and controlling shareholders retain formal ownership of shares, while shedding some or most of their economic ownership.⁸ In the United States, these strategies typically have been driven by insiders’ desire to shed risk while deferring taxes, rather than by vote buying motives. But insiders can readily use empty voting techniques to cement their control, and do so in other countries.

Conversely, investors can have greater economic ownership than formal voting rights, but also have informal, “morphable” voting rights that give the investor full ownership as a practical matter. Perry’s stake in a New Zealand company, Rubicon Ltd., which came to light in 2003, illustrates this possibility.⁹ Perry used equity swaps provided by derivatives dealers to hold a 16% economic stake in Rubicon, without complying with New Zealand’s large shareholder disclosure rules, which, like section 13(d) (“Section 13(d)”) of the Securities Exchange Act of 1934 (“Exchange Act”), require disclosure by 5% shareholders.¹⁰ When an election came along, Perry returned to its dealers, unwound the swaps, acquired the “matched shares” held by the dealers to hedge the swaps, and thus obtained formal voting rights. Perry’s nondisclosure was upheld under New Zealand law. Morphable voting rights can also be useful for reasons unrelated to disclosure.¹¹

7. We discuss this example and provide citations *infra* in Part II.B.

8. See, e.g., *Donoghue v. Centillum Commc’ns Inc.*, 2006 U.S. Dist. LEXIS 13221 (S.D.N.Y. Mar. 28, 2006) (describing variable prepaid forward contracts and discussing 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 Insiders*, 36 J. FIN. & QUANTITATIVE ANALYSIS 345 (2001) (discussing zero-cost collars and equity swaps); Rachel Emma Silverman & Jane J. Kim, *IRS Targets Strategy for Wealthy Executives*, WALL ST. J., Feb. 9, 2006, at D1 (describing variable prepaid forwards).

9. We discuss this example and provide citations *infra* in Part II.C.

10. Compare Securities Amendment Act 1988, § 26 (N.Z.), with Exchange Act § 13(d), 15 U.S.C. § 78m(d) (2000).

11. We discuss a number of other uses of morphable voting rights *infra* in Part II.C.

The new vote buying is largely unregulated and often unseen. Corporate case law governing “classic” vote buying does not touch it. That case law presumes a direct transfer of voting rights from a vote seller to a vote buyer; it then assesses the business justification for the seller’s transfer of voting rights. In the leading Delaware case, *Schreiber v. Carney*, vote buying is defined as “a voting agreement supported by consideration personal to the stockholder, whereby the stockholder . . . votes as directed by the offeror.”¹² In contrast, the new vote buying often involves no identifiable “seller” nor an identifiable “transfer” of voting rights. The new vote buyer can, for instance, follow a two-step process. It buys shares in the open market and then enters into a derivatives transaction that offsets economic ownership of the shares. The vote buyer is left only with voting ownership. It has engaged in two conventional transactions—purchasing shares and using a derivative for hedging purposes—that are not individually suspect. For record date capture, the sale of votes occurs through share lending—an ordinary activity with legitimate uses unrelated to vote buying.

Federal ownership disclosure rules scarcely touch the new vote buying either. Institutional investors must disclose their share positions in public companies on Form 13F.¹³ But Form 13F does not cover transactions that offset either the voting rights or economic interest conveyed by these positions. Nor does it cover economic ownership acquired by holding equity swaps or other OTC derivatives. The Schedule 13D and Schedule 13G requirements for 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 to arguably evade 13D/13G disclosure.¹⁴ Even in *Perry-Mylan*, where Perry filed a Schedule 13D, it made only limited disclosure of its hedging agreements.¹⁵ Disclosure by insiders and 10% shareholders under section 16 of the Exchange Act (“Section 16”) focuses on economic ownership.¹⁶ Section 16 disclosure captures empty voting through hedging (since hedging affects

12. *Schreiber v. Carney*, 447 A.2d 17, 23 (Del. Ch. 1982).

13. SEC 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].

14. Schedule 13D, 17 C.F.R. § 240.13d-101 (2005) [hereinafter Schedule 13D]; Schedule 13G, 17 C.F.R. § 240.13d-102 (2005) [hereinafter Schedule 13G].

15. News reports suggest that the Securities and Exchange Commission (“SEC”) is considering an enforcement action against Perry, presumably under Section 13(d) rules. *See, e.g.,* Ianthe Jeanne Dugan, *Hedge Funds Draw Scrutiny over Merger Play*, WALL ST. J., Jan. 11, 2006, at C1.

16. Exchange Act § 16, 15 U.S.C. § 78p (2000 & Supp. 2002).

economic ownership) but likely does not capture empty voting through share borrowing (since economic ownership does not change).

Because the new vote buying is seldom captured by disclosure rules, its scale is unknown. We did, however, search for and compile a list of over twenty confirmed or publicly rumored examples, almost all since 2002. It is no accident that most of these examples are recent, nor that many involve hedge funds. The theoretical possibility of decoupling votes from economic ownership is not new.¹⁷ What is new is investor ability to do so on a large scale, declining transaction costs due to financial innovation, and a trillion-dollar-plus pool of sophisticated, lightly regulated, hedge funds, free from conflicts of interest and concerns with adverse publicity that may deter other institutional investors from using decoupling strategies.

The corporate governance risk posed by the new vote buying is clear, but the remedy is not. Policymakers abroad—notably in Hong Kong and the United Kingdom—are beginning to confront the new vote buying. U.S. policymakers will soon need to address it.¹⁸

In our view, the near term need is for enhanced ownership disclosure (crafted with sensitivity to the costs of disclosure), to let regulators assess how often new vote buying occurs and how it affects shareholder vote outcomes. If disclosures are made on a real-time basis (a step that goes somewhat beyond our proposal), the information they provide 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 recommendations. 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 ownership to economic-plus-voting ownership, the rules must cover both economic and voting ownership. Second, the disclosure rules should be "good enough" to let regulators and investors assess when and where vote buying

17. For an example of how to hedge a share position with options, see, for example, RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 546–52 (8th ed. 2006).

18. We discuss recent regulatory responses to the new vote buying in the United Kingdom and Hong Kong *infra* in Part IV.C. 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. See David Marcus, *Thinking Big Thoughts*, CORP. CONTROL ALERT, Aug.–Sept. 2005, at 6, 6.

occurs, without imposing large new costs on investors. Third, the rules should treat long and short positions symmetrically.

Fourth, the ownership disclosure rules can be much simplified and better integrated. Currently, there are five distinct, highly idiosyncratic, complex SEC ownership disclosure regimes. These disclosure regimes apply respectively to large active shareholders (Schedule 13D), large passive shareholders (Schedule 13G), institutional investors generally (Form 13F), insiders and 10% shareholders (Section 16), and mutual funds.¹⁹ Our proposals would significantly simplify this complex scheme, and move toward an integrated system for share ownership disclosure that builds on existing Section 16 and mutual fund disclosure rules. Better integrated, more consistent ownership disclosure rules could well reduce compliance costs and be worthwhile on this basis alone, quite apart from their 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. While the optimality of these thresholds is contestable, we believe that they are at least reasonable. We also believe that whatever the thresholds are, the disclosure rules should be internally consistent. Moreover, the political history of disclosure, in the United States 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 will be. Our aim is to make that disclosure coherent, simple, and relatively low-cost.

As a regulatory response to hidden (morphable) ownership, disclosure alone may suffice. For empty voting, additional responses may also be needed. Still, we consider it premature to go beyond disclosure at this point. One reason is that empty voting can sometimes be beneficial and sometimes not, depending on the circumstances. On the problematic side, empty voting by insiders is likely to facilitate entrenchment and undermine external oversight. Empty voting with negative economic interest is also troubling, as in the Perry-Mylan example.

On the positive side, hedge funds can use empty voting to influence governance at underperforming corporations. Oversight of company managers by large shareholders is often considered to be beneficial, but is

19. We discuss these rules *infra* in Part IV.

often ineffective.²⁰ Empty voting could let votes move from less to better informed hands and, thus, could enhance the effectiveness of shareholder oversight.²¹ Laxey's record date capture at British Land provides a possible example of the efficiency-enhancing use of decoupling.

Of course, those who take a less benign view of investor activism and the market for corporate control would likely disagree. For instance, Martin Lipton has claimed that hedge funds, institutional investors, and "abusive" takeovers cause managers to focus too much on short-term results.²² Under this view, decoupling by outside investors would exacerbate this problem. We do not address here the optimal level of shareholder oversight of corporate managers; we merely note that many observers believe that more oversight would be beneficial on balance.

A second problem with some potential regulatory responses is that the variety of hedging strategies and the substitutability of one strategy for another make restrictions on empty voting hard to draft and hard to enforce. Enhanced disclosure may provide the information needed to write substantive rules to limit empty voting, but we are not there yet.

Longer term, several families of strategies could potentially address empty voting. One family focuses directly on voting rights. The key question is: under which circumstances should the voting rights of an empty voter be limited or denied altogether? One incremental strategy would let corporations amend their charters to limit empty voting. Changes in federal proxy rules and stock exchange requirements may be needed to allow this. Midstream charter amendments to address empty voting could

20. See, e.g., ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* (2001); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 *UCLA L. REV.* 811, 830-49 (1992).

21. See Susan E.K. Christoffersen, Christopher C. Geczy, David K. Musto & Adam V. Reed, *Vote Trading and Information Aggregation* (Jan. 20, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=686026>.

22. 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) (arguing that managers seeking to satisfy the short-term expectations of institutional investors sacrifice investments for the future, such as research and development and capital expenditures); Martin Lipton, *Is This the End of Takeovers?*, *WASH. POST*, Nov. 6, 1988, at H2 (referring to "abusive" takeovers as "forcing [American companies] to focus on short-term stock market results"); Martin Lipton et al., Wachtell, Lipton, Rosen & Katz, *Be Prepared for Attacks by Hedge Funds* (Dec. 21, 2005), http://www.realcorporatelawyer.com/pdfs/wlrk_122205-02.pdf (referring to hedge fund attackers as "self-seeking, short-term speculators looking for a quick profit at the expense of the company and its long-term value"). For an early discussion of the short-termism claim (and the related issue of conflicts among "generations" of shareholders), see, for example, Hu, *New Financial Products*, *supra* note 4, at 1278-87.

be problematic, however. Companies might propose rules that allow empty voting strategies used by insiders, while blocking strategies used by bothersome outsiders.

The mechanics of shareholder voting—the voting architecture—also need rethinking. These mechanics do not easily accommodate large-scale share lending programs involving, even for a single institutional owner, diverse lending arrangements and multiple decisionmakers. For example, some institutional investors who lent British Land shares to Laxey were not aware they were doing so, including governance activist Hermes.²³ “Overvoting” of shares (in which, in effect, a share lender and a share borrower seek to vote the same shares) is another problem area.

A third family of strategies focuses on supply and demand forces relating to the new vote buying. One simple step would be a safe harbor to allow pension funds and other institutions to recall lent shares around voting record dates in order to vote their shares. Regulators could also potentially require institutional investors to recall lent shares and vote in important elections, or otherwise tighten rules governing share lending. Changes in capital adequacy, tax, and other rules relating to equity derivatives and share lending could make these activities less attractive.

This Article proceeds as follows. Part II unpacks the functional elements of the new vote buying and collects the public examples we have been able to locate. Part III describes the traditional contexts for the analysis of vote buying and reviews the theoretical and empirical literature that bears on decoupling. Part IV discusses the current ownership disclosure rules and proposes a simpler, more comprehensive, “integrated ownership disclosure” regime. Part V offers a menu of longer-term responses that go beyond disclosure. Part VI concludes.

This Article has two shorter companions. One is directed at an academic finance audience.²⁴ The second is directed at legal practitioners

23. See Jenny Davey, *Laxey Faces Defeat in Attempt to Break Up British Land*, *TIMES* (London), July 17, 2002, at 23 (Business); Martin Dickson, *Not City Cricket*, *FIN. TIMES* (London), Sept. 28, 2004, at 22 (Companies) (reporting on Hermes).

24. An initial version of our three articles was first presented publicly in May 2005, at the annual meeting of the American Law and Economics Association. See Henry T. C. Hu & Bernard S. Black, *Empty Voting: Shareholder Voting Rights and Coupled Assets* (2005) (unpublished manuscript, on file with authors). Subsequent versions were posted on SSRN, beginning on January 6, 2006. See Henry T. C. Hu & Bernard S. Black, *Hedge Funds, Insiders, and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies* (European Corp. Governance Inst., Law Working Paper No. 56/2006, 2006), available at <http://ssrn.com/abstract=874098> [hereinafter Hu & Black, *Hedge Funds and Empty Voting*].

and regulators.²⁵ As far as we are aware, this Article and its companions are the first attempt to systematically address the new vote buying and its corporate governance implications.²⁶

II. THE TECHNOLOGY OF THE NEW VOTE BUYING

A. THE FUNCTIONAL ELEMENTS OF THE NEW VOTE BUYING

In their classic 1983 article on voting in corporate law, Frank Easterbrook and 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.”²⁷ This was an oversimplification, but only a bit. For the most part, voting rights were inextricably linked to shares.

With the new vote buying, in contrast, the economic return on shares can be separated from the related voting rights. The derivatives revolution in finance, combined with the growth of the share lending market, is making the decoupling of economic ownership from voting rights ever easier and cheaper.²⁸ Moreover, with the rise of hedge funds and their adoption of shareholder activism as an investment strategy, decoupling may have found its muse.

The variety of decoupling strategies can be overwhelming. We therefore begin by specifying the core functional elements of the new vote buying. Throughout this Article, we assume a simple context: a publicly held corporation with one class of common shares (each share carrying one vote), and diversified shareholders with homogeneous preferences and expectations. We focus on shareholder wealth maximization as a corporate

25. Henry T. C. Hu & Bernard S. Black, *Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. (forthcoming 2006), available at <http://ssrn.com/abstract=887183>.

26. See, e.g., David Marcus, *Hedge Fund Voting: The Devil We Don't Know*, CORP. CONTROL ALERT, Mar.–Apr. 2006, at 10. Other articles or working drafts in the legal literature that have either discussed or touched on this issue include Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775; David Skeel, *Behind the Hedge*, LEGAL AFFAIRS, Nov.–Dec. 2005, at 28; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (Apr. 9, 2006) (preliminary draft, on file with authors).

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

28. We discuss these supply and demand factors *infra* in Parts II.E and V.D.

goal and leave aside nonshareholder constituencies.²⁹ We sometimes refer to an outside investor who engages in new 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 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 refer to either 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, as a practical matter, it had the power to return to its derivatives dealers at any time, unwind its equity swaps, and obtain the voting shares from the dealers.³⁰ 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**” that conveys returns that relate directly to those 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.

The separation of voting rights from economic ownership often depends on combining economic ownership of shares with ownership of a coupled asset. Coupled assets include derivatives (such as options, futures, and equity swaps) and other financial products, as well as contractual rights (such as rights under a share loan agreement). The coupled asset could

29. We also generally leave aside the distinctions between the welfare of the corporation and the welfare of the shareholder, between shareholder welfare and shareholder wealth, conflicts involving different kinds of shareholders (for example, diversified versus undiversified, hedged versus unhedged, and holders of general common stock versus holders of tracking stock versus holders of preferred stock), and conflicts among different “generations” of shareholders (for example, short term versus long term). See, e.g., Hu, *Behind the Corporate Hedge*, *supra* note 4; Henry T. C. Hu, *Hedging Expectations: “Derivative Reality” and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985 (1995) [hereinafter Hu, *Hedging Expectations*].

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

either increase or decrease economic ownership. Investors may also hold **“related non-host assets”**—assets, often securities of another company, whose value is related to the value of the host company’s shares. For example, if the host company plans to acquire a target in a share-for-share merger with a fixed exchange ratio, the target’s shares are a related non-host asset.

By **“net economic ownership,”** we mean a person’s combined economic ownership of host shares and coupled assets. This net ownership can be positive, zero, or negative. We characterize as **“empty voters”** any persons whose voting rights substantially exceed their net economic ownership.

The level of 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 upside at \$60 and downside at \$45. The executive will retain partial economic ownership, which will be higher for share prices within the \$45 to \$60 range than outside this range.

The combined return from host shares, coupled assets, and related non-host assets produces what we call an **“overall economic interest”** in taking actions that affect firm value, which can be positive, zero, or negative. In the Perry-Mylan example, Perry combined full ownership of Mylan shares with coupled assets (equity swaps and other hedges), which 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 ownership + 9.9% economic ownership] - [9.9% economic ownership] =

[9.9% voting ownership]

Perry also held a related non-host asset—shares of King Pharmaceuticals. Perry was left with full voting rights, but a **negative overall economic interest**—it would profit if Mylan overpaid for King.³¹

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 in practice, this hidden ownership includes

31. We discuss this example and provide citations *infra* in Part II.B.

informal voting rights, we term this **“hidden (morphable) ownership.”** These **“morphable voting rights”** will generally not be verifiable by outsiders, and depend on market customs. Perry’s hidden (morphable) ownership of Rubicon offers an example.

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

Table 1 offers some illustrative examples of the principal forms of the new vote buying.

TABLE 1. Some forms of new vote buying

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

Example	Voting Ownership	Economic Ownership	Coupled Asset	Net Economic Ownership	Related Non-host Asset	Overall Economic Interest
<i>Empty Voting</i>						
Share ownership hedged with 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)	Not known
Record date capture (Laxey-British Land)	Yes (high)	Direct (low)	Share loan	Yes (low)	No	Low
Record date capture followed by 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)
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
<i>Hidden (Morphable) Ownership</i>						
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 derivatives dealers' matched shares	Indirect	Equity swaps	Yes	No	High
Eliminating voting rights: morphing between de facto and no voting rights (Livedoor/Nippon)	Depended on success of takeover bid	Direct	Share loan	Yes	No	High

B. EMPTY VOTING THROUGH COUPLED ASSETS

We examine in this section to an examination of the mechanics of empty voting achieved through coupled assets. Section C addresses hidden ownership. Section D addresses some extra complexities introduced by related non-host assets.

1. Empty Voting Through Equity Derivatives

a. Perry-Mylan Laboratories and Similar Examples

As of late 2004, Perry Corporation owned 7 million shares of King Pharmaceuticals, a generic drug maker. Mylan Laboratories agreed to acquire King Pharmaceuticals in a stock-for-stock merger. If the merger closed, Perry would make a \$28 million profit. To complete the merger, however, Mylan Labs needed shareholder approval, and Mylan's shares had dropped sharply when the deal was announced.³²

Perry, therefore, bought a 9.9% stake in Mylan, which it could vote in favor of the merger, but hedged its economic ownership through equity swaps and other unspecified transactions. In an equity swap, the "long" side receives from the "short" side an economic return equivalent to the return on the underlying shares. Perry took a short equity swap position in Mylan; the derivatives dealers likely hedged their long position, perhaps by selling Mylan shares short. A second hedge fund, Citadel, was rumored to have followed the same strategy as Perry.³³

Carl Icahn, a major Mylan shareholder, opposed the acquisition. He sued Mylan and Perry under federal securities law, including Section 13(d).³⁴ He claimed that Perry and other unnamed hedge funds had acquired 19% of the Mylan votes, with no economic ownership. If so, Perry

32. In some cases, our descriptions in this Article of new vote buying examples rely in part on news reports that refer to market rumors or other sources which may not be accurate. Our discussion of the Perry-Mylan situation is based on Perry Corp., Schedule 13D as to Mylan Laboratories, Inc. (Nov. 19, 2004); Complaint, High River Ltd. P'ship v. Mylan Labs., Inc., 353 F. Supp. 2d 487 (M.D. Pa. Dec. 10, 2004) (No. 04-2677) [hereinafter, Icahn Complaint]; Jesse Eisinger, *Icahn Cries Foul at Perry's No-risk Play in Takeover Fight*, WALL ST. J., Dec. 15, 2004, at C1; Christopher Faille, *Perry Plans to Sell Stake in Mylan*, HEDGE WORLD DAILY NEWS, Mar. 23, 2005; 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 [hereinafter Sorkin, *Nothing Ventured*].

33. See Andrew Ross Sorkin, *For a Takeover Artist, One Bluff Too Many?*, N.Y. TIMES, Nov. 28, 2004, § 3, at 6; Scott Stuart, *Mylan, King and Murphy's Law*, CORP. CONTROL ALERT, Apr. 2005, at 8. In February 2005, after Mylan abandoned its acquisition plans, Citadel sold its 4.4% stake in Mylan. *Business Briefs*, PITTSBURGH POST-GAZETTE, Feb. 15, 2005, at D8.

34. See Icahn Complaint, *supra* note 32.

and kindred investors had a negative overall economic interest in Mylan. They would want Mylan to complete the deal even if Mylan's value suffered. The lawsuit became moot when Mylan abandoned the acquisition because of accounting problems at King.³⁵

Several other anecdotes can illustrate empty voting through hedged share purchases. 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 AXA bonds (including the Highfields Capital hedge fund) acquired MONY shares to oppose the merger. Both groups may have hedged their MONY purchases; neither group voted based on whether the merger was good for MONY.³⁶ In the 2002 proxy fight between Walter Hewlett and Hewlett-Packard ("H-P") over H-P's proposed merger with Compaq Computer, which Mr. Hewlett opposed, there were rumors that Compaq shareholders acquired hedged H-P positions in order to vote for the merger.³⁷ Empty voting might have affected the outcome of this extremely close vote. 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 the shares while hedging his economic ownership with (short call, long put) options positions.³⁸

These strategies are troubling. Many acquisitions turn out poorly for the acquirer.³⁹ The major U.S. stock exchanges require the acquirer's shareholders to approve a large stock-for-stock merger. Yet in practice, the

35. Tara Croft, *Mylan: King Deal Doomed*, DAILY DEAL, Jan. 12, 2005. Mylan dropped its plans to acquire King in February 2005. In May 2005, Perry disclosed that it had sold its Mylan shares. See *Icahn & Co.: Icahn Discontinues Litigation Against Perry Corp. and Mylan Laboratories*, PHYSICIAN L. WKLY., June 29, 2005, at 9.

36. See *In re MONY Group, Inc. S'holder Litig.*, 853 A.2d 661 (Del. Ch. 2004); *In re MONY Group, Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004). AXA issued the bonds to finance its acquisition of MONY.

37. See *Icahn Complaint*, *supra* note 32, at 4; Sorkin, *Nothing Ventured*, *supra* note 32.

38. See Louise McCoach, *The Glencore Decision: A Case for Reform?* (Nov. 2005) (unpublished manuscript, on file with authors) [hereinafter *McCoach 2005*]; Louise McCoach, *The Glencore Decision: A Case for Reform? An Update* (Mar. 2006) (unpublished manuscript, on file with authors) [hereinafter *McCoach 2006*] (discussing Coles Myer and other Australian new vote buying instances).

39. See, e.g., ROBERT F. BRUNER, *DEALS FROM HELL: M&A LESSONS THAT RISE ABOVE THE ASHES* (2005); RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 363-97 (2d ed. 1995); Sara B. Moeller, Frederik P. Schlingemann & René M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-firm Returns in the Recent Merger Wave*, 60 J. FIN. 757 (2005).

acquirer's shareholders rarely vote down even an apparently overpriced merger. Empty voting on the acquirer's side by the target's shareholders, employed if the vote is likely to be close, could reduce whatever constraint the vote requirement now instills on the acquiring firm.

Moreover, empty voting can readily be extended to proxy fights for control. Neither side can be counted on to play fair and simply solicit shareholder votes. The temptation to buy votes quietly will be strong, especially if the other side may be doing so. Cleverness in vote buying—a characteristic not necessarily associated with the ability to run the company well—may become central to proxy fight success.

b. Liberty Media-News Corporation

More subtle decoupling can also play a role in corporate governance, as shown by Liberty Media's acquisition of a large stake in Rupert Murdoch's News Corporation ("News Corp."). In January 2004, Liberty Media filed a Schedule 13D stating that it had recently bought 125 million voting News Corp. shares.⁴⁰ After these purchases, Liberty Media owned 192 million (9.1%) of News Corp.'s voting shares, second only to the Murdoch family's 30%. Liberty Media already owned 843 million nonvoting shares, for a combined holding of "approximately 17.4% of the outstanding equity."⁴¹ Liberty Media also disclosed that it had entered into a forward contract to sell 152 million voting shares to Citibank in three

40. Our discussion of this example is based on Liberty Media Corp., Schedule 13D as to News Corporation Limited (Jan. 20, 2004) [hereinafter Liberty Media, *January 2004 13D*]; Liberty Media Corp., Schedule 13D/A (Amendment No. 1) as to News Corporation Limited (Nov. 3, 2004); Tim Burt, *Prince Pledges to Aid Murdoch*, FIN. TIMES (London), Nov. 18, 2004, at 32 (Companies); 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; Mike Farrell, *Why Liberty Halted Its "Forward" Pass*, MULTICHANNEL NEWS, Sept. 26, 2005, at 65; Martin Peers, *News Corp.'s Net Increases by 27% on TV Strength*, 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; Robert Bennett et al., Liberty Media Group, Conference Call on Q3 2004 Liberty Media Group Earnings (Nov. 9, 2004), in FD (FAIR DISCLOSURE) WIRE, Nov. 2004; *Liberty Media Corporation Announces Early Termination of Total Return Swap with Merrill Lynch*, PR NEWSWIRE, Dec. 20, 2004, <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/12-20-2004/0002669843&EDATE=> [hereinafter *Early Termination*].

41. Technically, Liberty Media held two kinds of American Depositary Receipts ("ADRs"). One ADR represented four "Ordinary Shares"—shares with full voting rights. We refer to Ordinary Shares simply as "voting shares." The other ADR represented four "Preferred Limited Voting Shares"—shares with limited voting rights. We refer to these shares simply as "nonvoting shares." See Liberty Media, *January 2004 13D*, *supra* note 40, at 2. In November 2004, News Corp. reincorporated in Delaware and its new "class A" (nonvoting) shares and "class B" (voting) shares began trading on the New York Stock Exchange. News Corp., Form 8-K, Exhibit 99.1 (Nov. 12, 2004) ("News Corporation Completes Reincorporation to United States.").

tranches beginning in 2008 for a fixed price, thus hedging most of its economic interest in the voting shares. Yet, in our terminology, Liberty Media was not an empty voter because its overall economic ownership *exceeded* its voting interest.⁴² Liberty Media has since continued to modulate its economic and voting ownership of News Corp.⁴³

c. Insider Hedging and Entrenchment

Corporate executives and controlling shareholders are often ill-diversified. 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 (“NYSE”)-listed companies with 2001 revenues between \$250 million and \$1.5 billion found that more than one in ten had chief executive officers who owned more than 10% of their shares.⁴⁴ In about half of those companies, insiders held more than 50% of the shares. This lack of diversification will often cause insiders to be more averse to firm-specific risk than diversified outside shareholders.⁴⁵

Investment banks, for a suitable fee, have developed a number of strategies to accommodate insiders' desire to hedge their economic exposure. One popular strategy, known as a zero-cost collar, involves buying a put option (to limit downside loss) while simultaneously selling a

42. Liberty Media had not previously disclosed its ownership of nonvoting shares. Thus, in our terminology, it had hidden ownership. This ownership might have been morphable as well, perhaps by swapping nonvoting shares for voting shares, as Liberty Media in fact did later in 2004. *See infra* note 43.

43. In November 2004, Liberty Media entered into and publicly disclosed an equity swap with Merrill Lynch under which, upon receiving certain government approvals, Liberty Media would acquire about 8% of the News Corp. voting shares in exchange for nonvoting shares; its 17% voting interest would then roughly correspond to its economic interest. In December 2004, Liberty Media announced it would terminate the swap early and acquire the voting shares. *Early Termination*, *supra* note 40. In September 2005, one analyst asserted that Liberty Media had hedges on 7% of its News Corp. voting shares and 19% of its nonvoting shares. Farrell, *supra* note 40.

44. Dennis Simon, *In Splitting Leadership, Look at CEO Ownership*, DIRECTORS & BOARDS, Winter 2004, at 24, 25.

45. While corporate executives will generally prefer to take less risk than diversified shareholders would consider optimal, the opposite may be true in certain circumstances. For further discussion of this and related issues such as when public corporations should hedge against risk see, for example, Hu, *Hedging Expectations*, *supra* note 29, at 1024–27, 1033–40; Hu, *Misunderstood Derivatives*, *supra* note 4, at 1492–94; Henry T. C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 287–95, 314–32, 365–66, 385–86 (1990).

call option (thus reducing potential gain).⁴⁶ Such a collar preserves voting rights but sharply reduces economic ownership. A 2001 study reports that on average, senior executives in U.S. public companies used collars for 36% of their holdings, and thereby reduced their economic ownership by 25%.⁴⁷ In the past five years, executive hedging appears to have increased dramatically.⁴⁸

In short, the impact of insider decoupling is mixed. On the one hand, insider hedging may mitigate the risk-taking conflict between managers and diversified shareholders. But the same technology could allow insiders to boost their voting control at little economic risk, thus weakening the market for corporate control as a disciplining mechanism.

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. We discuss these alternatives in Part III.

2. Empty Voting Through Record Date Capture

Before a shareholder meeting, a company's board of directors establishes a voting record date.⁴⁹ Shareholders who hold shares at the close of business on the record date have the right to vote at the meeting, which is typically a month or so after the record date. One way to hold votes without economic ownership is to hold shares but hedge through coupled assets. A second way is record date capture—borrowing shares in the share lending market for a limited period around the record date.

So far as the company is concerned, the borrower owns the shares (and the associated votes). In a typical loan, the borrower contracts with the

46. If the company pays no dividends and the put and call options have the same exercise price and expiration date, this transaction is economically equivalent to selling shares. More commonly, the call option exercise price is somewhat above the put option exercise price, hence the term "collar" (because economic exposure is limited to the range between the call exercise price and the put exercise price). In the zero-cost version of the collar transaction, the proceeds from the sale of the call equal the cost of the put, so the insider pays no net amount to initiate the collar.

47. Bettis et al., *supra* note 8, at 346. Anecdotal evidence is consistent with the pervasiveness of such hedging. One observer noted in 2001 that the demand for equity derivatives by American clients had "exploded." Adam Green, Peter Holland & Cornelia Spring, *Why Wealthy Clients Use Equity Derivatives*, RISK, Dec. 2001, at S11. Paul Allen, cofounder of Microsoft, avoided losing approximately \$970 million on 76 million Microsoft shares through the use of collars. *Compensation Resources*, REPORT ON SALARY SURVEYS, Feb. 2001, at 8. Robert Belfer, a director of Enron, used collars to lock in floor prices between \$55 and \$66 for about 1 million Enron shares. Cassell Bryan-Low, *Enron Director Hedged Bets*, WALL ST. J., Feb. 20, 2002, at C20.

48. See Ronald Fink, *Overexposed*, CFO MAG., Apr. 2006, at 85.

49. See, e.g., DEL. CODE ANN. tit. 8, § 213(a) (2005).

share lender to (1) return the shares to the lender at any time at the election of either side, and (2) pay to the lender an amount equal to any dividends or other distributions the borrower receives on the shares.⁵⁰ The loan is secured with cash or Treasury securities. Taxes aside, this loan contract (a coupled asset in our terminology) leaves the borrower holding votes without economic ownership, while the lender has economic ownership without votes.

A traditional use of share borrowing is to facilitate short-selling.⁵¹ The borrower sells the borrowed shares in the market, ending up with no votes and negative economic ownership. Later, the short-seller closes out the short position by buying shares in the market and delivering these shares back to the share lender. But omit the short sale, and share borrowing becomes an easy route to empty voting.

The shares of most publicly traded stocks in the United States can be borrowed. A recent study of which shares were available for borrowing from a single large financial institution found that stocks that could not be borrowed accounted for less than 1% of market capitalization.⁵² Borrowed shares are usually cheap—one study finds that the typical cost is about fifteen basis points per year.⁵³ The number of borrowable shares is often

50. For a discussion of customary share lending practices, see, for example, BOND MKT. ASS'N, MASTER SECURITIES LOAN AGREEMENT (2000) (under U.S. law); INT'L SEC. & LENDING ASS'N, GLOBAL MASTER SECURITIES LENDING AGREEMENT (2000) (under U.K. law); Gene D'Avolio, *The Market for Borrowing Stock*, 66 J. FIN. ECON. 271 (2002); Darrell Duffie, Nicolae Garleanu & Lasse Heje Pedersen, *Securities Lending, Shorting, and Pricing*, 66 J. FIN. ECON. 307 (2002). For descriptions of the share lending market, see Jeff Cohen, David Haushalter & Adam V. Reed, *Mechanics of the Equity Lending Market*, in SHORT SELLING: STRATEGIES, RISKS, AND REWARDS 9 (Frank J. Fabozzi ed., 2004); Mark C. Faulkner, *An Introduction to Securities Lending*, in SECURITIES FINANCE: SECURITIES LENDING AND REPURCHASE AGREEMENTS 3 (Frank J. Fabozzi & Steven V. Mann eds., 2005) [hereinafter SECURITIES FINANCE & LENDING]. On the history of share lending, see Kevin Burke & George Martello, *The Evolution of Securities Lending*, in SECURITIES LENDING AND REPURCHASE AGREEMENTS 1 (Frank J. Fabozzi ed., 1997).

51. By adopting Regulation SHO in 2004, the SEC sought to limit "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. SEC Short Sales Rule, Exchange Act Release No. 34-50103, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (amending or adopting Securities Act Rules 105, 200–203, 17 C.F.R. § 239.105, 200–.203 (2005)) [hereinafter Short Sales, Exchange Act Release No. 34-50103]. This effort has not been totally successful. See Aaron Lucchetti & Kara Scannell, *Despite SEC Rules, a Small Amount of Naked Shorting Appears to Persist*, WALL ST. J., Apr. 13, 2006, at C1.

52. D'Avolio, *supra* note 50, at 273.

53. See Christoffersen et al., *supra* note 21. D'Avolio, *supra* note 50, reports that the borrowing cost was less than 1% per year for 91% of the companies in his sample. Borrowing may be cheap on average, but not in every situation. 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. *Charter Share Issue Approved by the SEC*, WALL ST. J., July 19, 2005, at C3; Peter Grant, *SEC Is Slow to Approve Charter's Odd Stock Sale*, WALL ST. J., June 24, 2005, at C3.

large—during some recent corporate battles, up to 20% of the company's shares were held by borrowers.⁵⁴

The Laxey Partners-British Land incident, discussed in Part I, offers an example of record date capture.⁵⁵ Laxey sought a breakup of British Land and opposed the reelection of British Land's chairman. British Land's chairman was rather displeased with what he called Laxey's "rent-a-vote" strategy.⁵⁶ There was irony all around. British Land saw Laxey as abusing the 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 lenders. Hermes did apologize.

In early 2006, a far more questionable use of record date capture appears to have occurred in Hong Kong. Henderson Land offered to buy the 25% minority interest in Henderson Investment, a publicly held affiliate.⁵⁷ Most minority shareholders favored the buyout, and Henderson Investment's share price increased substantially. 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 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

54. See Kate Burgess & James Drummond, *Transparency Finds a High-level Champion: A Captain of Industry Calls on Investors to Lead by Example on Accountability*, FIN. TIMES (London), Apr. 22, 2005, at 22 (Companies).

55. Our discussion of the Laxey Partners-British Land situation 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 (London), Apr. 19, 2004, at 3 (FT Report); 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 (London), Jan. 13, 2003, at 18; Simon Targett, *Top Pension Funds Plan Securities Lending Code*, FIN. TIMES (London), June 14, 2004, at 1 (FT Report); John Waples, *Ritblat Hits at CSFB and Laxey for Vote "Conspiracy"*, SUNDAY TIMES (London), July 21, 2002, at 1 (Business). Gimbel, *supra*, suggests that Laxey acquired voting power through a combination of record date capture and other strategies.

56. See Ritblat, *supra* note 55.

57. Our discussion of the Henderson Investment situation relies 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; Francesco Guerrera & Florian Gimbel, *Henderson Stock Lending Fears*, FIN. TIMES (Asia ed.), Feb. 1, 2006; Alex Frew McMillan, *Hong Kong Studying Voting Issues on Borrowed Shares*, INFOVEST21 NEWS, Jan. 25, 2006. The news reports do not name the hedge fund that may have single-handedly blocked the buyout.

buyout, and then sold those shares short, thus profiting from its private knowledge that the buyout would be defeated. One hedge fund alone may have held enough shares to defeat the buyout.

Henderson Investment involves elements redolent of both Laxey-British Land and Perry-Mylan. As with Laxey-British Land, hedge funds used record date capture to obtain votes. As with Perry-Mylan, one or more hedge funds held a negative overall economic interest—or more precisely, would have negative economic ownership by the time the voting outcome was known. These hedge fund shareholders apparently blocked a deal that would benefit other shareholders.

Consider next a variant on record date capture. If shares cannot be borrowed, an alternative vote capture technique is available that promises nearly empty voting. An investor can buy shares just before the record date and sell them soon thereafter. The investor incurs round-trip transaction costs, but has economic ownership for only a short period of time. The investor can hedge this limited risk fully by buying put options on the shares (a coupled asset), or partially by shorting a broad share index or an industry index (a related non-host asset).

Short-term ownership plus such a hedge entails fully or substantially empty voting. The timing of this limited ownership further attenuates the link between economic ownership and voting rights. The record date is well before the date at which votes are cast. There is no reason to expect company-specific news on the record date. By the time the voting outcome is known, the investor will have shed any economic exposure, and will suffer no ill effects from voting in ways that reduce firm value; indeed, as in Henderson Investments, the investor could even gain from doing so.⁵⁸

We discuss in Part V the efforts by pension funds and other shareholders in the United Kingdom to respond to record date capture.

58. 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 27, at 411 n.41. This is simply not so.

C. HIDDEN (MORPHABLE) OWNERSHIP

1. Morphing from de Facto to Formal Voting Rights

a. Access to Derivatives Dealers' Matched Shares

Equity derivatives can also be used to avoid disclosing economic ownership under disclosure rules that turn largely on voting rights rather than economic ownership. Perry has used equity derivatives for this purpose, as well.⁵⁹ In early 2001, Perry was a major holder of Rubicon Ltd., a New Zealand public company. New Zealand has rules requiring disclosure of 5% ownership positions in public companies, similar to Section 13(d).⁶⁰ In June 2001, Perry gave notice that it had ceased to be a 5% holder in Rubicon. A year later, to everyone's surprise, Perry disclosed that it held 16% of Rubicon, having bought 31 million shares from Deutsche Bank and UBS Warburg just in time to vote at Rubicon's 2002 annual general meeting.

What happened during the period when Perry apparently was not a substantial holder of Rubicon shares? In May 2001, Perry shed its voting rights, but not its economic interest. It sold 31 million shares to two derivatives dealers and simultaneously took the long side of equity swaps for 31 million shares. Perry's 16% economic ownership did not change, but it ceased reporting because, it claimed, the equity swaps fell outside the New Zealand disclosure rules. When Perry needed the voting rights, it terminated the swaps and bought the shares back from the dealers. A lawsuit by another major Rubicon shareholder, challenging Perry's right to vote, ensued. The trial court, in ruling against Perry, noted in passing that Perry had entered into "hundreds of equity swap transactions."⁶¹ On appeal, Perry's position was upheld.⁶²

In Mylan, Perry coupled the purchase of Mylan shares with a short equity swap position to achieve voting rights with no net economic ownership. With Rubicon, Perry held long equity swaps in Rubicon shares to achieve economic ownership without formal voting power, which would

59. Our discussion of the Perry-Rubicon situation is based on *Ithaca (Custodians) Ltd. v. Perry Corp.*, [2003] 2 N.Z.L.R. 216 (H.C.), *rev'd*, [2004] 1 N.Z.L.R. 731 (C.A.); [2004] 2 N.Z.L.R. 182 (C.A.) (refusing conditional leave to appeal).

60. *See supra* note 10 and accompanying text.

61. *Ithaca (Custodians) Ltd.*, 2 N.Z.L.R. 216, ¶ 232.

62. *Ithaca (Custodians) Ltd.*, 1 N.Z.L.R. 731, ¶ 9.

have triggered disclosure. At the same time, Perry retained de facto voting rights exercisable at Perry's discretion, because it could return to the investment banks at any time and unwind the swap. Put another way, Perry held "morphable" voting rights—which would disappear when Perry wanted to hide its stake, only to reappear when Perry wanted to vote.

How did Perry know that it had access to the shares? The dealers needed to hedge their exposure from extending the equity swaps to Perry. 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 need to incur transaction costs to hedge in another way. Perry could also expect the banks to happily sell the shares back to Perry when Perry chose to unwind the equity swaps. Even the New Zealand Court of Appeal, which ruled in Perry's favor, stated:

[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 at 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 he had thought that, if he wanted to terminate the swaps and purchase the shares, it would be commercially sound for the . . . counterparties to sell him those shares.⁶³

One reason the Court of Appeal concluded that disclosure was not required was that it believed similar disclosure would not be required in Australia, the United States, or the United Kingdom.⁶⁴

There are a variety of ways for a derivatives dealer holding the short side of an equity swap to hedge its exposure, but holding matched shares is a common means.⁶⁵ Especially when the equity swap involves a large number of shares in a thinly traded company, alternative hedging strategies may be limited. When the derivatives dealer hedges an equity swap with matched shares, a market practice may well be emerging in which both sides expect that the dealer, if asked, will either unwind the swap and sell the shares to its client, as Perry's dealers did, or vote the matched shares as

63. *Id.* ¶ 66.

64. *Id.* ¶ 77.

65. *See, e.g.*, Michael D. Dayan & Glen A. Rae, *OTC Equity Derivatives: Hedging Transactions and Equity Swaps*, in PRACTICING LAW INST., SWAPS & OTHER DERIVATIVES IN 2004, at 284 (Edward J. Rosen ed. 2004) (diagramming an equity swap and its hedging).

its client wants. The commercial practice between derivatives dealers and some clients may extend to the manner in which the dealers hedge.⁶⁶ Holding matched shares to hedge an equity swap may be a preferred strategy when the client is concerned with governance, precisely because doing so lends itself to vote morphing.

As evidence of these customs, the Code Committee of the United Kingdom's Panel on Takeovers and Mergers recently stated that it is "frequently the expectation" of a long equity swap holder that the derivatives dealer would "ensure" that an equivalent number of shares are available to be voted by its customer and/or sold to the customer on closing out the contract.⁶⁷ If the dealer did not hold matching shares and hedged in another way, the holder would "normally expect" the dealer to acquire the shares, even if this resulted in cost to the dealer.⁶⁸

As examples of market expectations, the committee pointed to the behavior of hedge funds and derivatives dealers in 2004 in connection with BAe Systems' bid for Alvis and Philip Green's bid for Marks & Spencer.⁶⁹ BAe Systems obtained commitments to support its offer from a number of hedge funds that had entered into equity swaps⁷⁰ as to Alvis shares. Some funds agreed to request physical settlement of the swaps and then support the BAe offer. For other hedge funds, the derivatives dealer (with the fund's consent) committed to accept the offer as to the dealers' matched shares.⁷¹ Similarly, Philip Green announced that its bid for Marks &

66. For a contrary example, where an unhappy customer sued Citibank for changing the way it hedged equity swaps and other equity derivatives, see *Caiola v. Citibank, N.A.*, 295 F.3d 312 (2d Cir. 2002).

67. See CODE COMM., U.K. PANEL ON TAKEOVERS & MERGERS, DEALINGS IN DERIVATIVES AND OPTIONS: OUTLINE PROPOSALS RELATING TO AMENDMENTS PROPOSED TO BE MADE TO THE TAKEOVER CODE AND THE SARS § 3.3 (Jan. 2005) [hereinafter U.K. TAKEOVER PANEL, JANUARY 2005 PROPOSAL].

68. *Id.* § 3.4.

69. Our discussion of BAe Systems-Alvis is based on *id.*; Kate Burgess, *Panel Plans Changes to Disclosure Rules*, FIN. TIMES (London), Jan. 8, 2005, at 2 (Companies). Our discussion of Philip Green-Marks & Spencer is based on U.K. TAKEOVER PANEL, JANUARY 2005 PROPOSAL, *supra* note 67, § 3.4(b); Jeremy Warner, *Outlook: Uncharted Waters*, INDEPENDENT (London), July 14, 2004, at 39 (Business).

70. The U.K. instrument corresponding to a U.S. 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.

71. In its comments to the Code Committee, the International Swaps and Derivatives Association did not challenge the Committee's description of market expectations. It mildly disputed the Committee's discussion of the derivatives dealers' interests in voting (or accepting a takeover bid) in accordance with their clients' preferences, explaining that the Committee's description was "somewhat simplistic." Letter from Richard Metcalfe, Int'l Swaps & Derivatives Assoc., to Panel on Takeovers & Mergers 5 (Feb. 28, 2005) (on file with authors).

Spencer was supported by investment banks who held 8.3% of Marks & Spencer's shares as matched shares to hedge equity swaps. This support was presumably at the direction of the hedge funds who held the long sides of these swaps.

Market expectation that a dealer will unwind a swap is not a guarantee, as illustrated by a 2006 buyout offer by Sears Holdings for the minority shares in its Sears Canada subsidiary.⁷² A hedge fund had previously acquired equity swaps in Sears Canada from Scotiabank. Scotiabank later became the dealer-manager for Sears Holdings' buyout offer. The offer required approval by a majority of the Sears Canada minority shareholders. Sears Canada's independent directors opposed the bid; so did many Sears Canada shareholders. The hedge fund asked Scotiabank to unwind the swap so it could vote against the offer. Scotiabank not only refused, but also committed to vote its Sears Canada shares *for* the offer. Scotiabank thus became an empty voter; perhaps with negative economic interest because it was an agent for Sears Holdings. The hedge fund complained about Scotiabank's failure to observe swap market conventions and said it was "looking forward to regulatory and legal scrutiny of this transaction."⁷³

b. Avoiding Mandatory Bid Rules and Other Uses

Hidden (morphable) ownership can be used for other purposes, besides avoiding disclosure. One use involves avoiding mandatory bid rules. In many countries, a shareholder who exceeds a threshold percentage of share ownership must offer to buy all remaining shares at a formula price. Holding swaps instead of shares can let a shareholder avoid these rules. In 2005, for example, the Agnelli family, which controlled Fiat, entered into equity swaps for Fiat shares with Merrill Lynch without publicly disclosing this fact.⁷⁴ The family wanted to retain control of Fiat after a forthcoming debt-for-equity swap, which would dilute the Agnellis'

72. Our discussion of Sears Canada is based on Jesse Eisinger, *In Canada, a Face-off over Sears*, WALL ST. J., Apr. 12, 2006, at C1.

73. *Id.*

74. Our discussion of the Agnelli-Fiat transactions is based on *IFIL-Exor Investigation Merrill Lynch Milan HQ Searched*, IL SOLE 24 ORE (Italy), Mar. 10, 2006 (IFIL is the Agnelli family vehicle that acquired the swap position); *IFIL Receives Consob Equity Swap Report*, IL SOLE 24 ORE (Italy), Feb. 23, 2006; Johanna Iivonen, *Italian Stock Market Regulator Rules Against IFIL in Fiat Case*, WORLD MARKETS ANALYSIS, Feb. 23, 2006; *Italy's Consob Rules IFIL Not Obligated to Bid for Fiat, but Swap Deal Probed*, AFX INT'L 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 (Italy), Feb. 25, 2006.

stake. If they had bought Fiat shares directly, they would have crossed 30% ownership, thus triggering Italy's 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 Agnellis unwound their equity swaps and obtained the swap dealer's 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.

The goal of acquiring shares more cheaply also emerged in Australia during the 2005 takeover bid by Centennial for Austral Coal.⁷⁵ Rival Glencore acquired a "blocking position" (sufficient to prevent Centennial from reaching 90% ownership and squeezing out remaining shareholders) through a combination of shares and equity swaps (which the derivatives dealers hedged with matched shares). Glencore claimed its swap position did not need to be disclosed under Australia's large shareholder disclosure rules, which are triggered by 5% share ownership. It 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%. The Panel's decision, however, was reversed on appeal by the Australian courts.⁷⁶

The goal of avoiding a mandatory bid rule also underlies the earliest publicly known 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%.⁷⁷ Direct ownership of 20% or more would have triggered Australia's mandatory bid rule. Brierley disclosed its swap position; it merely sought (successfully) to evade the mandatory bid rules.

2. Toeholds and the Social Virtues of Stealth

Hidden (morphable) ownership may not always be socially undesirable. One potential benefit involves an unresolved puzzle in finance: why do more takeover bidders not acquire toeholds, even though

75. Our discussion of Austral Coal is based on *Glencore Int'l AG v. Takeovers Panel* (2006) F.C.A. 274 [hereinafter *Glencore Int'l AG*]; *McCoach 2005*, *supra* note 38; *McCoach 2006*, *supra* note 38; Nigel Morris, Director, Takeovers Panel, Austral Coal Ltd. 02—Decision and Review Application (July 1, 2005), <http://www.takeovers.gov.au/display.asp?ContentID=956> [hereinafter *Austral Coal Takeovers Panel Decision*].

76. *Glencore Int'l AG*, *supra* note 75.

77. Our discussion of Brierley-Fairfax Holdings is based on *McCoach 2005*, *supra* note 38; *McCoach 2006*, *supra* note 38.

doing so would appear to be highly profitable.⁷⁸ The most plausible explanations are concerns about prompting a price run-up, which could increase the overall cost of the acquisition; and that the toehold may increase the likelihood of bidder resistance.⁷⁹ An equity swap offers a quiet toehold that need not be publicly disclosed.⁸⁰ Nondisclosure might reduce market impact cost. Even if it does not, reducing bidder resistance could enhance the market for corporate control. Proponents of an active corporate control market might therefore consider nondisclosure of toeholds, up to some level, to be socially desirable.

An Australian example illustrates. In 2004, BHP Billiton, before announcing a bid for WMC, acquired a 4.3% toehold through equity swaps.⁸¹ BHP disclosed its toehold before crossing the 5% threshold for disclosing a direct share position. Its reasons for acquiring swaps rather than shares are not known. Perhaps it wanted to have the option of keeping its stake hidden or acquiring more than 5% before disclosing its position.

3. Shedding Voting Rights

The foregoing uses of vote morphing involve *acquiring* shares or informal voting rights. A twist on the vote morphing concept involves *shedding* voting rights under specified conditions—morphing from having formal or informal voting rights to not having them. Japan's first-ever hostile takeover bid, the 2005 bid by Livedoor for Nippon Broadcasting, illustrates. In February 2005, Livedoor announced that it had acquired a 35% stake in Nippon.⁸² Livedoor wanted to acquire Nippon in order to

78. See, e.g., Arturo Bris, *Toeholds, Takeover Premium, and the Probability of Being Acquired*, 8 J. CORP. FIN. 227, 227–28 (2002); Sandra Betton, B. Espen Eckbo & Karin S. Thorburn, *The Toehold Puzzle* (European Corp. Governance Inst., Finance Working Paper No. 85/2005, 2005), available at <http://ssrn.com/abstract=715601>.

79. See Sandra Betton & B. Espen Eckbo, *Toeholds, Bid Jumps, and Expected Payoffs in Takeovers*, 13 REV. FIN. STUD. 841, 878–81 (2000).

80. Bris, *supra* note 78, at 244.

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

82. Our discussion of Livedoor-Nippon Broadcasting is based on Michiyo Nakamoto, *Investment Banking: Historic Battle Establishes Combat Rules*, FIN. TIMES (London), June 27, 2005, at 5 (FT Report); David Pilling, *White Knight New Villain of Fuji TV Saga*, FIN. TIMES (London), Mar. 28, 2005, at 21 (Companies); *Softbank to Return Fuji Shares*, DAILY YOMIURI (Tokyo), Apr. 23, 2005, at 8; Martin Foster, *Livedoor Suffers Blow in Bid*, THEDEAL.COM, Mar. 24, 2005, <http://www.thedeal.com/NASApp/cs/CS?pagename=TheDeal/TDDArticle/StandardArticle&bn=NULL&c=TDDArticle&cid=1111624424202>; Kyodo News Service, *Softbank Investment becomes Fuji TV's Largest Shareholder*,

influence Fuji TV, in which Nippon had a 22.5% stake. Nippon responded by entering into multiyear agreements to lend its Fuji TV shares to Softbank Investment and Daiwa Securities. Nippon retained economic ownership. Unlike a customary share loan, however, it had no contractual right to rescind the loans.

If Nippon won the takeover battle, there was at least a possibility, and perhaps an informal understanding, that the borrowers would unwind the loan agreements and return the Fuji TV shares. If Livedoor won, it faced a substantial risk that Softbank and Daiwa would refuse to unwind the loans, thus denying Livedoor what it really wanted—voting rights for the Fuji TV shares. The defense was successful. Livedoor and Fuji TV agreed to a partnership, and Livedoor ended its effort to acquire Nippon. Softbank promptly returned the Fuji shares to Nippon.⁸³

Here, morphable voting rights were not used to let the holder obtain de facto voting rights and yet avoid *disclosing* those rights. Instead, Nippon apparently used vote morphing to *deny* voting rights to Livedoor while retaining access to the votes if the takeover threat disappeared. A *substantive* purpose was involved, not a disclosure one.

D. RELATED NON-HOST ASSETS

We consider here some complexities introduced by the possibility that related non-host assets may contribute importantly to a shareholder's overall economic interest.

1. Mergers

One recurring situation in which related non-host assets are important involves a stock-for-stock merger. In the Perry-Mylan situation, Perry had voting ownership, but zero economic ownership. Its related non-host asset (shares in the target, King) made its overall economic interest negative. But there can also be situations in which related non-host assets can *increase* a shareholder's overall economic interest. Actions by hedge funds involving

FORBES.COM, Mar. 24, 2005, http://www.forbes.com/infoimaging/feeds/infoimaging/2005/03/24/infoimagingcomtex_2005_03_24_ky_0000-5439-.industrytopstories.merg.html.

83. See *Nippon Broadcasting, Softbank Investment End Fuji TV Stock Loan Deal*, AFX NEWS, June 30, 2005; *Softbank to Return Fuji Shares*, *supra* note 82. We were unable to find news reports on what happened to the shares that Nippon loaned to Daiwa.

Deutsche Boerse's proposed acquisition of the London Stock Exchange ("LSE") illustrate.⁸⁴

In December 2004, Deutsche Boerse proposed buying the LSE. 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 Corp. alumnus.⁸⁵) The acquisition was opposed by other major shareholders and was eventually abandoned. What connects this story to vote buying is that certain hedge funds—perhaps the same ones—shorted a significant number of LSE shares soon after the opposition was announced. Assuming that some hedge funds were both long Deutsche Boerse and short LSE, they were betting that the acquisition would fail, in which case Deutsche Boerse shares would rise and LSE shares would fall.

These hedge funds' overall economic interest in defeating the merger was larger than if they held only Deutsche Boerse shares. This would tend to offset the usual collective action problem that any one Deutsche Boerse shareholder would bear much of the cost of opposing the merger, but would benefit only in proportion to its fractional Deutsche Boerse stake. A short-sale of LSE shares might provide sufficient additional incentives for large shareholders to undertake the cost of this potentially beneficial activity.

Variants on the same coupled-asset position, however, could have the opposite effect. If an investor's short position in LSE were large relative to its long position in Deutsche Boerse, it would be more interested in LSE shares dropping in price than in Deutsche Boerse shares rising. The investor would have an incentive to oppose an acquisition that would benefit Deutsche Boerse, or indeed both companies combined. Conversely, merger arbitrageurs who follow the common strategy of going long target, short acquirer would have incentives to support the merger regardless of its

84. Our discussion of the Deutsche Boerse-LSE situation is based on 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; Norma Cohen, *Investors Warn D Borse Board*, FIN. TIMES (London), Feb. 22, 2005, at 21 (Companies & Markets); Norma Cohen & Patrick Jenkins, *D Borse Acts to Heal TCI Rift*, FIN. TIMES (London), Apr. 21, 2005, at 25 (Companies); William Hutchings, *Deutsche Börse Bows To Hedge Fund Pressure*, FIN. NEWS ONLINE, Feb. 1, 2005; *Seifert's Second Proposal*, ECONOMIST, Dec. 18, 2004; *Winners and Losers: CEO Werner Seifert Sheds Some Light on the Reasons Why Deutsche Boerse Decided to Drop Its £1.3 Billion Bid for the London Stock Exchange*, GUARDIAN (U.K.), Mar. 14, 2005, at 11.

85. See Jason Singer, *Ivy Leave: Yale Parts Ways with Hedge Fund*, WALL ST. J., Mar. 29, 2006, at C1.

merits. Thus, the new vote buying could both empower Children's Investment Fund and Atticus to pressure Deutsche Boerse to make a "good" decision, and empower others, such as classic merger arbitrageurs, to support misguided mergers.

We have already discussed above a number of other merger situations where the voting outcome may have been affected by new vote buying. It is not much of a stretch to imagine a subterranean battle for votes between hedge funds and other investors with differing overall economic interests. In such a battle, it might be little more than happenstance if the voting outcome corresponded to the acquisition's value to the acquirer, or to both companies together.

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 non-host asset is that its value correlates with the value of host shares. Thus, an executive at Ford who is concerned about the future of American car companies, but is reluctant to buy put options on Ford stock,⁸⁶ and might trigger short-swing profit recapture under Section 16. The executive could instead buy puts on shares of General Motors or a Ford supplier. The correlation between the returns on Ford shares and those on General Motors or a Ford supplier may be high enough for the executive's purposes.⁸⁷

E. INNOVATIONS UNDERLYING THE NEW VOTE BUYING

Supply and demand considerations suggest that the new vote buying is likely to continue to grow. Three factors stand out. First, continued improvements in financial technology are likely to drive down transaction costs. Equity swaps and other OTC equity derivatives on individual securities were not invented until the late 1980s.⁸⁸ By the end of 2004, the worldwide market for OTC equity derivatives was over \$4 trillion, up 50%

86. Aside from possibly infuriating superiors and shareholders, the transaction could potentially be considered a deemed sale of Ford shares and trigger short-swing profit recapture under Section 16.

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

88. See Joanne M. Hill, *The History of Equity Derivatives*, in THE HANDBOOK OF EQUITY DERIVATIVES 33-48 (Jack Clark Francis, William W. Toy & J. Gregg Whittaker eds., 1995).

over the previous year.⁸⁹ This growth presumably both reflects and spurs lower transaction costs and increased quality and variety of products.⁹⁰

Second, share lending has grown rapidly over the past decade.⁹¹ In the United Kingdom, share lending in late 2004 was approximately £80 billion, compared with just £3.5 billion in 1996.⁹² In the United States, the securities lending market, including equity and debt, rose to \$1.3 trillion in mid-2004 from about \$940 billion a year earlier.⁹³ The driving forces have been growth in the derivatives market and the rise of hedge funds, whose trading strategies often include short-selling.

Large institutional investors, such as pension funds, public retirement funds, and mutual funds lend their shares in a variety of ways. Some lenders use specialized third-party lending agents. Often, the custodian banks which clear and hold their positions act as lending agents. A few large lenders directly contract with borrowers. For instance, the California Public Employees Retirement System lends shares through an auction system. Broker-dealers also lend shares that they hold on behalf of margin customers (keeping the revenue) and encourage retail investors to sign margin accounts to facilitate this profitable business.⁹⁴

On the borrowing side, a few large borrowers borrow on their own, but most borrow indirectly through broker-dealers, partly because the brokerage firm is more creditworthy, and partly to hide the borrower's identity. Broker-dealers also borrow for their own accounts to facilitate market-making and hedging the risks on derivatives that they enter into with customers.⁹⁵

Third, hedge funds have grown rapidly in the last decade and are now estimated to now have over \$1 trillion in investor assets; their impact is

89. See International Swaps and Derivatives Association, Summary of Recent Survey Results, <http://www.isda.org/statistics/recent.html> (last visited May 8, 2006).

90. For a discussion of the modern process of financial innovation and difficulties in framing regulatory responses, see, for example, Hu, *Misunderstood Derivatives*, *supra* note 4.

91. See, e.g., Heather McKenzie, *Securities Lending Grows Up*, FIN. NEWS ONLINE, Oct. 2, 2000; Gene Picone & Richard Warne, *A Coming of Age*, PENSIONS MGMT., Sept. 1, 2003. See also *supra* note 50 (sources on the share lending market and the history of share lending).

92. See Kate Burgess, James Drummond & Alex Skorecki, *UK Stock Lending More Than Doubles*, FIN. TIMES (London), Nov. 17, 2004, at 22 (Companies) (reporting estimates by Crestco, the U.K. share trading settlement agency).

93. See Phyllis Plitch, *Funds' Lending Sparks "Short" Debate*, WALL ST. J., May 25, 2005, at B2 (citing data tracked by the Astec Consulting Group).

94. Standard margin account agreements allow brokers to lend customer shares. See *infra* text accompanying note 266.

95. See Faulkner, *supra* note 50, at 17.

compounded by many funds' use of leverage.⁹⁶ Hedge fund managers typically have wide discretion as to trading strategies. Unlike mutual funds and pension funds, hedge funds face few regulatory limits. Moreover, many hedge fund managers are comfortable using equity derivatives and other sophisticated financial tools. Recently, many have adopted corporate governance activism as an investment strategy.⁹⁷ Hedge funds usually have fewer conflicts of interest than other institutional investors, and less concern with adverse publicity, so they can be more aggressive in pursuing these opportunities.

F. THE EXTENT OF NEW VOTE BUYING

Since much new vote buying is undisclosed, its extent is necessarily unknown. But there is value in collecting the known instances in one place. Table 2 lists, in rough reverse chronological order, the publicly disclosed or rumored examples of new vote buying that we were able to find. The list is surely partial. Still, the number of examples and their diverse nature suggest the scale of the new vote buying, while the dates suggest its recent advent. Other sources also suggest that new vote buying is reasonably common. These include:

- regulatory changes in Hong Kong (2003) and the United Kingdom (2005) to require disclosure of economic ownership, and self-regulatory efforts in the United Kingdom to limit record date capture;⁹⁸
- the existing market customs on unwinding of swaps and voting of matched shares by derivatives dealers;⁹⁹
- statements by lawyers at major firms as to whether hidden ownership positions must be disclosed. These include partners at:

96. There is no reliable data on the number of hedge funds or their assets under management. See SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS—STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 1 n.2 (2003) [hereinafter SEC, HEDGE FUND REPORT]. For the \$1 trillion estimate in mid-2005, see *At Deadline; CalSTRS Boosts Emerging*, PENSIONS & INVESTMENTS, Aug. 8, 2005, at 1 (reporting an estimate by Tremont Capital). It is clear, however, that the industry has grown rapidly. The Hennessee Group estimates that hedge fund assets grew from \$50 billion in 1993 to \$592 billion in 2003. SEC, HEDGE FUND REPORT, *supra*, at 1 n.4.

97. 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 (London), Aug. 9, 2005, at 19 (Companies); Henny Sender, *Hedge Funds: The New Corporate Activists*, WALL ST. J., May 13, 2005, at C1.

98. We discuss these reforms *supra* in Parts IV.C and V.D.

99. We discuss these market conventions *supra* in Part II.C.

- Freehills in Australia;¹⁰⁰
- Allen & Overy in the United Kingdom (the primary outside counsel for the International Swaps and Derivatives Association), stating that disclosure is not required for cash-settled U.S. Equity derivatives;¹⁰¹
- Cleary Gottlieb in the United States (stating that “a long position under an equity swap would generally not be treated as beneficial ownership” under SEC rules);¹⁰²
- Lawsuits in the United States (involving Perry-Mylan), Australia (involving Glencore-Austral Coal), and New Zealand (involving Perry-Rubicon).¹⁰³

Quantitative evidence related to decoupling includes the evidence discussed above that executive hedging (with vote buying effects, even if vote buying is not the principal goal) is common,¹⁰⁴ and the evidence, discussed below, on record date capture.¹⁰⁵

100. See Neil Pathak & Weyinmi Popo, *Cash-settled Equity Swaps in Takeovers*, FREEHILLS, June 30, 2005, http://www.freehills.com/publications/publications_5108.asp.

101. Chin-chong Liew, *Disclosure Requirements for Purely Cash-settled Derivatives*, H.K. LAW., June 2000, at 59.

102. 2 EDWARD F. GREENE ET AL., *U.S REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS* § 13.02(2) n.25 (7th ed. 2004).

103. We discuss Perry-Mylan *supra* in Part II.B, and Perry-Rubicon and Glencore-Austral Coal *supra* in Part II.C.

104. See Bettis et al., *supra* note 8, and our discussion of insider hedging *supra* in Part II.B.

105. See Christoffersen et al., *supra* note 21, and our discussion of this research *infra* in Part III.B.

TABLE 2. Decoupling examples

This table lists, in rough reverse chronological order, the known or publicly rumored instances of new vote buying that 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 or Related Non-host Asset	Description
2006	Sears Canada	Canada	Hedge fund (Bill Ackman) and Scotiabank	X (by Scotiabank)	X (by Ackman, 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 II.C
2005	Fuji TV	Japan	Nippon Broadcasting		X	Share lending	See Part II.C
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. ¹⁰⁶
2004-2005	WMC Resources	Australia	BHP Billiton		X	Equity swaps	See Part II.C
2004-2005	Mylan Laboratories	U.S.	Perry Corp. (hedge fund)	X		Equity swap	See Part II.B
			Citadel (hedge fund) (possible)	X		Unknown	See Part II.B
2004	DFS	U.K.	Polygon (hedge fund)		X	Equity swap	Polygon sought to influence DFS despite owning only one share of stock (it had 3% economic ownership through equity swaps). ¹⁰⁷
2004	Alvis	U.K.	Hedge funds (helping BAe Systems to acquire Alvis)		X	Equity swaps	See Part II.C

106. See Bryan Frith, *Portman Trading Should Be Reviewed*, AUSTRALIAN, Mar. 4, 2005, at 22.

107. See Richard Fletcher, *US Hedge Fund Builds Up Large Stake in DFS*, SUNDAY TIMES (London), Aug. 22, 2004, at 2.

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden (Morphable) Ownership	Coupled or Related Non-host Asset	Description
2004	Marks & Spencer	U.K.	Hedge funds (helping Philip Green to acquire Marks & Spencer)		X	Equity swaps	See Part II.C
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. ¹⁰⁸
2004	MONY Group	U.S.	Holder and short sellers of AXA convertible bonds	X		Acquirer’s (AXA) convertible bonds	See Part II.B
2004	News Corp.	Australia & U.S.	Liberty Media	X	Hidden: yes Morphable: maybe	Forward contract	See Part II.B
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. ¹⁰⁹
2002	Hewlett-Packard	U.S.	Holder 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

108. See, e.g., Martin Dickson, *The Secret City Battle over Canary Wharf: Role of Derivatives in Takeover Battles*, FIN. TIMES (London), Apr. 24, 2004, at 2 (Companies); Lina Saigol, *UBS Wins Takeover Panel Appeal over Canary Vote*, FIN. TIMES (London), Apr. 24, 2004, at 2 (Companies).

109. See Bank of England, Stock Lending and Repo Committee, Summary of Meeting Held at the Bank of England (Dec. 11, 2002), <http://www.bankofengland.co.uk/markets/gilts/slrdec02.pdf>.

III. LEGAL AND FINANCE THEORY AND EVIDENCE

A. CLASSIC THEORY OF VOTING RIGHTS: INTRODUCTION

Why do common shareholders (and only common shareholders) have voting rights? The conventional contractarian answer flows from the shareholders' status as residual claimants to the firm's value. This gives them incentives to monitor management. The effectiveness of voting rights is limited by collective action problems, but the market for corporate control offers a response—shareholders can sell their shares and associated voting rights to an acquirer.¹¹⁰ Making voting rights proportional to one's share in the firm's residual value reduces agency costs by matching economic incentives with voting power.¹¹¹ Corporate law permits corporations to deviate from one-share-one-vote based on the usual claim that informed parties can choose optimal arrangements on their own.¹¹² Most U.S. public companies, however, retain a one-share-one-vote structure, likely reflecting the optimality of this structure for most firms.

The Delaware courts, meanwhile, celebrate shareholder voting, viewing it as the “ideological underpinning upon which the legitimacy of directorial power rests.”¹¹³ The usual lax business judgment rule does not apply to company actions that undermine shareholder voting rights. Instead, phrases like “compelling justification” course through the opinions.¹¹⁴ The judges see themselves as preventing the “wrongful subversion of corporate democracy by manipulation of the corporate machinery.”¹¹⁵ The Delaware courts also accord great deference to shareholder votes. For example, a central theme of Delaware takeover law is to distrust market decisions by shareholders (selling shares in tender offers) and favor voting decisions.¹¹⁶

110. See, e.g., ROBERT CHARLES CLARK, *CORPORATE LAW* 93–95, 389–400 (1986); Easterbrook & Fischel, *supra* note 27, at 403–06, 408–10.

111. See CLARK, *supra* note 110, at 390; Easterbrook & Fischel, *supra* note 27, at 408–10.

112. See, e.g., Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 808–09 (1987).

113. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

114. *Id.* at 661. See also *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1121, 1131 (Del. 2003).

115. *MM Cos.*, 813 A.2d at 1127 (quoting *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 239 (Del. 1982)).

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

The new vote buying thus strikes directly at both the economic and legal logic behind shareholder voting rights. In Part III.B, we take a closer look at the finance-theoretic arguments and empirical evidence relating to the link between economic ownership and voting rights. In Part III.C, we address the relevance of other circumstances in which voting and economic ownership can diverge. Part III.D considers past legal responses to the separation of votes from economic ownership. Part III.E discusses some potentially testable empirical implications of the new vote buying.

B. LITERATURE REVIEW: THEORY AND IMPLICATIONS FOR NEW VOTE BUYING

1. Theory

a. One-share-one-vote

Several strands of theoretical literature develop the basic contractarian argument favoring a one-share-one-vote capital structure. One strand derives from the hostile takeovers of the 1980s and focuses on the role of a one-share-one-vote regime in enhancing the functioning of the market for corporate control¹¹⁷ and the power of large shareholders to influence management.¹¹⁸

A more recent strand derives from the cross-country law-and-finance literature, in which a major concern is the ability of controlling shareholders to “tunnel” away more than their share of firm value. Here, higher economic ownership by insiders predicts lower tunneling.¹¹⁹ The intuition is simple. Assume tunneling is costly because it reduces firm value. The higher the insiders’ economic ownership, the greater the share of this cost they bear, and, hence, the less tunneling they engage in. A large gap between insiders’ voting rights and economic ownership can also distort the firm’s investment decisions.

117. See OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 95–125 (1995); Sanford J. Grossman & Oliver D. Hart, *One Share—One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988); Milton Harris & Artur Raviv, *Corporate Governance: Voting Rights and Majority Rules*, 20 J. ECON. FIN. 203, 226–28 (1988).

118. See Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 463 (1986).

119. See Lucian Arye Bebchuk, Reinier Kraakman & George G. 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 (Randall K. Morck ed., 2000); Art Durnev & E. Han Kim, *To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation*, 60 J. FIN. 1461 (2005).

Although disparity between economic and voting ownership encourages tunneling, it could serve other goals. Assume, for example, that insiders are unwilling to relinquish control. Greater ability to hedge economic ownership could make insiders less averse to firm-specific risk, and, hence, more likely to approve risky positive net present value investment projects and less likely to engage in value-reducing hedging within the firm.¹²⁰ Vote buying by outside shareholders can also reduce free rider obstacles that limit the effectiveness of shareholder voting as a constraint on managers, as some of the examples in Part II suggest. Thus, the new vote buying is not necessarily efficiency-reducing.

A final strand of analysis focuses not on the impact of decoupling at the firm level, but instead on legal choices made by entire nations. For example, if political influence depends on what one controls, a legal regime that permits disparity between voting power and economic ownership can let a single family control a larger industrial empire. This can foster an economically and politically powerful elite that in an extreme case can “capture the state.”¹²¹ Conversely, a disparity between insider control and economic ownership may arise in response to state power, as private actors seek countervailing influence.¹²² In this approach, the disparity between insider economic ownership and control, and other aspects of investor protection are endogenous to other country-level institutions.¹²³

b. The Value of Votes: Individual Versus Collective Value

A core concern with decoupling derives from the related observations that for outside investors, votes have limited individual value, but can have substantial collective value; and that in most circumstances, the value of a vote is a small fraction of the value of a share. Imagine that there were an explicit market for votes, decoupled from shares, and that someone was interested in acquiring a majority of the votes. The vote buyer could make a two-tier offer: price X until it gets a majority, zero thereafter. Much as in a two-tier tender offer for shares, shareholders would face pressure to sell votes at any price greater than the back end price (here, zero), lest they end

120. See *supra* note 45.

121. Joel S. Hellman, Geraint Jones & Daniel Kaufmann, *Seize the State, Seize the Day: State Capture and Influence in Transition Economies*, 31 J. COMPARATIVE ECON. 751 (2003); Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 655–57 (2005).

122. Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998).

123. Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005, 1007–08, 1027 (2005).

up with the back-end price. Moreover, at present, the vote buyer can conduct a rolling two-tier tender offer without rules. Shareholders will thus face time pressure to sell fast, lest others sell first.

The limited value of individual votes can be formalized using “oceanic” Shapley values, which measure the likelihood that a voter will be pivotal. The Shapley value of a small “oceanic” shareholder depends on the holdings of significant shareholders.¹²⁴ If a firm has n outstanding shares, one significant shareholder holding a fraction x of the shares and many oceanic shareholders, the significant shareholder’s Shapley value is $\{x / (1 - x)\}$ if the significant shareholder holds less than half the shares ($x < 0.5$); and 1 if the significant shareholder holds a majority ($x \geq 0.5$). The oceanic shareholders have combined Shapley values of $\{1 - (\text{the significant shareholder’s value})\}$, and thus Shapley value per share of $\{(1 - 2x) / n(1 - x)^2\}$ for $x < 0.5$; and 0 for $x \geq 0.5$. This per-share Shapley value, and thus the value of their votes, drops sharply as the significant shareholder approaches absolute control ($x = 0.5$) and disappears once control is achieved.

Moreover, in tender offers for shares, the pool of bidders is constrained because the front-end offer must exceed the current market price to attract takers. Thus, unless large-scale looting is feasible, the tender offer will be profitable only if the new controller can run the firm at least as well as the old controllers. A vote buyer does not face similar constraints. If the price of votes approaches zero, then even small private benefits of control can justify the effort to acquire control.

c. Equilibrium Versus Nonequilibrium Models

The economics literature includes some theoretical models in which explicit competition between incumbents and raiders for votes, decoupled from shares, operates similarly to a market for coupled shares and votes.¹²⁵ These models suggest that if insiders can be prevented from using a market for votes to lock up control before a raider appears, a control contest for

124. See J.S. Milnor & Lloyd S. Shapley, *Value of Large Games II: Oceanic Games*, 3 MATHEMATICS OF OPERATIONS RESEARCH 290 (1978); N.Z. Shapiro & Lloyd S. Shapley, *Value at Large Games I: A Limit Theorem*, 3 MATHEMATICS OF OPERATIONS RESEARCH 1 (1978). Cf. Jeffrey Zwiebel, *Block Investment and Partial Benefits of Corporate Control*, 62 REV. ECON. STUD. 161 (1995) (applying the concept to blockholdings in firms).

125. See, e.g., Douglas H. Blair, Devra L. Golbe & James M. Gerard, *Unbundling the Voting Rights and Profit Claims of Common Shares*, 97 J. POL. ECON. 420 (1989); Zvika Neeman and Gerhard O. Orosel, *On the Efficiency of Vote Buying When Voters Have Common Interests*, INT’L REV. OF L. & ECON. (forthcoming 2007).

votes could have (minor) efficiency advantages compared to a contest for shares.

The models, however, are “extremely stylized”¹²⁶ and nonequilibrium in nature, in ways that give them limited relevance to the contexts in which new vote buying is likely to arise. Most centrally, the models assume that vote buying occurs only during a limited period. The incumbents and the raider compete through fully disclosed offers for votes, which expire at the same time. The models thus presume a competition for votes that is tightly constrained in time and transparent to all participants.

A more realistic model, still to be developed, is likely to lead to different conclusions. What is needed is an equilibrium model in which (1) the insiders can quietly acquire votes at any time, before a raider emerges; (2) once acquired, votes can be held indefinitely; and (3) if insiders do not keep control, a raider can quietly acquire votes at any time. While such a model is beyond the scope of this project, we suspect that in equilibrium, insiders will keep control, if only to ward off raids by outsiders seeking to extract private benefits.

If insiders did not keep control in such a world, raiders would have an incentive to make “Saturday night special” offers to buy votes—timed to put maximum pressure on shareholders to sell, and to not give the insiders time to respond.¹²⁷ Those offers would likely produce a regulatory response, much as short-fuse tender offers for shares helped give rise to our current tender offer rules.¹²⁸

2. Empirical Evidence

a. Divergence Between Insiders’ Voting and Economic Ownership

The theoretical work which predicts adverse value effects when insiders can separate economic ownership and voting rights is supported by a reasonably solid body of empirical evidence, both in the United States and internationally. There are several strands of relevant research. One evaluates the stock price effects of dual-class recapitalizations in the United

126. Blair et al., *supra* note 125, at 423.

127. Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 775 n.2 (1982) (discussing “Saturday night specials” and other tender offer terminology).

128. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1162–63 (1981) (discussing the history of tender offer regulation).

States, a takeover defense popular during the 1980s.¹²⁹ The announcement of a dual-class recapitalization significantly reduces share price.¹³⁰

A second body of empirical work corresponds to the concern with tunneling by controlling shareholders. In many countries, founding families often maintain control by holding higher voting than economic ownership, through high voting shares or circular or pyramidal group holding structures.¹³¹ In the United States, Paul Gompers, Joy Ishii, and Andrew Metrick offer evidence that a disparity or “wedge” between economic and voting ownership created through dual-class common shares adversely affects share prices. Tobin’s “q” (a common measure of firm value) decreases with insiders’ voting rights (holding economic ownership constant) up to about 45%, a range which covers most of the firms in their sample.¹³² A wedge between voting rights and economic ownership predicts lower share prices in other countries, as well.¹³³

These studies are based on the trading prices of *noncontrolling* shares. Thus, it is possible that the lower value of minority shares is offset by the higher value of *controlling* shares, which do not trade, so their value cannot be observed. There is some evidence, however, that a larger wedge predicts lower firm profitability.¹³⁴

b. The Value of Voting Rights

Empirical work has also been done seeking to directly assess the value of voting rights. This literature offers a sense for how much of a firm’s value is at stake in new vote buying. There are two basic ways to measure

129. We discuss these recapitalizations *infra* in Part III.C.

130. See, e.g., Larry Y. Dann & Harry DeAngelo, *Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure*, 20 J. FIN. ECON. 87 (1988); Jeffrey N. Gordon, *Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988); Gregg A. Jarrell & Annette B. Poulsen, *Dual-class Recapitalizations as Antitakeover Mechanisms*, 20 J. FIN. ECON. 129 (1988). But see M. Megan Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. FIN. ECON. 313 (1987) (finding no significant effect).

131. See Claessens et al., *supra* note 2, at 82–83, 110.

132. Gompers et al., *supra* note 2.

133. See Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159 (2003); Bernard Black, Hasung Jang & Woochan Kim, *Does Corporate Governance Predict Firms’ Market Values? Evidence from Korea*, 22 J.L. ECON. & ORG. (forthcoming 2006), available at <http://ssrn.com/abstract=311275>.

134. Gompers et al., *supra* note 2; Sung Wook Joh, *Corporate Governance and Firm Profitability: Evidence from Korea Before the Economic Crisis*, 68 J. FIN. ECON. 287, 290 (2003).

the value of votes: The first measures the value of control as a fraction of firm value. The second measures the premium value of high-vote relative to low-vote shares.

Thus, Alexander Dyck and Luigi Zingales compare the price paid to acquire a control block with the contemporaneous value of noncontrolling shares.¹³⁵ Tatiana Nenova examines differences between the trading prices of separate classes of voting stock.¹³⁶ Both studies find wide variation across countries in the value of control, with this value often equal to a substantial fraction of firm value.¹³⁷ In the United States, the mean value of control is relatively low, around 2%–4% of firm value.¹³⁸ This value can be much larger, however, for a particular company that is undergoing a change in control.¹³⁹ Turning to the premium accorded to high-vote shares relative to low-vote shares, single-country estimates range from 5%–10% in the United States¹⁴⁰ to 82% in Italy.¹⁴¹

c. Market for Corporate Control

Insider entrenchment through new vote buying could have an effect similar to strong takeover defenses. Gompers, Ishii, and Metrick report evidence that U.S. firms with strong takeover defenses have lower Tobin's *q* than firms with weak defenses.¹⁴² Martijn Cremers and Vinay Nair report evidence of abnormal returns to a portfolio of firms with weak takeover

135. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004).

136. Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-country Analysis*, 68 J. FIN. ECON. 325 (2003).

137. In addition to these cross-country studies, other single country estimates of the value of control as a percentage of firm value include 3%–8% in Sweden, see Kristian Rydqvist, *Takeover Bids and the Relative Prices of Shares That Differ in Their Voting Rights*, 20 J. BANKING & FIN. 1407, 1419–20 (1996); and 30% in Italy, see Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125 (1994).

138. See Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371, 394 (1989) (discussing value difference based on large block trades); Nenova, *supra* note 136.

139. See Harry DeAngelo & Linda DeAngelo, *Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock*, 14 J. FIN. ECON. 33 (1985); Luigi Zingales, *What Determines the Value of Corporate Votes?*, 110 Q.J. ECON. 1047, 1049–52 (1995).

140. See Ronald C. Lease, John J. McConnell & Wayne H. Mikkelson, *The Market Value of Control in Publicly-traded Corporations*, 11 J. FIN. ECON. 439, 469 (1983); Zingales, *supra* note 139, at 1047.

141. See Zingales, *supra* note 137, at 126 (also collecting other single country estimates, including 6.5% in Sweden, 13% in the United Kingdom, 23% in Canada, 27% in Switzerland, and 45% in Israel).

142. See Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

defenses, but only in the presence of outside blockholders.¹⁴³ At the same time, a bidder's ability to use hidden ownership to amass a toehold stake can facilitate takeover bids.

d. Record Date Capture

One recent working paper provides evidence on record date capture. Susan Christoffersen, Christopher Geczy, David Musto, and Adam Reed, using proprietary data on loans of U.S. shares by a custodian bank in 1999 and by a broker-dealer from 1996 to 2001, report that loans spike on the record date, increasing on average from 0.21% to 0.26% of outstanding shares.¹⁴⁴ The spike in borrowing on the record date strongly supports the existence of some record date capture. The spike is higher for firms with poorer performance, for votes that turn out to be close, and for votes that produce higher support for shareholder proposals or opposition to management proposals.

Christoffersen and her colleagues offer evidence that borrowing shares around a record date costs no more than borrowing at another time—around fifteen basis points per year. To them, this suggests that an information aggregation process is at work, in which ill-informed lenders consciously yield their shares to better-informed borrowers, who can vote wisely, to everyone's benefit.

Their data offers clear evidence that record date capture occurs, but we are not persuaded by this “active lending” interpretation of their findings. First, we consider it unlikely that lenders often consciously yield shares for voting purposes. As we discuss in Part V.C, most lenders seek to earn a profit from lending in general, pay little attention to record dates or which companies' shares they are lending, and often outsource the process to a lending agent.¹⁴⁵ To us, it seems more likely that share borrowers are the active agents. Second, the benefits from information aggregation will arise only if borrowers have a *positive* economic interest. This is sometimes not the case, as situations such as Perry-Mylan and Henderson Investments illustrate. They also lack data on who is borrowing. Third, they assume that outside investors are borrowing, but their results are consistent with insiders sometimes anticipating a close vote and borrowing to ensure victory.

143. K.J. Martijn Cremers & Vinay B. Nair, *Governance Mechanisms and Equity Prices*, 60 J. FIN. 2859 (2005).

144. Christoffersen et al., *supra* note 21.

145. We discuss share lending practices *supra* in Part II.E and *infra* in Part V.C.

C. ANALOGIES TO OTHER FORMS OF DECOUPLING

1. Dual-class Common Stock, Pyramids, and Circular Control

Much of the potential use of the new vote buying will likely come from insiders and from outsiders seeking control (who will become insiders if they succeed). For insiders, new vote buying is only one of a number of techniques for decoupling economic and voting ownership. Other strategies include dual-class common stock, pyramidal ownership structures (with insiders controlling the top company in the pyramid), and circular ownership structures (with insiders controlling a pivotal company). For insiders then, new vote buying is a new tool, but not a fundamentally new opportunity. It is worth considering, then, the differences between new vote buying and these older decoupling techniques.

One central difference is that, with dual-class capital structures, pyramids, and circular control, outside investors know what they are getting. Thus, insiders pay a market penalty when, say, companies issue lower-voting shares. This penalty is the most likely reason why a high percentage of U.S. initial public offerings involve companies with a one-share-one-vote capital structure.

Both the theoretical work discussed above and the available evidence on the effects of insider decoupling involve a disclosed wedge between economic ownership and voting rights. An undisclosed wedge is more problematic than a disclosed wedge. Consider a firm with a controlling shareholder. If the wedge is disclosed and stable over time, investors will presumably pay a lower price for shares of a firm with a large wedge, which reflects the controller's distorted incentives.

Suppose instead that decoupling is hidden and easy to change over time. Investors will not know which firms' insiders have a large wedge between economic and voting ownership. Investors also will not know how this wedge fluctuates over time. Insiders may be able to cede control to the market for a time, but cheaply reacquire it later, perhaps when a threat to day-to-day control emerges. Some insiders may be able to apparently cede control, thus obtaining the market price benefits of doing so, while actually retaining control. In general, one would expect investors to react, as in any

adverse selection situation, by discounting the prices they pay for shares of all companies. This will increase the cost of public equity capital.¹⁴⁶

Hidden, low-cost decoupling could also contribute to a “lemons” equilibrium in which dispersed ownership is unstable even if it maximizes firm value, so that most firms retain concentrated ownership. Bebchuk develops a model in which, in a market with high private benefits of control, dispersed ownership would be first-best if it could be sustained, but is unstable because a new controller could pay a market price for shares and then profit by self-dealing.¹⁴⁷ Empirical studies provide evidence of the collapse of initially dispersed ownership after mass privatization in the Czech Republic and Bulgaria.¹⁴⁸

2. Dual-class Recapitalizations

Dual-class recapitalizations—efforts by company managers to create a dual-class structure *after* the company has sold full-voting shares to investors—offer a possibly better analogy to the new vote buying than dual-class stock or pyramid structure. Dual-class recapitalizations became popular in the United States during the hostile takeover wave of the 1980s, after the NYSE relaxed its one-share-one-vote rule. In a typical recapitalization, the company would propose a dual-class voting structure in which insiders would acquire high-vote shares. The low-vote shares would have slightly superior economic rights, such as a slightly higher dividend, perhaps five cents per share per year.¹⁴⁹

These recapitalizations let insiders acquire control without paying a market price for doing so. Outside shareholders voted to approve the recapitalizations because their votes were individually worth less than the higher dividend.¹⁵⁰ Consistent with insiders acquiring control for a less-than-market price, the announcement of a dual-class recapitalization

146. See Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

147. See Lucian Arye Bebchuk, *A Rent-protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. W7203, 1999), available at <http://ssrn.com/abstract=203110>.

148. Edward Glaeser, Simon Johnson & Andrei Shleifer, *Coase Versus the Coasians*, 116 Q.J. ECON. 853 (2001); Vladimir Atanasov, Bernard Black, Conrad S. Ciccotello & Stanley B. Gyoshev, *The Anatomy of Financial Tunneling in an Emerging Market* (May 16, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=902766>.

149. See, e.g., Gordon, *supra* note 130; Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986).

150. See Gilson, *supra* note 112.

significantly reduced share price.¹⁵¹ Most forms of midstream recapitalizations were then banned through joint action by the SEC and the stock exchanges, precisely because they let insiders amass control without paying a market price for doing so.¹⁵² In some respects, new vote buying is worse than a dual-class recapitalization. A recapitalization at least required disclosure and a shareholder vote; the new vote buying requires neither.

3. Voting by Record Owners

Another analogy involves the common practice in which investors hold shares in “street name” rather than in their own name. The ultimate “record owner” is a securities depository (Depository Trust Company (“DTC”) is the principal depository), which holds shares for the accounts of its members—banks and broker-dealers—who, in turn, hold shares for their clients.¹⁵³ Sometimes larger custodian banks or brokers hold for smaller ones. As a matter of formal corporate law, DTC, through its nominee, Cede & Co., is a majority shareholder of almost every publicly traded U.S. company, yet it has no economic ownership.

If DTC had voting discretion, this would be empty voting with a vengeance. However, a web of market practices and SEC and stock exchange rules ensure that voting rights, having been separated from economic ownership, are largely reunited in practice. DTC and other depositories pass voting authority to the banks and broker-dealers for which they hold shares. The banks and broker-dealers, in turn, must ask their clients for voting instructions and follow those instructions if provided. If a client does not return voting instructions, NYSE Rule 452 allows the bank or broker-dealer to vote on routine matters, but not on major matters, such as a contested election of directors or an acquisition. The NYSE publishes weekly a list of upcoming elections and agenda items on which broker-dealers can vote only if instructed by clients.¹⁵⁴ This is not

151. See sources cited *supra* note 130.

152. See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (invalidating the SEC’s prior 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); Gilson, *supra* note 112.

153. On the current system and its origins, see, for example, Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, Exchange Act Release No. 34-50758, 69 Fed. Reg. 70,852, 70,852 nn.1–2 (Dec. 7, 2004); MICHAEL T. REDDY, *SECURITIES OPERATIONS* 127–64 (2d ed. 1995).

154. See NYSE, Inc., Rule 452 (2002). On the origins and structure of Rule 452 and similar NASDAQ and American Stock Exchange rules, see Bainbridge, *supra* note 152; Task Force on S’holder Proposals of the Comm. on Fed. Regulation of Sec., Am. Bar Ass’n, *Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109 (2003).

too dissimilar from the current market practice underlying hidden (morphable) ownership. As we discussed in Part II.C, derivatives dealers often hold matched shares to hedge long equity swap positions they have provided to their clients. At least in the United Kingdom, the dealers will usually agree to convey voting rights back to the clients on demand, either by unwinding the swaps and selling the matched shares to their clients, or by voting the matched shares as directed by their clients.

D. CLASSICAL VOTE BUYING DOCTRINE AND DECOUPLING

Corporate law polices the connection between economic interest and voting power through the classic common law prohibition on “vote buying,” defined as the sale of a shareholder’s voting rights, shorn of economic interest, to a third party.¹⁵⁵ The original 1932 *Restatement of Contracts* made such a sale illegal.¹⁵⁶ New York’s corporate law prohibits shareholders from selling or changing their votes for money “or anything of value.”¹⁵⁷ The central concern was that vote buying would lead to self-dealing by those who thereby gain control.

The current Delaware attitude toward vote buying is more tolerant. The leading 1982 case of *Schreiber v. Carney* centered on a loan by Texas International Airlines to a controlling shareholder to obtain that shareholder’s support for a restructuring.¹⁵⁸ The court found that this was vote buying, but explained that “each arrangement must be examined in light of its object or purpose.”¹⁵⁹ Vote buying was permitted for a proper purpose if it satisfied a test for intrinsic fairness.¹⁶⁰ In *Schreiber*, the court found a proper purpose—the restructuring would further the interest of all Texas International stockholders.¹⁶¹ And the terms were apparently fair, for which the best evidence was approval by a vote of other shareholders.

In general, the vote buying cases are unlikely to reach new vote buying without a major change in current doctrine. *Schreiber* defines vote buying as a voting agreement supported by “consideration personal to the

155. See, e.g., *Chew v. Inverness Mgmt. Corp.*, 352 A.2d 426 (Del. Ch. 1976); Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776 (1979) (compiling cases); Michael D. Schmitz, Comment, *Shareholder Vote Buying—A Rebuttable Presumption of Illegality*, 1968 WIS. L. REV. 927.

156. RESTATEMENT OF CONTRACTS § 569 (1932).

157. N.Y. BUS. CORP. LAW § 609(e) (McKinney 2003).

158. *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982).

159. *Id.* at 25.

160. *Id.* at 24.

161. *Id.* at 26.

stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed.”¹⁶² The focus is on a **vote seller** who *transfers the voting right* to a vote buyer.

The new vote buying falls outside this definition. For instance, a new vote buyer can acquire voting rights through a two-step process that involves neither a vote sale nor a transfer of voting rights: *first*, purchase shares; and *second*, shed the economic rights associated with those shares, leaving the share purchaser holding only the voting rights associated with the shares. Consider the Perry-Mylan situation.¹⁶³ Perry purchased Mylan shares, and entered into equity swaps which hedged its economic ownership. Neither step involved either a **vote seller** or a transfer of voting rights. Instead, these transactions involved a **share purchaser** and a *transfer of economic interests*. Indeed, both were perfectly ordinary market transactions: a share purchase and a hedging transaction. Similarly, insiders using collars retain voting rights while shedding economic ownership. Again, the decoupling is achieved by two normal market transactions—the purchase of shares and the hedging of economic risk—rather than a single suspect purchase of votes.

Record date capture also falls outside current vote buying doctrine. 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 problematic.

Vote buying by insiders, however, remains suspect because of possible fiduciary duty constraints. In the battle over H-P’s acquisition of Compaq, Walter Hewlett asked the court to set aside the votes by Deutsche Bank on grounds of vote buying, alleging that Deutsche Bank’s vote was coerced by threats from H-P management that the bank’s future business relationship with H-P would suffer if the bank voted against the merger.¹⁶⁴ The court found no evidence of coercion, but seemed to presume the

162. *Schreiber*, 447 A.2d at 23.

163. We discuss this example *supra* in Part II.B.

164. *Hewlett v. Hewlett-Packard Co.*, No. Civ.A. 19513-NC, 2002 WL 818091, at *12 (Del. Ch. Apr. 30, 2002).

illegitimacy of coercion, had it occurred.¹⁶⁵ We return to this insider fiduciary duty limitation in Part V.B.4.

E. TESTABLE HYPOTHESES

Suppose that disclosure rules, such as the ones we propose below, provided good data on the extent of empty voting and hidden (morphable) ownership (which would no longer be hidden); both are reasonably widespread; and there is no change, other than disclosure, in current rules. What results might we expect?

One set of hypotheses involves the markets on which the new vote buying depends. Around the record date for a contested vote, we would expect (1) an increase in demand for share borrowing; and (2) a possible decrease in the supply of lendable shares, because some lenders will want to vote their shares. This should increase the cost of borrowing shares or creating a short equity swap position (for which the dealer may hedge by borrowing shares and selling them short). In an extreme case, the cost of borrowing shares or obtaining short equity swap positions might spike as the contestants view to acquire enough votes to carry the election. Christoffersen and her colleagues report higher lending volume around record dates with little apparent change in price,¹⁶⁶ but this seems unlikely to be an equilibrium outcome for contested elections.

Cheaper decoupling should increase the overall level of decoupling. It might be feasible to exploit cross-country or cross-firm differences in the availability and cost of decoupling to test whether these differences predict differences in the extent of decoupling.

A related hypothesis involves the minimum ownership that insiders need to maintain to ensure control. Ownership of 30%–35% of a company's shares has generally been considered sufficient for control. If insiders can more readily reduce economic ownership while maintaining voting ownership, and outsiders can acquire votes at modest cost, both factors should lead controlling families to maintain higher voting ownership.

165. For further discussion of vote buying, see Thomas J. Andre, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533 (1990); Clark, *supra* note 155; Douglas R. Cole, *E-proxies for Sale? Corporate Vote-buying in the Internet Age*, 76 WASH. L. REV. 793 (2001).

166. Christoffersen et al., *supra* note 21.

A final hypothesis involves the equity swap market. One possible reason for the rapid growth in this market is the desire of hedge funds and other investors to conceal their ownership. If so, more effective disclosure rules could reduce use of equity swaps. Once again, cross-country or cross-firm tests might be feasible.

IV. DISCLOSURE: CURRENT RULES AND REFORM PROPOSAL

A. GENERAL CONSIDERATIONS

We turn now to how disclosure rules relate to the new vote buying. In Part IV.B, we address the extent to which current share ownership disclosure rules reach empty voting or hidden (morphable) ownership. In Parts IV.C and IV.D, we offer an “integrated ownership disclosure” reform proposal that would both ensure disclosure of much of the new vote buying and simplify current ownership disclosure rules.

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.

Currently, there are five discrete ownership disclosure systems, for (1) active 5% shareholders on Schedule 13D;¹⁶⁷ (2) passive 5% shareholders on Schedule 13G;¹⁶⁸ (3) institutional investors, including hedge funds, on Form 13F;¹⁶⁹ (4) company insiders under Section 16; and (5) mutual funds.¹⁷⁰ These systems, taken together, are bewilderingly complex. Different rules often apply in determining what triggers the disclosure requirements and what must be disclosed if disclosure is required. Economically identical holdings are often disclosed in different ways, depending on how an investor achieves a particular combination of voting and economic ownership. Positions involving OTC derivatives often escape disclosure, when a substantively identical position involving exchange-traded derivatives would be disclosed. Ownership of call options may

167. Schedule 13D, *supra* note 14.

168. Schedule 13G, *supra* note 14.

169. Form 13F, *supra* note 13.

170. *See infra* Part IV.B.4.

require disclosure, but (the nearly equivalent) sale of put options may not. And so on. A derivatives-savvy hedge fund can often avoid disclosure.

Table 3 summarizes the current disclosure requirements. Their complexity and illogic is immediately apparent.

TABLE 3. Current ownership disclosure requirements relating to new vote buying

This table summarizes how long and 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.

Reporting Scheme	Reporting Frequency	Long Positions				Short Positions						Stock Lending and Borrowing	
		As Trigger		If Filing Required		As Trigger			If Filing Required			Lending	Borrowing
		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		
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	Probably no	Yes (as trigger); Probably no (in disclosure)	
Mutual Funds	Quarterly	Yes		Yes	Yes			Yes			No (except by implication from disclosure of short sales)		

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 must file a Schedule 13D with the SEC within ten days after crossing the 5% threshold.¹⁷¹ Certain types of institutional investors who invest “passively” (in the ordinary course of business and without intent to influence control) can instead file a more abbreviated Schedule 13G (generally on February 15 of each year, reporting year-end positions).¹⁷² Both schedules are publicly available.

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.”¹⁷³ Beneficial ownership of shares includes “the right to acquire beneficial ownership . . . within sixty days, including . . . through the exercise of any option [or] warrant.”¹⁷⁴ The SEC discourages gaming by providing that any person who uses any “contract, arrangement, or device” to evade these reporting requirements is nonetheless deemed to be a beneficial owner.¹⁷⁵

Filers must report the number and percentage of shares beneficially owned, and any purchases or sales within the past sixty days.¹⁷⁶ 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.¹⁷⁷ Item 7 requires the filing of certain related “written agreements” as exhibits.¹⁷⁸ 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.

171. See Exchange Act Rule 13d-1, Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1(a), (i) (2005).

172. See Exchange Act 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 tenth day of the next month. *Id.*

173. Exchange Act Rule 13d-3(a), 17 C.F.R. § 240.13d-3(a) (2005).

174. Exchange Act Rule 13d-3(d)(1)(i), 17 C.F.R. § 240.13d-3(d)(1)(i) (2005).

175. Exchange Act Rule 13d-3(b), 17 C.F.R. § 240.13d-3(b) (2005).

176. Schedule 13D, *supra* note 14, at Item 5; Schedule 13G, *supra* note 14, at Item 4.

177. Schedule 13D, *supra* note 14, at Item 6.

178. *Id.* at Item 7.

How Schedules 13D and 13G treat share lending and borrowing is unclear. Borrowing (which comes with voting power) would likely both count toward triggering disclosure and be disclosable on both forms. Record date capture without a control intent, however, 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 not captured by Schedule 13G.

b. Application to Hidden (Morphable) Ownership

Will the 13D and 13G requirements capture hidden (morphable) ownership? We will use Perry-Rubicon as an example.¹⁷⁹ Perry held just under 5% of Rubicon's shares, plus equity swaps conveying an additional 11% economic ownership. Its direct holding of shares would not trigger disclosure. The equity swaps, by themselves, would likely not trigger disclosure either. The swaps in Perry-Rubicon were cash-settled and 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, if it had a sufficiently firm expectation that it could exchange its equity swap position for shares at any time. But there is no clear guidance in the rule or in SEC no-action letters. Practitioners at law firms prominent in the OTC derivatives market apparently take the position that disclosure of cash-settled equity swap positions is normally not required. Partners at Allen & Overy, the primary outside law firm of the International Swaps and Derivatives Association (the main trade association for the OTC derivatives industry), and at Cleary Gottlieb have both taken this position.¹⁸⁰

The nondisclosure of cash-settled equity swaps can be questioned if one looks beyond the terms of the swap itself to the economic context. A derivatives dealer which takes a short equity swap position will almost surely hedge its exposure, often by holding matched shares. This hedging choice was adopted in Perry-Rubicon. Perry sold Rubicon shares to Deutsche Bank and UBS Warburg concurrent with entering the equity swaps. There was a very good chance that Perry could return to its dealers and exchange its swap position for shares, without an explicit prior discussion. (Access to the dealers' matched shares is not always a certainty; the hedge fund in the Sears Canada situation was surprised to find its dealer

179. We discuss this transaction *supra* in Part II.C.

180. See GREENE, *supra* note 102 (book by Cleary Gottlieb); Liew, *supra* note 101 (article by Allen & Overy partner).

less accommodating than it had expected.¹⁸¹ Is this expectation a sufficient “arrangement, understanding or relationship (legal or otherwise),” taking into account 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. Perry lost at trial, but won on appeal.

Australia has reached a similar result, under similar large shareholder disclosure rules. In 2005, Glencore International, which held just below 5% of Austral Coal, entered into equity swaps with two derivatives dealers, thereby acquiring another 6.5% in economic ownership, before disclosing its overall position.¹⁸² The Australian Takeovers Panel held that Glencore should have disclosed its combined position as soon as its economic ownership crossed the 5% threshold.¹⁸³ The Panel found that Glencore expected the derivatives dealers to acquire matched shares to hedge the equity swaps, and that the dealers’ incentive to hold the matched shares gave Glencore “a real degree of effective negative control” over disposal of these shares. The Panel’s decision, however, was reversed on appeal by the Federal Court of Australia.¹⁸⁴

Hidden (morphable) ownership might arguably be analogized to “stock parking” for disclosure purposes.¹⁸⁵ The argument would be that the shares “parked” with another party in conventional parking arrangements are similar to the “matched shares” held by a derivatives dealer to hedge an equity swap provided to a client. In both cases, there is little or no market risk to the financial intermediary and the transaction may be used to avoid disclosing ownership. There are material distinctions, however, between the two situations. Parking involves an understanding that the client will buy the stock back at a later date and protect its counterparty against loss. With an equity swap, there is no such understanding and the dealer must protect itself against loss.

181. We discuss the Sears Canada incident *supra* in Part II.C.

182. We discuss the Glencore-Austral Coal transaction *supra* in Part II.C.

183. See Austral Coal Takeovers Panel Decision, *supra* note 75. The Takeovers Panel based this decision on the policy concerns underlying large shareholder disclosure rules, rather than on the specific language of the statute.

184. See *Glencore Int’l AG*, *supra* note 75.

185. The key stock parking case, *United States v. Bilzerian*, 926 F.2d 1285 (2d Cir. 1991), discusses parking arrangements.

c. Application to Empty Voting

Consider next how Schedules 13D and 13G affect empty voting, using Perry-Mylan as an example. Perry acquired 9.9% of Mylan's shares. Had Schedule 13G been available, no disclosure of its hedges would have been needed, nor disclosure of its position until February 15 of the next year. Perry initially took the position that Schedule 13G was available, and filed a Schedule 13D only after Carl Icahn filed a Schedule 13D indicating an intent to acquire Mylan, a step that Perry opposed.¹⁸⁶ Perry's view that its intent to oppose Mylan's merger with King did not involve a control intent is debatable. But even if a Schedule 13D filing was required, what should Perry disclose about its hedges? Not much, or so Perry judged. Item 6 of Schedule 13D requires disclosure of "any contracts, arrangements, understandings or relationships" relating to Mylan shares. Perry duly said that it had engaged in "security-based swap agreements" and that "to execute certain hedging transactions," it had entered into share loan transactions with Bear Stearns and Goldman Sachs.¹⁸⁷ This opaque disclosure was likely not accidental.

Consider next the common situation in which an investor holds a stake in both acquirer and target, which affects economic interest in the acquirer. Deutsche-Boerse-LSE and Hewlett-Packard-Compaq offer examples of this scenario.¹⁸⁸ Assume that a hedge fund files a Schedule 13D; must it disclose its position in the target? The answer is no. Item 6 requires disclosure of contracts or arrangements with respect to "any securities of the issuer."¹⁸⁹

In sum, Schedules 13D and 13G provide only limited disclosure of the existence and nature of the new vote buying. One can quibble with the level of detail that Perry provided or its failure to attach the hedging agreements as exhibits.¹⁹⁰ But from a policy perspective, picking at the language of disclosure rules that were not written with empty voting in mind is beside the point. The real problem is that the 13D and 13G rules

186. See Neil Whoriskey & Brandon W. Gardner, *Arbitrage in an M&A Context—Issues Raised by the Mylan Case*, M&A LAW., Sept. 2005, at 15.

187. Perry Corp., Schedule 13D as to Mylan Laboratories, Inc., at Items 4, 6 (Nov. 19, 2004).

188. We discuss these examples *supra* in Parts II.B and II.D, respectively.

189. Schedule 13D, *supra* note 14, at Item 6 (emphasis added).

190. Item 7 of Schedule 13D requires filing of "all written agreements, contracts, arrangements, understandings, plans or proposals relating to . . . 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." *Id.* at Item 7. Perry's counsel presumably decided that its hedges were none of these.

were written in the 1970s, when neither swaps nor any other OTC derivatives existed.¹⁹¹

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

The third ownership disclosure regime applies to institutional money managers, including hedge funds, who must disclose their holdings at the end of each quarter by filing Form 13F with the SEC.¹⁹² Form 13F is filed forty-five days after the end of each quarter. With regard to the 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.¹⁹³ The term “institutional investment manager” is defined broadly to include (1) any person, other than a natural person, who invests in or buys or sells for its own account; and (2) any person, whether or not a natural person, who exercises investment discretion with respect to the account of any other person.¹⁹⁴ This captures hedge funds, whether located in the United States or offshore, but not high net worth individuals, unless they invest for the accounts of others.¹⁹⁵ The SEC publishes an “Official List of Section 13(f) Securities.” This list is limited to common shares and exchange-traded options of U.S. public companies.¹⁹⁶ Anything not on the list need not be disclosed.

Critically, Form 13F requires no disclosure for securities that are not publicly traded, even if they are economically identical to disclosable securities. For example, positions in exchange-traded options are disclosable, but substantively identical positions in OTC options are not. Money managers need not report options they have *written* rather than

191. Swaps were introduced in secrecy in the late 1970s and became full-fledged financial products only in 1981, with the disclosure of some details of a currency swap between IBM and the World Bank. See Henry T. C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 363 (1989).

192. 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 13.

193. See Exchange Act § 13(f)(1), (f)(5)(A) (2000); 15 U.S.C. § 78m(f)(1), (f)(5)(A) (2000); Exchange Act Rule 13f-1, 17 C.F.R. § 240.13f-1 (2005).

194. See Exchange Act § 13(f)(5)(A); 15 U.S.C. § 78m(f)(5)(A).

195. See Exchange Act Rule 13f-1, 17 C.F.R. § 240.13f-1 (2005); SEC Division of Investment Management: FAQ About Form 13F, Question 4 (May 2005), <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* (EFA Annual Conference Paper No. 446, 2003), available at <http://ssrn.com/abstract=423940>.

196. See Exchange Act Rule 13f-1(c), 17 C.F.R. § 240.13f-1(c) (2005); SEC 13F FAQ, *supra* note 195, at Question 7.

bought, even if the written position is economically equivalent to a disclosable purchased position. Long share positions are reported; short positions are not.¹⁹⁷ Share lenders report ignoring the loan (that is, the lender reports owning the shares); share borrowers report nothing.¹⁹⁸

Even for covered securities, Form 13F requires quite limited information. The “Information Table” at its heart is simply a list of each security owned, 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.¹⁹⁹

Form 13F requires reporting of shares as to which a manager has voting power or investment power, whether sole or shared. If, however, a manager has voting authority over “routine” matters and no authority to vote on “nonroutine” matters, the manager reports as if it had no voting authority. Nonroutine matters include a “contested election of directors, a merger, a sale of substantially all the assets, [and] a change in the articles of incorporation affecting the rights of shareholders” while routine matters include selecting an accountant, uncontested election of directors, and approval of an annual report.²⁰⁰

Hidden (morphable) ownership positions will usually escape 13F reporting. These positions commonly rely on OTC derivatives, which are not reported. 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 while hedging economic ownership, the direct ownership will be reported; its empty character will not. Moreover, it is usually easy to hide a voting stake altogether. For example, a hedge fund could, in effect, exchange its shares for economically equivalent swap positions before quarter end, and then unwind the swaps and reacquire shares from the derivatives dealers immediately afterwards.

197. SEC Form 13F FAQ, *supra* note 195, at Question 41 (“You should not include 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.”).

198. *Id.* at Question 42.

199. See Form 13F, *supra* note 13, at Special Instructions ¶¶ 9–12.

200. *Id.* at Special Instructions ¶ 12(b)(viii).

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.²⁰¹ Outside shareholders usually 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 six-month period. Acquiring economic ownership while avoiding coverage is straightforward. The 10% ownership threshold is based on beneficial ownership in the Section 13(d) sense, which focuses on voting power rather than economic interest.²⁰² If a cash-settled equity swap lets a hedge fund avoid disclosure under Section 13(d), the same swap will also let the fund avoid Section 16 disclosure.

If disclosure is triggered, however, the positions to be disclosed are based on “beneficial ownership” in the separate Section 16 sense, which focuses on economic ownership.²⁰³ The relevant forms (Forms 3, 4, and 5) require disclosure of most economic interests.²⁰⁴ An initial filing must be made on Form 3 within ten days after the event which triggers coverage.²⁰⁵ Changes are reported on Form 4. Form 5 is an annual statement of changes. All forms are publicly available. Section 16 beneficial ownership is defined broadly to include any “pecuniary interest.”²⁰⁶ Disclosable positions 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.”²⁰⁷

This definition is quite broad. Equity swaps and other equity derivatives must be disclosed, whether physically- or cash-settled, and

201. See Exchange Act Rules 16a-1(a), 16a-2, 17 C.F.R. §§ 240.16a-1(a), 16a-2 (2005).

202. 17 C.F.R. § 240.16a-1(a). Registered broker-dealers, banks, and certain other entities and individuals are exempt so long as they hold shares without “divesting such person of beneficial ownership of a security” or entering into an arrangement that would violate the antigaming provisions of 17 C.F.R. § 240.13d-3(b). *Id.*

203. Exchange Act Rule 16a-2, 17 C.F.R. § 240.16a-2 (2005). For nonexperts in securities law, yes, the SEC has indeed defined the same term—beneficial ownership—in two different ways, once under Section 13(d) and once under Section 16.

204. Form 3, Initial Statement of Beneficial Ownership of Securities, 17 C.F.R. § 249.103 (2005) [hereinafter Form 3]; Form 4, Statement of Changes in Beneficial Ownership of Securities, 17 C.F.R. § 249.104 (2005) [hereinafter Form 4]; Form 5, Annual Statement of Beneficial Ownership of Securities, 17 C.F.R. § 249.105 (2005) [hereinafter Form 5].

205. Exchange Act Rule 16a-3, 17 C.F.R. § 240.16a-3(a) (2005); Form 3, *supra* note 204, at Instruction 3.

206. 17 C.F.R. §§ 240.16a-2, .16a-3, & .16a-4.

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

whether exchange-traded or OTC. A derivative's value need not precisely track share value; the derivative must be disclosed if its value is "derived from the value of an equity security."²⁰⁸ There is an exception for "broad-based" index options, futures, and market baskets of stocks. By implication, derivatives whose value is based on a narrow index are covered. Thus, Section 16 covers some related non-host assets—albeit with ambiguity about which ones. 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."²⁰⁹ Changes in ownership are reported using specific transaction codes, including "S" (sale), "C" (conversion), "O" (exercise of an out-of-the-money derivative), "X" (exercise of an in- or at-the-money security), and "K" (an equity swap or similar security).²¹⁰

It seems likely that few, if any, Section 16 filers report share borrowing or lending.²¹¹ There is no explicit SEC requirement to report share borrowing or lending, there is no relevant transaction code, and we have found no SEC or practitioner guidance even discussing this question. Section 16 reporting focuses on economic ownership, which lending and borrowing does not change in any significant way. The lender can recall the lent shares at any time and receives from the borrower a payment to compensate for any dividends or other distributions during the period of the loan. The borrower's 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.²¹²

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

208. *Id.*

209. Form 3, *supra* note 204.

210. Form 4, *supra* note 204.

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

212. *See, e.g.*, ARNOLD S. JACOBS, 16A SECTION 16 OF THE SECURITIES EXCHANGE ACT § 7.31 (2005). We concede that the lender's economic position does not remain completely the same. For instance, there are tax differences between dividends and payments by the borrower in lieu of dividends, but 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 dividend tax rate.

4. Mutual Fund Reporting

The final set of reporting obligations applies to mutual funds, which must report to the SEC quarterly on their portfolio holdings (the filing is public) and provide a summary list semiannually to investors.²¹³ 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 a spot check of several disclosure filings suggests that disclosure of counterparties and certain numerical information such as notional amounts is common. There is no requirement to disclose specific share lending or non-short-sale-related borrowing positions.²¹⁴

Thus, while the details are different, mutual fund reporting is similar to insider reporting in that it (1) focuses on economic ownership; (2) covers all positions, both long and short, whether or not they convey voting rights; (3) covers both exchange-traded and OTC derivative positions; but (4) apparently does not cover share lending or non-short-sale-related borrowing. Both systems cover hidden (morphable) ownership reasonably well, as well as some flavors of empty voting. Mutual fund disclosure captures only quarter-end positions, however.

C. REFORMING THE DISCLOSURE SYSTEM

1. General Considerations

As Table 3 and Part IV.B show, the current disclosure rules are highly complex, treat substantively identical positions inconsistently both across

213. The basic forms for mutual fund disclosure are Forms N-1A, N-CSR, and N-Q. See SEC, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 33-8393, 69 Fed. Reg. 11,244, 11,254–57 (Mar. 9, 2004); SEC Form N-1A, Registration Statement Under the Securities Act of 1933, General Instructions, ¶ 22 (b)–(c), available at <http://www.sec.gov/about/forms/formn-1a.pdf> (discussing annual and semiannual reports); SEC Form N-CSR, Certified Shareholder Report of Registered Management Investment Companies, General Instructions, ¶ 6, available at <http://www.sec.gov/about/forms/formn-csr.pdf>; SEC Form N-Q, Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company, General Instructions, available at <http://sec.gov/about/forms/formn-q.pdf>.

214. Mutual funds typically list the securities that they have lent in their schedule of investments with a footnote stating that “[a]ll or a portion of this security is on loan.” Susan C. Peters, *Accounting Treatment of Loans of Securities*, in SECURITIES FINANCE & LENDING, *supra* note 50, at 205. Mutual fund balance sheets disclose the total value of securities on loan. *Id.* A mutual fund with a short position has negative economic ownership which must be disclosed; implicit in this disclosure is that the fund had borrowed shares.

and within disclosure regimes, do not effectively address either empty voting or hidden (morphable) ownership, and for the most part do not cover share lending and borrowing. In big picture, Schedules 13D and 13G focus on voting ownership, while Section 16 and mutual fund disclosures focus on economic ownership. Form 13F covers only specific positions in publicly traded shares and exchange-traded options. Some of these radical differences in focus may have once made sense. Some of the omissions may once have been unimportant. But in a world of easy decoupling of voting and economic ownership, plus a massive OTC derivatives market, greater uniformity and fewer omissions are called for.

The “integrated ownership disclosure” proposal that we set forth below would provide improved though still imperfect disclosure of both empty voting and hidden ownership, while substantially simplifying the current ownership disclosure rules. Our proposal builds on existing disclosure technology and requires only information readily accessible to investors. In large part, the proposal simply extends existing disclosure practices 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 adding a single set of rules for what must be reported. We expect, but cannot prove, that overall disclosure costs would decline.

We propose simplifying the disclosure architecture by (1) moving toward common standards for triggering disclosure and for disclosing positions once disclosure is required; (2) providing a single set of rules for which ownership positions to disclose and how to disclose them; (3) requiring disclosure of all positions conveying voting or economic ownership, arising from shares or coupled assets; and (4) requiring symmetric disclosure of positive and negative economic ownership. We do not directly address disclosure of related non-host assets, but our proposals would often require disclosure of holdings in both acquirers and targets, which are one important category of related non-host assets.

Our disclosure proposal should capture hidden (morphable) ownership reasonably well for current Schedule 13D and Section 16 filers, because these filers must report ownership and changes therein promptly. Disclosure will be patchier for other filers because they must report only end-of-period positions. We return to this issue in Part IV.D, below.

We expect that this new information will be useful to investors, as well as to corporations, Delaware judges, banking and securities regulators, and legislators as they contemplate how to respond to new vote buying. But

even if the new disclosure had no other value, the simplification we propose—largely integrating what are now five discrete ownership disclosure systems—would likely be worthwhile.

In offering this proposal, we do not reassess the current disclosure thresholds, disclosure frequencies, and delay periods, nor, to an appreciable extent, which investors must report their positions. Implicitly, then, we assume that there is rough economic or political logic supporting the current rules. We also believe, however, that whatever the thresholds and delay periods may be, the disclosure rules should be internally coherent. Consider a tax analogy. One can believe that current tax rates are too high, and still prefer a system with few loopholes over a loophole-ridden system that produces lower overall taxes but favors the tax-clever and produces horizontal inequity.

We recognize that ownership disclosure has both benefits and costs.²¹⁵ On the benefit side, share pricing will be more efficient if investors know what major investors are doing and have advance notice of possible changes in control. Moreover, price-relevant information often has greater private value than social value. Requiring disclosure can reduce costly, often duplicative, private search for information. On the cost side, private search for information can enhance share price efficiency, and the corporate control market is animated in part by private returns to search. Thus, outside investors must receive some reward for finding 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.

In addition to their potential economic logic, large shareholder disclosure rules respond to the intuition that investors should know who a company's major shareholders are and whether those shareholders are buying or selling, and that a company's insiders should have an opportunity to respond to a takeover attempts. The history of ownership disclosure suggests that, precise thresholds and delay periods aside, our society will not tolerate hidden control of major companies, nor control contests waged behind closed doors. So disclosure of major positions there will be. Our

215. We discuss the benefits and costs of disclosure in more detail in Hu & Black, *Hedge Funds and Empty Voting*, *supra* note 24, at Part 4.

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

Our proposed disclosure reforms build largely on the Section 16 rules and current mutual fund practice. For derivative positions, we would extend Section 16-type disclosures to shareholders who report on Form 13F and Schedules 13D and 13G. Short positions 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 that must report on Form 13F by counting any economic ownership of shares, directly or through derivatives, toward the \$100 million threshold. We would count on a gross basis all long and short positions toward the triggering threshold for Schedules 13D and 13G and Form 13F. Banks, broker-dealers, and others who hold both proprietary and investment advisory positions, would report each separately, subject perhaps to limited exceptions for short-term positions held in connection with market-making activities.

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

We regard as a very close question whether a large pure short economic position, defined as negative economic ownership with no accompanying voting ownership, should require disclosure. Our proposal errs on the side of simplicity and symmetry in providing that both long and short positions would be disclosed and count for triggering a filing requirement.²¹⁶

Regulators will need to develop guidelines for reporting of derivative positions that are not addressed by the current Section 16 and mutual fund

216. The principal arguments for disclosure are the value of simplicity and symmetry, the practical difficulty in drafting an exception that is limited to a short position with no accompanying formal or informal voting rights, reduced gaming risk, and the value to investors of more complete knowledge of other investors' market 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. For a discussion of how U.S. tax and regulatory rules raise the cost of short selling, and, thus, contribute to market inefficiency, 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).

rules. As a lodestar principle, we believe that reporting persons should disclose information sufficient to let a derivatives dealer, with access to information on volatility and other pricing parameters, 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, the reporting person would set out the core contractual terms—principally the strike price, the expiration date, the number of shares, the counterparty, and 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 the “cubbyhole” approach used in the current 13F rules.²¹⁷

Our proposals for enhanced disclosure of economic ownership are generally consistent with recent regulatory changes made in the United Kingdom and Hong Kong in response to certain aspects of the new vote buying. In 2005, the U.K. Panel on Takeovers and Mergers extended large shareholder reporting to persons with either economic or voting ownership.²¹⁸ In 2003, Hong Kong similarly extended large shareholder disclosure requirements to persons with both long and short equity derivatives positions.²¹⁹ The 2006 Henderson Investment incident may prompt Hong Kong to take further action.²²⁰ The most important difference

217. For analyses of how financial innovation subverts traditional classification-based regulation, see Hu, *Misunderstood Derivatives*, *supra* note 4; Hu, *supra* note 191; Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319 (1991).

218. See CODE COMM., U.K. PANEL ON TAKEOVERS & MERGERS, DEALINGS IN DERIVATIVES AND OPTIONS: DETAILED PROPOSALS RELATING TO AMENDMENTS PROPOSED TO BE MADE TO THE TAKEOVER CODE—PART 1: DISCLOSURE ISSUES §§ 5.1–5.2 (May 2005); CODE COMM., U.K. PANEL ON TAKEOVERS & 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. 2005); PANEL EXECUTIVE, U.K. PANEL ON TAKEOVERS & MERGERS, SUMMARY OF CHANGES TO THE TAKEOVER CODE (Oct. 2005). Cf. Fin. Servs. Auth. (U.K.), *Hedge Funds: A Discussion of Risk and Regulatory Engagement* (Fin. Servs. Auth., Discussion Paper No. 05/4, 2005).

219. See HONG KONG SEC. & FUTURES COMM'N, OUTLINE OF PART XV OF THE SECURITIES AND FUTURES ORDINANCE (CAP. 571)—DISCLOSURE OF INTERESTS (Aug. 2003) [hereinafter HONG KONG SFC, PART XV OUTLINE]; HONG KONG SEC. & FUTURES COMM'N, REVIEW OF THE DISCLOSURE OF INTERESTS REGIME UNDER PART XV OF THE SECURITIES AND FUTURES ORDINANCE (Jan. 2005) [hereinafter HONG KONG SFC, REVIEW]. Previously, insiders had reportedly made extensive use of OTC derivatives to reduce or increase their economic ownership in their own companies, precisely because of what the head of equity derivatives at a major institution called the “nondisclosure factor.” Melvyn Westlake, *Rules of the Game*, ASIA RISK, Apr. 2002, available at <http://www.asiarisk.com.hk/public/showPage.html?page=3206>.

220. See, e.g., Cheng, *supra* note 57.

between the United Kingdom and Hong Kong approaches is that Hong Kong does (as we do), while the United Kingdom 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.²²¹

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

221. 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, 446–48 (2005).

TABLE 4. Proposal for more integrated ownership disclosure

This table summarizes the disclosure rules 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	

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

As we have seen, large shareholder disclosure under Schedule 13D or 13G focuses on voting ownership. Our proposed extension is simple: voting and economic ownership should each be reported, and should each count toward triggering the reporting obligation. The Section 16 concept of economic ownership can be carried over to Schedules 13D and 13G and expanded to include share borrowing and lending positions which affect voting ownership. Each position would be separately disclosed using transaction codes adapted from Section 16 reporting. 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. We would require 13D reporting if a position is held with a view toward affecting a shareholder vote, even if the vote does not affect control.

Take Perry's position in Mylan as an example. Perry, once it crossed 5% ownership of Mylan, would report on Schedule 13D because it held its position with a view toward affecting the Mylan vote on acquiring King. It would report each position conveying positive or negative economic or voting ownership and attach its hedging 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 the loss of information should be modest because most institutions will have to report their positions quarterly on Form 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 file a Schedule 13D or 13G. The hedge fund's overall position is net short, yet it may well have access to 6% voting rights if a shareholder vote arises that can affect company value.

For some derivative positions, questions will arise as to how to measure effective economic exposure. An equity swap conveying the economic return on 1 million shares should count as economic ownership of 1 million shares. But what about a call option? In derivatives terminology, δ ("delta") is the change in option value for a small change in

the price of the underlying asset.²²² 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?

We believe that reporting the precise economic ownership for call options and other derivatives with deltas that vary with share price or other factors would add undue complexity and cost. We propose instead a cruder approach. Currently, Rule 13d-3 provides a simple rule for reporting call options: one reports the number of shares that the option relates to.²²³ This is equivalent to assuming $\delta = 1$. We believe the number of matched shares for a derivative position should be computed in a similar fashion. This is consistent with the recent reforms in Hong Kong.²²⁴

3. Institutional Money Managers and Mutual Funds

We propose that 13F disclosure of economic and voting ownership should use the same format and contain information about the same positions as Schedules 13D and 13G. The principal differences would be: (1) the trigger for reporting; and (2) Schedule 13D would continue to require reporting of *changes* in position, while Form 13F and Schedule 13G would require only period-end reporting. The current reporting threshold is ownership of \$100 million in section 13(f) securities. We would change this to \$100 million in economic ownership of U.S. equity securities. This will prevent an institution from avoiding disclosure by holding primarily equity derivatives and keeping its direct equity holdings under \$100 million.

Currently, data on share lending is sparse. Even the aggregate size of the market can only be estimated.²²⁵ The largest borrowers of stocks are prime brokerage firms; the largest lenders are major institutions. Beyond these facts, and some individual anecdotes, little else is known. Simply aggregating the share lending and borrowing that would be reported by 13F

222. More technically, delta is the partial derivative of the option price with respect to the price of the underlying asset. E. BRIYS, M. BELLALAH, H.M. MAI & F. DE VARENNE, *OPTIONS, FUTURES AND EXOTIC DERIVATIVES* 124 (1998).

223. 17 C.F.R. § 240.13d-3 (2005).

224. See HONG KONG SFC, PART XV OUTLINE, *supra* note 219, § 2.5 (section entitled "How many shares am I taken to be interested in if I hold equity derivatives?").

225. Thus, one specialist's May 2005 estimate of the size of the United States' institutional securities lending market drew on a combination of the firm's own internal client surveys and Federal Reserve statistics. See Plitch, *supra* note 93, at 1. Cf. Dan Barnes, *Learning the Cost of Stock Lending*, *BANKER*, May 2005, at 62, 63 (explaining that the size of the global securities lending market is "fairly unclear").

filers would capture a large fraction of total activity, and provide valuable data on this market.

Cost concerns are more important for Form 13F reports than for Schedules 13D and 13G because every major institutional investment manager would have to file Form 13F on a quarterly basis, and report all positions held. But institutional money managers should have ready access to the portfolio information we propose to collect. Some hedge funds, for example, currently provide quite detailed reports to investors.²²⁶ Thus, there will be a one-time cost in revising internal reports to match the new reporting format, but ongoing 13F filing costs should be similar to current costs, and similar to costs that mutual funds now incur.

Because additional costs will be limited, there should be no howls of outrage at compliance costs. Indeed, we discussed our proposal informally with several major institutions (both mutual funds and hedge funds), and heard no howls. Their principal concern was with disclosing trading positions that are currently concealed.

Yet, to some extent, we have already crossed that bridge. Form 13F was intended to require institutional money managers to disclose their equity holdings. The reporting is delayed forty-five days after quarter end to reduce the competitive impact of disclosure. Changes in the derivative markets have undermined the completeness of reporting but it is not apparent that the basic tradeoff between disclosure and competitive secrecy was seriously misdrawn, especially because secrecy has more private value than social value. The money managers we spoke to were generally comfortable with the current delay periods.

The foregoing changes to Form 13F would result in mutual fund advisory firms (such as Fidelity and Vanguard) providing greater decoupling-related information as to their aggregate holdings. The individual funds these firms manage would continue to provide the fund-specific disclosures on holdings that they do so currently. Both advisory firms and individual funds, however, would be subject to the new empty voting disclosure rules to which we now turn.

226. For a discussion of so-called risk reporting to hedge fund investors, see LESLIE RAHL, *HEDGE FUND RISK TRANSPARENCY* 65–81 (2003).

D. DISCLOSURE OF LARGE EMPTY VOTING POSITIONS

Periodic reporting (Form 13F, Schedule 13G, and mutual fund disclosure), will miss most empty voting strategies that are used for a short period around that record date. For example, an institution could borrow up to 5% of a company's shares, vote them, reverse the borrowing before the quarter ends, and report nothing. Current filers will report their positions, but not whether they engaged in empty voting.

To address empty voting by periodic filers, we propose that these filers report any occasions where they cast votes which substantially exceeded their economic ownership. To limit the reporting burden for filers who engage in ordinary hedging activities, we would only require disclosure if a filer voted shares which exceeded its economic ownership by at least 0.5% (or some other threshold amount) of a company's outstanding shares. We would rely on the crude rules discussed above to measure economic ownership. A precise measure of economic ownership is not critical if the goal is only to determine whether a position must be disclosed. Greater precision would be needed if one were to limit voting rights based on economic ownership.

Consider the AXA-MONY merger as an example.²²⁷ Suppose that a hedge fund held AXA convertible bonds, wanted the merger to be completed, borrowed 4% of MONY's shares before the record date, voted for the merger, and then reversed the borrowing. The hedge fund would report, in its next 13F filing, that it had borrowed and voted the MONY shares; what issues it had voted on; how it had voted; the dates of borrowing, voting, and position reversal; and its economic ownership of MONY shares and of any related non-host assets that affected its vote (in this case, the AXA bonds). Laxey Partners, in the British Land case, would disclose that it held 1% economic ownership of British Land, but had borrowed shares representing an additional 8% in order to support a proposal to split up British Land.²²⁸

This reporting should not be onerous. It will apply only to institutions that engage in large-scale empty voting. These should be a small fraction of all filers. If empty voting is widespread, the filing burden will be higher, but so will the need for the information.

227. We discuss the AXA-MONY example *supra* in Part II.B.

228. We discuss the Laxey Partners-British Land example *supra* in Part II.B.

This reporting would be on the usual forms, and would occur some time after the vote. Thus, it will usually be made too late to affect the voting outcome. Delayed reporting is a tradeoff of disclosure cost against timeliness. If empty voting is widespread, the decision to allow delayed reporting can be revisited.

We would require current filers (Schedule 13D filers and insiders) to report significant empty voting through an amended filing (a 13D amendment for 13D filers and a Form 4 for insiders).

E. SUMMARY

As a response to hidden (morphable) ownership, our integrated disclosure proposal may well be sufficient. For empty voting, disclosure will be valuable, but may be only a first step. Disclosure seems likely to reduce the incidence of empty voting. Even hedge funds may sometimes hesitate to do publicly what they might do in the dark. Insiders might hesitate, as well. Derivatives dealers might take “reputational risk” into account in deciding whether to facilitate a client’s empty voting.

Disclosure should also provide the information required to assess the need for further empty voting reforms. This information will also prove useful for international coordination. The new vote buying is international in scope, so coordination will be important for any regulatory response. This need for both information and international coordination has been recognized by the private sector. The principal current private effort to address new vote buying is taking place through the International Corporate Governance Network (“ICGN”), a group of major institutional investors drawn from the United States (including CalPERS—the California Public Employees’ Retirement System), the United Kingdom (including Hermes), France (including Crédit Agricole), and elsewhere.²²⁹

V. LONGER RUN RESPONSES TO EMPTY VOTING

A. GENERAL CONSIDERATIONS

As we discussed in Part III, the theory and evidence bearing on whether shares should be linked to votes, and on how a market for votes,

229. See INT’L CORP. GOVERNANCE NETWORK, ICGN STOCK LENDING CODE OF BEST PRACTICE (2005); LINTSTOCK, SHARE LENDING VIS-À-VIS VOTING: A REPORT COMMISSIONED BY THE INTERNATIONAL CORPORATE GOVERNANCE NETWORK 3, 22 (2004).

decoupled from shares, might operate, provide mixed signals. There are circumstances in which such a market is problematic, but also circumstances in which, suitably constrained, it could strengthen shareholder oversight of managers. For this and other reasons, including the difficulty of regulating an activity that can take many forms, about which little is yet known, we consider it premature to propose additional rules to address empty voting.

Still, some simple examples can illustrate why some additional regulation will probably be needed. For takeover bids, an unregulated market for shares, coupled with votes, has well-known problems, driven by the high value ascribed to the marginal shares that just convey control, and the subsequent lower value of remaining shares. These problems have led to extensive regulation, including a minimum offer period and a ban on two-tier offers. Similar problems would afflict a battle for control 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. After-the-fact disclosure would not change the hedge fund's ability to profit at other shareholders' expense.

Or consider Scotiabank's decision to refuse to unwind an equity swap and instead vote Sears Canada shares, held to hedge an equity swap, in favor of Sears Holdings' buyout offer.²³⁰ In substance, Scotiabank was apparently an empty voter, akin to a nominal holder, while the hedge fund was perhaps the real economic owner.

There is value, therefore, in developing a menu of possible additional regulatory options and beginning to evaluate their merits. Below, we discuss three families of strategies. The most obvious strategies focus directly on voting rights (Part V.B). A second family involves reforming an aging "voting architecture" that was developed before the emergence of OTC equity derivatives and large-scale share lending (Part V.C). The third involves interventions that would affect supply and demand forces in the markets that support decoupling (Part V.D). We make no claim that the rules we discuss are desirable, only that they are possible.

230. We discuss the Sears Canada incident *supra* in Part II.C.

A further issue is the locus of regulation. Some responses are federal in nature, while others can be implemented by the stock exchanges, by states, or by individual companies. At the federal level, securities law focuses on disclosure. The SEC likely cannot directly regulate empty voting. Such an effort would affect the internal affairs of corporations, traditionally governed by state law.²³¹ Moreover, one might hesitate before seeking further federalization of corporate law, soon after the major step in that direction taken in the Sarbanes-Oxley Act. A federal response could lock in overregulation—as some scholars suggest may be the case with Sarbanes-Oxley.²³² Thus, there could be reason to prefer responses that do not expand the SEC's regulatory reach.

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.²³³ Thus, in a recent article, Shaun Martin and Frank 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.”²³⁴

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 multiple ways to decouple votes from economic ownership. Martin and Partnoy address only short sales and option positions. They do not discuss, and may be unaware of, record date capture, equity swaps, and other alternatives. One also needs a good way to measure economic ownership.

231. See *Business Roundtable v. SEC*, 905 F.2d 406, 413 (D.C. Cir. 1990) (invalidating the SEC's effort to ban dual-class recapitalizations because it “invades the ‘firmly established’ state jurisdiction over corporate governance”); Bainbridge, *supra* note 152.

232. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *YALE L.J.* 1521 (2005); Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-listed in the US* (Univ. of Texas, Law & Econ. Research Paper No. 55, 2005), available at <http://ssrn.com/abstract=876624>.

233. Martin & Partnoy, *supra* note 26, at 776.

234. *Id.* at 793–94. In effect, Martin and Partnoy deal with certain narrow aspects of what we refer to as empty voting, and do not deal at all with hidden (morphable) ownership, the other half of the new vote buying.

A further problem is determining when a single “investor” holds equivalent economic and voting ownership. Suppose, for example, that an investment advisory firm runs both a conventional, long-only mutual fund that holds General Motors shares, and a hedge fund, with a different portfolio manager, which is short General Motors shares. Should the conventional fund lose the power to vote because of the hedge fund’s short position? Should it matter whether the advisory firm centralizes its voting decisions or delegates them to individual fund managers?

Bringing related non-host assets into a calculus of overall economic interest raises further complexities. Consider the AXA-MONY transaction.²³⁵ The problem was not that holders of AXA convertible bonds had a *negative* economic interest in MONY, as that they had an orthogonal interest which was their primary concern.

Once one moves from a 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 that would exceed economic ownership, the technical difficulties in measuring economic ownership become fearsome. One must grapple with complex derivative positions, in which the effective economic exposure changes whenever share price changes. In developing the integrated disclosure proposal in Part IV, we attempted to invent a workable scheme for numerical disclosure of effective economic ownership. The effort became absurdly complex and we gave it up as misguided. A substantive limit on voting rights would revive those difficulties. An effort to limit voting rights due to an investor holding related non-host assets would raise further complications.

Moreover, as we discussed in Part III, vote buying is not always harmful. It can sometimes move votes from passive or ignorant investors to investors who can cast informed votes.²³⁶ Insiders who hold partly hedged positions will 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 requires measuring economic ownership with reasonable precision, persuade us to err on the side of caution. At this point, we are neither ready to recommend limiting

235. We discuss this transaction *supra* in Part II.B.

236. See Christoffersen et al., *supra* note 21 and our position on their analysis in Part III.B.

voting rights when they substantially exceed economic ownership, nor to argue that such a rule would be a serious error. The disclosure we propose above may provide the knowledge needed to draft a workable rule. It would also let courts grapple with this issue on a case-by-case basis.

2. Voting by Record Owners; Extension to Equity Swaps

The case of empty voting by shareholders with zero economic ownership deserves special attention because it is common and, in part, already regulated. As we discussed in Part III.C, our system of record ownership already decouples economic from voting ownership. Our legal system has responded by partly recoupling voting and economic ownership. Economic owners can provide voting instructions, which record owners must follow; if no instructions are given, the record owner can vote on routine matters but not major matters.

These rules can provide precedent for a broader effort to reconnect voting rights to economic ownership when technology has severed them. Consider, for example, a derivatives dealer who holds matched shares to hedge the interest leg of an equity swap. As we discussed in Part II.C, the holder of the equity leg of the swap often has informal voting rights. Disclosure aside, these informal rights reconnect voting and economic ownership in a manner analogous to the rules governing record owners. In this situation, the market is usually placing voting rights where they ought to be, so intervention beyond disclosure may not be needed.

One might also extend current rules governing record owners to dealers who hold matched shares to hedge equity swaps.

3. Corporation Opt-in

An obvious alternative to mandatory limits on empty voting would be to let corporations decide whether to require a link between economic and voting ownership.²³⁷ There is a spectrum of options.

At the incremental end, companies can separate dividend and voting record dates, which will limit the impact of dividend capture strategies on voting rights. Some investors borrow shares around the dividend record date to capture the dividends paid by the company.²³⁸ For instance, a quirk

237. We first discussed the opt-in approach in the initial 2005 draft of this Article. *See supra* note 24.

238. PAUL MYNERS, REVIEW OF THE IMPEDIMENTS TO VOTING UK SHARES 4–5 (2005).

in French tax law lets French banks profit from this strategy. Their actions account for a significant fraction of share lending in the United Kingdom.²³⁹ Dividend-capture traders have no economic interest in the company. Their borrowing leaves fewer votes in the hands of the lenders—often pension funds and other institutions who might cast informed votes. The July 2005 draft of the ICGN Stock Lending Code of Best Practice urges companies to avoid this problem by separating their dividend and voting record dates.²⁴⁰ Company insiders, however, may have little incentive to take a step that moves more votes into interested hands.

How can a corporation limit empty voting by outside investors? A board-adopted bylaw is problematic from a policy perspective because it can easily be structured to entrench insiders. It also is not clear how much a bylaw could restrict voting rights, given that corporate statutes grant voting rights to record owners without regard to economic ownership. Moreover, case law promises close scrutiny of unilateral board actions affecting shareholder votes. As the Delaware Supreme Court recently stated in *MM Cos. v. Liquid Audio*, the 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.”²⁴¹

A charter amendment is more likely to succeed. Under Delaware law, one-share-one-vote is merely a default rule which applies “unless otherwise provided in the certificate of incorporation.”²⁴² Moreover, the most analogous case, *Williams v. Geier*, suggests that a charter amendment affecting voting rights will receive deferential business judgment review.²⁴³ While the dissent in *Williams* argued for intermediate review under *Unocal*

239. See MARK C. FAULKNER, INT’L SEC. LENDING ASS’N, SECURITIES LENDING & CORPORATE GOVERNANCE 7–8 (2005) (providing charts showing the difference between normal lending levels and lending levels near dividend dates); Angus McCrone, *Hints for Private Punters from the Secretive World of Stock Lending*, EVENING STANDARD (London), Jan. 30, 2004, at A44.

240. LINTSTOCK, *supra* note 229, § 8.4. See also MYNERS, *supra* note 238, at 4–5 (noting the problem, but not proposing a solution). Setting separate voting and dividend record dates is permitted under Delaware law. DEL. CODE ANN. tit. 8, § 213 (2005).

241. *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003).

242. DEL. CODE ANN. tit. 8, § 212(a) (2005).

243. *Williams v. Geier*, 671 A.2d 1368, 1377 (Del. 1996) (affirming summary judgment upholding a charter amendment). This case involved a “time-phased” voting arrangement in which shareholders who held shares for three years would have ten votes per share, while other shareholders would have only one vote per share. *Id.* at 1370–71. See also *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988); GILSON & BLACK, *supra* note 39, at ch. 24.

Corp. v. Mesa Petroleum,²⁴⁴ we suspect that even under this standard, the Delaware courts would allow an anti-empty-vote charter amendment that is supported by a colorable nonentrenchment motive.

On the other hand, stock exchange rules might block some potential charter amendments. Consider, for example, a time-phased voting plan, similar to the one approved in *Williams*, which limits the voting rights of short-term shareholders.²⁴⁵ This likely would run afoul of NYSE rules, which state that voting rights cannot be “disparately reduced or restricted through any corporate action or issuance” and offer as examples “time phased voting plans” and “capped voting rights plans.”²⁴⁶ How the NYSE will apply these rules to new types of charter amendments is necessarily unknown.²⁴⁷

Some vote-limiting strategies could also run afoul of the federal proxy rules. Consider, for example, a charter provision requiring shareholders to attest that they have economic ownership substantially equal to the number of votes they propose to cast. Given the SEC’s broad power to regulate the proxy process, including the form of proxies, such a provision would probably require SEC assent.

Beyond the positive question of what charter amendments are permissible, there are the policy questions: What limits should there be on charter amendments that address empty voting? Within those limits, what should companies do?

A charter provision adopted before a company goes public is likely not to be seriously inefficient, because if it were, the insiders would expect to receive a lower price for their shares. This market price response presumably explains why most U.S. companies go public with a one-share-one-vote structure. Scholars debate, however, the extent to which initial public offering (“IPO”) pricing captures more subtle variations in

244. *Id.* at 1385–87 (Hartnett, J., dissenting) (referencing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)).

245. This approach has a historical antecedent as a response to (truly old) empty voting. Shareholders often gamed the original English rule of one vote per shareholder by splitting their shares among their friends, each of whom could then cast one vote. Parliament responded to this strategy in 1767, by providing that only shareholders who had held shares for at least six months could vote. This limited vote-splitting to long-term friends, who were presumably in scarcer supply. See C.A. COOKE, CORPORATION TRUST AND COMPANY: AN ESSAY IN LEGAL HISTORY 74 (1951).

246. NYSE, Inc., Listed Company Manual § 313(A) (1998).

247. The NYSE states that its voting rights policy “will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time.” *Id.*

shareholder rights.²⁴⁸ Those doubts about the efficiency of IPO charters would likely include provisions that respond to empty voting.

In addition, the usual arguments for the efficiency of IPO charters do not apply to midstream charter amendments. 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.²⁴⁹ Companies could propose charter amendments that allow empty voting techniques used by insiders while restricting techniques used by outside investors. Time-phased voting is an example of a rule that could limit outsider empty voting and entrench insiders. One could reduce the bias in the charter amendment process by changing corporate law to allow shareholders to unilaterally amend company charters.²⁵⁰ A further concern is that empty voting allows the shareholder vote on a charter amendment to itself be bought. In the end, for midstream charter amendments, neither boards nor shareholders can be trusted to respond to empty voting in a value-enhancing way.

Thus, the “company choice” approach needs to be cabined. Yet it seems premature to assess how to limit charter amendments without knowing either the dimensions of empty voting or how companies might respond. Some charter provisions might be unobjectionable. Others might be acceptable at the IPO stage, but problematic midstream.

4. State Corporate Law

A separate question from the extent to which companies can limit vote buying in their charters is whether corporate law does or should limit empty voting. As discussed in Part III.D, there are no explicit legal constraints as a general matter. Insiders, however, might be constrained by fiduciary duty. The rigor with which courts police shareholder elections makes it likely that company officers or directors would 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, for example,

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

249. 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).

250. For such proposals, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865–70 (2005); Bernard Black & Reinier Kraakman, *A Self-enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945–46 (1996).

Walter Hewlett claimed that H-P management had procured a favorable vote from Deutsche Bank through promises or threats related to future business dealings between the two companies.²⁵¹ H-P's managers said they had made no promises or threats and Chancellor Chandler concurred.²⁵² Yet it seems likely that procuring votes through a promise or threat would violate management's fiduciary duty and constitute classic vote buying. Suppose, instead, that H-P management had engaged in *new* vote buying to swing the outcome. There would be no classic vote buying, but the breach of fiduciary duty would be the same. Thus, the courts would likely disallow the procured votes.

Other efforts at empty voting could be hard for courts to reach under current doctrine, however. Consider, for example, a company founder or manager who hedges most of his economic ownership, well before a particular vote arises. Corporate law does not question the exercise of voting rights or even require disclosure of these arrangements; disclosure comes from the federal Section 16 rules. The insider need only avoid tripping the Section 16 short-swing profit forfeiture rules.

Judges may also need to update current doctrine on classic vote buying. The definition of what constitutes vote buying could be expanded to include, for instance, record date capture or acquiring votes by acquiring shares and then shedding economic interest. It seems premature to speculate as to how courts should address empty voting, given the multiple factual contexts in which it can be used. It is not hard, however, to see courts disallowing voting by empty voters with negative economic ownership or negative overall economic interest. This situation is analogous to cases involving voting by directors whose personal interests conflict with the corporation's interests.²⁵³ In both situations, the usual presumption that votes will be cast with the goal of increasing shareholder wealth is thrown into doubt.

In addition to limiting on voting rights, state law makers could respond to empty voting. As discussed above, corporation opt-in through a

251. *Hewlett v. Hewlett-Packard Co.*, No. Civ.A. 19513-NC, 2002 WL 818091, at *1, *8, *9 (Del. Ch. Apr. 30, 2002).

252. *Id.* at *9 (finding that “[d]uring the conference call [between Hewlett-Packard and Deutsche Bank], no one from HP used any threats or inducements regarding future business relationships Instead, [Hewlett-Packard CEO Carleton] Fiorina and [CFO Robert] Wayman argued HP’s case entirely on the merits.”).

253. 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).

midstream charter amendment is problematic because managers will predictably propose rules that primarily restrict vote buying by outsiders. A more balanced approach might limit voting by anyone, insider or outsider, with substantially greater voting than economic ownership, though this would raise the problem of how to measure economic ownership.

Yet 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.²⁵⁴ The risk that a voting outcome was influenced by empty voting strengthens their case. 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 favored by a majority shareholder vote.²⁵⁵

C. STRATEGIES FOCUSED ON VOTING ARCHITECTURE

The new vote buying has put stress on a “voting architecture” developed before the emergence of equity derivatives and large-scale share lending. At present, 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 fail if all shareholders entitled to vote did so.

Many institutional investors lend through agents, and do not keep track of which shares have been lent.²⁵⁶ Of the thirty-nine institutions which responded to a 2004 ICGN questionnaire on lending practices (including pension funds, mutual funds, banks, insurance companies, and other asset managers), thirty-one had lent shares.²⁵⁷ Most relied on agents and half reported that the agent could lend without the respondent’s knowledge. A substantial majority (twenty-one of thirty-one) reported that they “[r]arely, only in special circumstances” recall shares in order to vote

254. Gilson & Schwartz, *supra* note 116.

255. 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, 52–59 (2004).

256. See, e.g., Martin Dickson, *Myners’ Whiffometer*, *FIN. TIMES* (London), Mar. 15, 2005, at 22 (Companies) (“[S]ome fund managers may not be aware that the shares have been lent, since the beneficial owners may contract directly with custodians to lend.”); Kit Bingham, *Myners Rejects Calls for Curbs on Stock Lending*, *FIN. NEWS ONLINE*, Mar. 21, 2005.

257. See *LINTSTOCK*, *supra* note 229.

them.²⁵⁸ Moreover, attempts to recall shares for voting purposes sometimes failed. Based on this survey and other data, the ICGN's Securities Lending Committee is drafting a lending code of best practice. The current (July 2005) draft has detailed descriptions of how share lending stock affects voting rights, and calls for portfolio managers to be kept up to date on whether their shares have been lent.

Other recent analyses are consistent with the ICGN findings. In March 2005, a report sponsored by the Shareholder Voting Working Group—an industry-wide body convened to improve the voting process in the United Kingdom—stated that some fund managers were not aware that their shares had been lent.²⁵⁹ This was the case both for institutions which lend through agents and for institutions which run their own lending programs, where the lending department may not report loans to portfolio managers. Some institutions may not be 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.”²⁶⁰ To address this ignorance, the European Commission has proposed that an intermediary who lends shares on behalf of a beneficial owner should inform the owner of the impact of the loan on voting rights.²⁶¹

Better information may change lender behavior. CalPERS illustrates. CalPERS earned \$103 million from securities lending in the fiscal year that ended June 30, 2004.²⁶² Beginning in 2003, CalPERS has sought to balance its income 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.”²⁶³

Investor interest in preserving voting rights will vary. Any one investor faces a collective action problem: it can profit from lending and its vote probably will not matter. At one end, so-called exclusives (in which a lender agrees to make its portfolio or a portion of its portfolio to a

258. *Id.* at 15.

259. MYNERS, *supra* note 238, at 4–5, 11.

260. Kit Bingham, *Concern Grows over Borrowed Votes*, FIN. NEWS ONLINE, May 8, 2005.

261. *See* Kit Bingham, *EC Acts to Speed Up Translated Reports*, FIN. NEWS ONLINE, May 22, 2005.

262. Gregory Crawford, *Asking Questions: Securities Lending Scrutinized*, PENSIONS & INVESTMENTS, Oct. 4, 2004, at 15.

263. *See* CALPERS, SECURITIES LENDING AS IT RELATES TO PROXY VOTING 3 (2005) (report by CalPERS staff). We confess to being a bit skeptical about CalPERS' ability to know its borrowers well enough to implement this goal.

particular borrower) are generally awarded to the highest bidder(s), with little consideration given to other factors.²⁶⁴ At the other extreme, some institutional investors (such as Europe's biggest pension fund) have decided to stop lending shares despite the impact on their returns.²⁶⁵

For annual meetings, share lenders' decisions whether to hold and vote shares face a technical problem. The record date will often have passed before the company distributes its proxy statement. Hence, investors may not know what is on the agenda (beyond the usual need to elect directors and approve the auditor). A simple fix is available: companies need merely disclose the expected voting agenda when they announce record dates. To be sure, this same information could encourage record date capture. Still, providing timely information to share lenders seems preferable to the current system. Companies that do not offer this disclosure voluntarily could be required to do so.

A further step for share lenders, beyond knowing that they have lent their shares, is knowing to whom they have lent. Today, lenders often lend through agents, or lend to broker-dealers who act on behalf of clients who are unknown to the lender. Efforts are under way to require U.S. banks or broker-dealers that arrange securities loans to advise the *borrower* of the *lender's* identity. The concern is with credit risk, since the lender holds the borrower's collateral.²⁶⁶ These efforts could be extended to the converse, advising the lender of the borrower's identity.

Another concern is mechanical problems associated with voting.²⁶⁷ Currently, brokers who hold shares in street name solicit voting instructions from their clients. Suppose that a broker holds 2 million shares in a pooled account on behalf of margin customers, has lent 1 million shares, but

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

265. 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.

266. See *DTC Begins Testing for Agency Lending Disclosure*, SEC. INDUSTRY NEWS, July 13, 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 Network, Frequently Asked Question—Customer Identification Program Responsibilities Under the Agency Lending Disclosure Initiative (Apr. 25, 2006), http://www.fincen.gov/cip_faq.html.

267. For an introduction to these over-voting issues, see Martin & Partnoy, *supra* note 26; Chris Kentouris, *Decisive Movement on Proxy Miscounts*, SEC. INDUSTRY NEWS, Dec. 6, 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 Bus. Admin., Working Paper No. FR 01-19, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285768.

receives voting instructions covering 1.5 million shares. There is no coherent way to ensure that the broker will cast only 1 million votes, nor for the broker to decide whose voting instructions will count, nor for companies to respond if the broker casts more than 1 million votes—a problem known as “overvoting.” The NYSE issued a warning on overvoting for the first time in 2004, suggesting growing concern.²⁶⁸ Overvoting has come up in at least two recent proxy fights. In one, an election inspector disallowed 232,000 votes cast by a broker who had overvoted by less than 1000 votes, thus disenfranchising shareholders because of their broker’s error; the court upheld the inspector’s decision.²⁶⁹ The Securities Transfer Association, a trade group for transfer agents, reviewed 341 contested shareholder votes in 2005—and found overvoting in all of them.²⁷⁰ 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.”²⁷¹

One 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 for companies to allow this number of votes, even if the broker errs and overvotes. Another better solution might be to let share lenders elect whether to retain voting rights. Borrowers who need voting rights would have to borrow them from lenders who are willing to part with them. Borrowers for whom voting rights are unimportant could borrow shares-without-votes (presumably at lower cost) from lenders who wish to retain their voting rights. These borrowers would, in effect, borrow only the economic return on shares.

In sum, the current procedures for share voting and share lending need updating, if they are to provide lenders and borrowers with the information and options they need to decide what to do with their voting rights.

268. Kentouris, *supra* note 267.

269. See *Seidman & Assocs. v. G.A. Fin., Inc.*, 837 A.2d 21 (Del. Ch. 2003). See also Robert C. Apfel et al., *supra* note 267 (discussing a proxy contest at Integrated Circuit Systems and associated voting actions taken by brokers).

270. Bob Drummond, *One Share, One Vote: Short Selling Short-circuits the System*, INT’L HERALD TRIB., Mar. 1, 2006, at 20.

271. *Id.* (quoting Thomas Montrone, CEO of Registrar & Transfer, which oversees shareholder elections).

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 lending market. On the “supply” side of the market, one could regulate share lenders, lending agents, and derivatives dealers. Conveniently, most of these entities are subject to federal regulation. On the “demand” side, one could regulate the purposes for which hedge funds and other investors could acquire voting rights decoupled from economic ownership. We set out a few possibilities below, focusing primarily on share lending.

1. Limiting Share Lending and Requiring Institutional Voting

One approach would focus on institutions’ choice to lend shares around record dates. There is already a limitation on mutual fund lending, albeit not adopted with the new vote buying in mind. Under section 17(f) of the Investment Company Act, a mutual fund must keep its shares and other assets in the custody of a bank or another specified entity.²⁷² In a series of no-action letters, the SEC staff has taken the position that mutual funds violate section 17(f) if they lend at any given time securities representing more than one-third of their assets.²⁷³

Regulators could also encourage lenders to recall shares for voting purposes. Mutual fund and pension fund regulators already do this to some extent. For mutual funds, the SEC has stated in a no-action letter that

[w]e 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.²⁷⁴

272. See Peter A. Ambrosini & Karen B. Clark, *Custody of Mutual Fund Assets*, in MUTUAL FUND REGULATION § 10:1 (Clifford E. Kirsch ed., ring-bound ed. 2005).

273. See, e.g., The Brinson Funds et al., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1024 (Nov. 25, 1997); State Street Bank & Trust Co., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4607 (Sept. 29, 1972) [hereinafter State Street Bank & Trust, September]; State Street Bank & Trust Co., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4798 (Jan. 29, 1972).

274. State Street Bank & Trust, September, *supra* note 273, at *2. Cf. Peters, *supra* note 214, at 209 (explaining that mutual funds must have the ability to recall any security on loan to vote on a material event proxy).

This approach often lacks bite for annual meetings, partly for the technical reason noted above—the record date has typically passed before the company distributes its proxy statement. For extraordinary meetings, the agenda is known, but we are not aware of SEC efforts to enforce this guidance. Indeed, the SEC’s recent, controversial rules requiring mutual funds and investment advisers to disclose how they vote is silent on share lending. The adopting release states that funds and advisers can choose not to vote if the costs of doing so outweigh the benefits, and offers examples involving foreign shares.²⁷⁵

The Department of Labor (“DoL”) takes a similar approach to voting by pension plans subject to the Employment Retirement Income Security Act of 1974 (“ERISA”) (basically, company pension plans but not public pension plans). The DoL encourages voting but does not require pension plans to recall lent shares for a material vote.²⁷⁶ For foreign shares, the DoL notes that, although plan fiduciaries have a fiduciary responsibility to vote on issues that may affect share value, the Department recognizes that “the cost of exercising a vote on a particular proxy proposal could exceed any benefit that the plan could expect to gain in voting on the proposal.”²⁷⁷

A similar analysis presumably would apply to a pension plan deciding whether to vote or lend shares in U.S. companies. At the same time, the DoL appears to expect that plan trustees will recall lent shares in order to cast important votes. In a 1979 advisory opinion on a proposal to let employee benefit plans lend their shares, the Department stated that “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.”²⁷⁸ The DoL has also informally

275. See Final Rule, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 33-8188, 2003 WL 215451 (Jan. 31, 2003); Final Rule, Proxy Voting by Investment Advisers, Investment Advisors Act Release No. IA-2106, § II(A)(2)(a) & n.3, 2003 WL 255222 (Jan. 31, 2003) (discussing the circumstances when investment advisors need not vote).

276. See Interpretive Bulletin 94-2, in Interpretive Bulletins Relating to the Employment Retirement Income Security Act of 1974, 59 Fed. Reg. 38,86 (Dep’t of Labor, July 29, 1994) (to be codified at 29 C.F.R. pt. 2509) [hereinafter Interpretive Bulletin 94-2]; Clifford E. Kirsch, *Proxy Voting*, in MUTUAL FUND REGULATION, *supra* note 272, § 11.4 (describing the DoL’s approach).

277. Interpretive Bulletin 94-2, *supra* note 276, at 38,862.

278. Pension & Welfare Benefit Programs, Op. Dep’t of Labor No. 79-11A, 1979 ERISA LEXIS 81, at *6 (Feb. 23, 1979).

advised pension fiduciaries to consider carefully whether to lend shares around a record date for an important vote.²⁷⁹

One can readily imagine regulators strengthening this guidance, perhaps bringing an enforcement action or two, or extending to other classes of institutional investors either a nudge or a firm requirement to recall lent shares in order to cast important votes. The NYSE's list of major voting matters, on which broker-dealers can vote shares they hold of record only if instructed by clients, could be adapted to this use.²⁸⁰ The desirability of such a rule, however, is unclear. One reason why most institutional investors are usually passive is the conflicts of interest they face when voting. Public pension funds are not beholden to companies, but can have political rather than value-enhancing motives.²⁸¹ One might get better voting outcomes if institutions could lend shares to unconflicted hedge funds than if institutions are forced to vote themselves.

2. Safe Harbor for Voting Instead of Lending Shares

A more modest step would address the dilemma faced by an institutional investor which can either lend shares and profit from doing so, or hold and vote the shares. Lending will often be privately optimal, but collectively, institutional voting could benefit all shareholders. The inability of any one institution to capture the positive externality from voting will produce too much lending. This collective action problem is exacerbated because the revenues from lending are concrete while the value of voting is tough to quantify. Moreover, for institutions that owe fiduciary duties to investors or beneficiaries, standard measures of compliance with these duties focus on the interests of one's own principal, not society at large.

The SEC and DoL positions encouraging voting, discussed above, likely provide a quasi-safe harbor against fiduciary duty challenges for mutual funds and ERISA pension funds. But matters are less clear for other lenders. Would the trustees of a public pension plan, a college, or foundation violate their fiduciary obligations by leaving money on the table

279. Margaret Price, *Stock Lending, Proxy Votes Don't Always Mix*, PENSIONS & INVESTMENTS, Mar. 16, 1992, at 23 (describing a February 1992 statement of Ivan L. Strasfeld of the Labor Department).

280. See NYSE, Inc., Rule 452 (2002); *supra* note 154 and accompanying text.

281. See Black & Kraakman, *supra* note 250 (discussing institutional conflicts generally); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 795-853 (1993) (discussing public pension fund conflicts).

in order to cast a vote that will benefit all shareholders? The \$100 million plus that CalPERS earns annually by lending shares is real money. There is room for safe harbors for institutions that vote shares rather than lend them around a record date.

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

We outline here some of the existing tax and regulatory schemes that affect the share lending and equity derivatives markets. These could be tweaked to make share lending or equity swap transactions less attractive.

Tax considerations already affect share lending. For example, in 2004, the income tax rate on dividends was cut to 15%. Mutual funds pass their income through to investors. If a mutual fund lends shares and thus receives a dividend-equivalent payment instead of dividends, the substitute payment does not qualify for this reduced tax rate. At the margin, these tax consequences reduce the attractiveness of lending shares.²⁸² Similarly, if a broker lends customer shares and receives a dividend-equivalent payment, the customer will receive “payments in lieu of dividends,” which are not entitled to the 15% rate. The higher tax on dividend-equivalent payments reduces the attractiveness to customers of holding their shares in margin accounts (from which shares can be lent), and could reduce the supply of lendable shares.

Other significant decisions have also affected the taxation of share lending and equity derivatives. Until Congress acted in 1978, share lending had tax risks for both taxable and tax-exempt investors.²⁸³

SEC Regulation SHO in 2004 requires broker-dealers to “locate” securities available for borrowing before completing a short sale.²⁸⁴ Broker-dealers must also meet net capital requirements which turn in part on their share lending activity,²⁸⁵ as well as the SEC’s Customer Protection

282. For discussion of how these tax considerations could give tax-exempt pension funds a comparative advantage over mutual funds in lending, see Phyllis Feinberg, *Reduced Supply: New Law to Slow Mutual Funds’ Securities Lending*, PENSIONS & INVESTMENTS, Sept. 1, 2003, at 6.

283. Taxable investors faced a risk that a loan would be taxed as a sale while tax-exempt investors were concerned that lending income would be taxed as unrelated business income. See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001) (discussing Internal Revenue Code section 1058 for taxable investors and section 512(a)(5) for tax-exempt investors).

284. See Short Sales, Exchange Act Release No. 34-50103, *supra* note 51.

285. See Rule 15c3-1, Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2005).

Rule (Rule 15c3-3), which seeks to protect customers' assets if the firm fails.²⁸⁶ Under this rule, broker-dealers may only lend customers' securities pursuant to a written agreement that meets certain requirements. One can imagine requirements that would discourage lending; for example, annual reapproval of the broker's right to lend shares, or a statement that "we earned \$X last year by lending shares from your account and this increased your taxable income by an estimated \$Y."

Pension funds are subject to broad ERISA prohibitions on transactions with those who provide financial, advisory, or other services to the fund. The DoL has adopted exemptions which let a pension fund lend securities to banks and broker-dealers under specified conditions.²⁸⁷ Banks must comply with a "Revised Policy Statement on Securities Lending" adopted by the Federal Financial Institutions Examination Council in 1997.²⁸⁸ This statement focuses on how securities lending could affect bank soundness, and governs recordkeeping, internal controls, and credit analysis. These exemptions and regulations could be revisited, with an eye to discouraging lending for empty voting purposes.

Both general safety and soundness criteria and capital adequacy rules take into account securities lending and derivatives activity. The new Basel II accord governing major international banks substantially expands regulatory attention to credit and other derivatives, and includes new internal risk-management standards for controlling the risks posed by derivatives.²⁸⁹ Investment banks face two sets of capital adequacy requirements. Their broker-dealers are subject to general net capital rules.

286. SEC Customer Protection Rule, 17 C.F.R. § 240.15c3-3 (2005). *See generally* Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069 (2002).

287. *See* Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, 46 Fed. Reg. 7527 (Jan. 23, 1981); Class Exemption to Permit Payment of Compensation to Plan Fiduciaries for the Provision of Securities Lending Services, 47 Fed. Reg. 14,804 (Apr. 6, 1982); Proposed Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, 68 Fed. Reg. 60,715 (Dep't of Labor Oct. 23, 2003). *Cf.* Charles E. Dropkin, *Developing Effective Guidelines for Managing Legal Risks—U.S. Guidelines*, in SECURITIES FINANCE & LENDING, *supra* note 50, at 167 (briefly discussing regulatory regime for ERISA lenders).

288. *See* Revised Policy Statement on Securities Lending, 62 Fed. Reg. 38,991 (Fed. Fin. Insts. Examination Council July 21, 1997).

289. *See* BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS—A REVISED FRAMEWORK (2005) (discussing Basel II standards generally); BASEL COMM. ON BANKING SUPERVISION, THE APPLICATION OF BASEL II TO TRADING ACTIVITIES AND THE TREATMENT OF DOUBLE DEFAULT EFFECTS 1 (2005) (describing the application of Basel II to OTC derivatives and securities lending); Hu, *supra* note 217 (discussing the 1988 Basel I standards); Chris Kentouris, *Basel II Brings Choice, Uncertainty to Securities Lenders*, SEC. INDUSTRY NEWS, Jan. 17, 2005 (discussing the impact of Basel II on securities lending).

The affiliates that carry out OTC derivative transactions are subject to separate rules.²⁹⁰ Insurance companies are primarily regulated at the state level and states vary in the sophistication of their capital adequacy systems.

We make no claim that particular tax or regulatory tweaks are desirable, only that they are possible. Tax law, for example, is an unlikely vehicle for corporate governance engineering. In addition to the familiar Stanley Surrey-type arguments for the transparency of direct expenditures versus tax subsidies, the tax law governing financial products is already highly complex. Tolerable internal consistency in tax law has proven difficult to sustain in the face of creative tax-motivated derivatives design. To add a corporate governance goal in this area may entail an even more Rube Goldbergesque system that does not even catch the mouse.

4. Imposing Responsibilities on Share Lenders and Derivatives Providers

Another possible approach would be to put greater responsibility on share lenders or equity swap providers to know their clients, and how their clients will use share borrowing or swap. Banks were major actors in the Enron disaster, offering Enron a variety of exotic 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.²⁹¹ Another is that regulators now expect financial institutions to investigate their clients' use of complex financial products to game disclosure or tax rules.²⁹² In 2003, the SEC brought and settled actions against Citigroup and JPMorgan Chase related to structured finance transactions with Enron and Dynegy, which let Enron and Dynegy report loan proceeds as cash from operating activities. In 2003, the SEC settled a claim that American International Group had committed securities fraud by negotiating a nontraditional insurance policy with Brightpoint, Inc., which

290. See Rule 15c3-1, Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2005) (capital adequacy rules for broker-dealers); Final Rule, OTC Derivatives Dealers, Exchange Act Release No. 34-40594, 1998 WL 760754 (Nov. 3, 1998) (capital adequacy rules for broker-dealer affiliates that engage in derivatives transactions).

291. See *In re Enron Corp. Sec. Litig.*, Civ. No. H-01-3624, 2005 U.S. Dist. LEXIS 39867 (S.D. Tex. Dec. 22, 2005) (class action lawsuit against various investment and commercial banks and other defendants, in which settlements to date exceed \$6 billion). Bernard Black is an expert witness for the plaintiffs in this litigation.

292. See *In re Citigroup, Inc.*, Exchange Act Release No. 48,230, 2003 SEC LEXIS 1778 (July 28, 2003); SEC, *In re J.P. Morgan Chase & Co.*, Litigation Release No. 18,252 (July 28, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18252.htm>.

let Brightpoint misrepresent actual losses as insured losses.²⁹³ The SEC, Federal Reserve Board, and the Office of the Comptroller of the Currency have also advised financial institutions against using financial products to let their customers artificially alter their public financial statements or evade taxes.²⁹⁴ Regulators could take a similar interest in investment banks' creation of instruments designed to facilitate empty voting or evade ownership disclosure rules.

Indeed, for some broker-dealers, current rules already limit the purposes for which shares may be lent.²⁹⁵ Section 7 of the Exchange Act directs the Federal Reserve Board to adopt rules to prevent the excessive use of credit to purchase or carry securities.²⁹⁶ Under Federal Reserve Regulation T, which implements this mandate, broker-dealers who have material dealings with the general public are exempt from the usual margin rules that limit borrowing to acquire securities.²⁹⁷ Other broker-dealers, however, enjoy a more limited "permitted purpose" exemption.²⁹⁸ Under this exemption, these broker-dealers must make a good faith effort to determine the borrower's purpose and cannot lend shares for voting purposes.²⁹⁹ All the Federal Reserve would need to do to greatly limit record date capture is to make share lending for this purpose an illicit purpose for all broker-dealers. Such a ban on share lending for record date capture is already the informal norm in the United Kingdom.³⁰⁰

A similar "know your customer's purpose" approach could affect the market for some other forms of empty voting. Suppose that a hedge fund comes to a derivatives dealer, seeking to simultaneously buy shares and

293. *In re* Am. Int'l Group, Inc., Exchange Act Release No. 48,477, 2003 SEC LEXIS 2163 (Sept. 11, 2003).

294. *See* Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, Exchange Act Release No. 34-49695, 2004 WL 1514906 (May 13, 2004).

295. Different rules apply to different types of lenders. Dropkin, *supra* note 287.

296. Exchange Act § 7, 15 U.S.C. § 78g (2000).

297. *See* Regulation T, 12 C.F.R. § 220.2 (2005) (defining the "exempted borrower" exemption for major broker-dealers). *Cf.* Dropkin, *supra* note 287, at 172-74 (describing the general reach of Regulation T).

298. *See* 12 C.F.R. § 220.10(c) (describing the "permitted purpose" exemption).

299. In the analogous situation of dividend record date capture, the Federal Reserve staff ruled that share lending was not a permitted purpose. Federal Reserve Board Rulings and Staff Opinions Interpreting Regulation T, Fed. Reserve Regulatory Serv. 5-615.01 (July 6, 1984).

300. *See* MYNERS, *supra* note 238, at 13; BANK OF ENG., SECURITIES BORROWING AND LENDING CODE OF GUIDANCE ¶ 7.4 (2000) (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]").

hedge its economic exposure, ending up with pure votes. One could establish a presumption that the hedge fund's goal is empty voting. Depending on the extent of dealers' obligations to investigate their clients, the hedge fund could use different dealers for the two legs of the transaction, but this would greatly increase transaction costs.³⁰¹

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, though usually still a positive economic interest.

It is unclear how troublesome this "lite voting" is. Most executives' incentives should be decent, except for votes touching on corporate control. But if lite voting is problematic, one could make it less attractive by increasing the tax consequences of hedging. By hedging, executives have effectively sold a portion of their shares. Section 1259 of the Internal Revenue Code taxes, as constructive sales, a limited set of hedges.³⁰² For example, an equity swap that offsets "substantially all" economic exposure would trigger tax. Section 1259 is easy to avoid, however. Standard zero-cost collars do not trigger it, nor would a swap that offsets less than "substantially all" exposure.³⁰³ A more easily triggered standard could limit lite voting. This, however, is easier said than done. Efforts to tax hedging transactions are notoriously difficult.

VI. CONCLUSION

Shareholder voting is a core aspect of corporate governance. The central role of voting depends on a link between votes and economic

301. If the hedge fund transacts with a single derivatives dealer, the dealer can hedge by selling shares short to the hedge fund; thus, there is no market impact. If the hedge fund buys shares from one dealer and hedges with another, both sides must engage in market transactions, incurring both trading and market impact costs. One dealer will be buying while the other will be selling, but their actions will not be coordinated, so each side's trades will move the market to some extent.

302. 26 U.S.C. § 1259 (2000 & Supp. 2004).

303. For discussions of 26 U.S.C. § 1259, see, for example, 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); Simon D. Ulcickas, Note, *Internal Revenue Code Section 1259: A Legitimate Foundation for Taxing Short Sales Against the Box or a Mere Makeover?*, 39 WM. & MARY L. REV. 1355 (1998).

interest. Financial innovation, however, is undermining that link. In this Article, we explain how both investors and insiders can engage in large-scale, low-cost, often hidden decoupling of voting rights from economic ownership. This decoupling—the new vote buying—comes in two main flavors, which we term empty voting (more votes than economic ownership) and hidden (morphable) ownership (undisclosed economic ownership accompanied by informal voting rights).

Hedge funds have been pioneers in both forms of new vote buying. Insiders have used decoupling strategies to retain votes while shedding economic exposure. New OTC derivatives developed to transfer risk turn out to be well adapted for transferring votes. A now-massive share lending market serves both the traditional needs of short-sellers and the needs of empty voters.

In the past several years, decoupling has played a central role in the boardrooms of public corporations 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. How many more have remained hidden is unknown.

Not all vote buying is bad. Some could move votes from less informed to better informed investors and thus 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, threatens to unravel the longstanding connection between voting and economic ownership of shares. Voting outcomes might be decided by hidden warfare among company insiders and major investors, each employing financial technology to acquire votes. Adroitness in such financial technology may increasingly supplant the role of merit in determining the control of corporations.

Moreover, any regulatory response to decoupling must also consider its impact on derivatives and short-selling. Derivatives serve good purposes, as well as ill. Short sellers play a valuable role in securities markets, and depend on the same share lending market that facilitates the new vote buying. The right regulatory response to new vote buying is not obvious.

The first step is to better understand the new vote buying. For that, disclosure is the near term answer. This Article therefore develops an “integrated ownership disclosure” proposal that would both address new vote buying, and partially integrate and greatly simplify the five existing

share ownership disclosure regimes. The core of the proposal is to require more consistent, symmetric disclosure of both voting and economic ownership. Our proposal is sensitive to compliance cost; its simplicity, compared to the current regulatory patchwork quilt, may actually *reduce* the overall costs of regulatory compliance. Indeed, 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 sufficient to address hidden (morphable) ownership. For empty voting, it will likely prove to be only a first step. Eventually, perhaps soon, other responses to empty voting may be needed. We outline a menu of possible approaches, which fall into three broad families. One family focuses on voting rights themselves. A second addresses the aging architecture of our voting system. The third involves the supply and demand forces in the OTC derivatives and share lending markets on which the new vote buying relies.

Which additional regulatory approaches 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 presume a link between voting rights and economic ownership that can no longer be relied on.