Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms

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Most U.S. public companies have a one-share, one-vote capital structure, in which voting power is proportional to economic ownership. This ensures that shareholders have economic incentives to vote to increase firm value and helps to legitimate managers' exercise of authority over property the managers do not own. Berle-Means' "separation of ownership and control" suggests that shareholders have limited say over firm actions. Even so, mechanisms rooted in the shareholder vote, including proxy fights and takeover bids, constrain managers not to stray too far from shareholder wealth maximization.

The derivatives revolution and other capital markets developments threaten this familiar pattern. Both outside investors and insiders can readily decouple economic ownership of shares from voting rights to those shares. This decoupling -- which we call "the new vote buying" -- is often hidden from public view and is largely untouched by current regulation. Hedge funds have been especially creative in decoupling voting rights from economic ownership. Sometimes they hold more votes than economic ownership: a pattern we call "empty voting." Sometimes they hold more economic ownership than votes, though often with de facto ability to acquire the votes if needed -- a situation we call "hidden ownership" because the economic ownership is often not disclosed. Insiders also often use empty voting techniques.

This article offers a taxonomy of the new vote buying that unpacks its functional elements. We discuss the implications of decoupling for control contests and other shareholder oversight. We also propose a disclosure-based regulatory response. Our disclosure proposal would integrate and simplify five existing, inconsistent share ownership disclosure regimes, and is worth considering independent of its value with respect to decoupling. In the longer term, substantive responses to empty voting may be needed; we sketch some possible responses.

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I. Introduction

The governance structure of the modern corporation emerged in a period characterized by two central concepts. One was the "separation of ownership and control," which has been central to thinking about corporate governance since the 1930s. In stylized form, as conceived by Adolph Berle and Gardiner Means,[1] and converted to modern language, the professional managers of publicly held corporations hold few shares yet have substantial control over their firms. Shareholder-owners face large collective action problems in overseeing managers. Constraining managerial autonomy and reducing the divergence between managerial and shareholder interests are thus core goals for an overall governance system. State corporate law rules and federal disclosure rules are largely evaluated against these goals. So too are market-centered constraints, including institutional investor activism and the market for corporate control. These goals and the legal and market tools that foster these goals together comprise the corporate governance paradigm.

The second core concept was that a "shareholder" has economic ownership coupled with voting power. For much of the period in which modern corporate governance scholarship developed, one-share, one-vote structures were nearly universal, enforced by New York Stock Exchange listing standards. Even when dual-class structures became possible, around 1990, they remained uncommon. Our views of the ways in which institutional investor oversights and the market for corporate control can discipline wayward management depend on the coupling of economic interest and voting power. Terminology reflects this coupling: we use a single term, "ownership," to refer to possession of both the economic return on shares and corresponding

[1] ADOLPH BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

voting power. The deference that courts pay to shareholder votes is premised on the belief that shareholders have an economic interest in increasing share value and will vote to further that interest. Beyond the instrumental role of voting, Delaware courts treat the concept of shareholder-as-owner-and-voter as the core ideological basis for managerial exercise of authority over vast aggregations of property the managers do not own.[2] Securities and Exchange Commission (SEC) "large shareholder" disclosure rules also largely assume the coupling of economic ownership and voting power.[3]

The assumption that votes are tightly linked to economic interest is, however, increasingly untenable. The derivatives revolution in finance, especially the growth in equity swaps and other privately negotiated ("over the counter" or "OTC") equity derivatives, and related growth in the stock lending market, are making it ever easier and cheaper to decouple economic ownership from voting power.[4] Both company insiders and outside investors (especially hedge funds) 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 interest. Persons with more votes than economic interest are said to be "long the vote." In an extreme case, an investor can be long the vote while holding a "net short" economic position, which gives the investor an incentive to vote in ways that reduce company value.

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

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

[4] The complexities raised by the "new vote buying" are new examples of the challenges the derivatives revolution and modern financial innovation generally pose to corporate governance principles. For discussions of the overarching issue, see, *e.g.*, Henry T. C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991); Henry T. C. Hu, *Behind the Corporate Hedge: Information and the Limits of "Shareholder Wealth Maximization,"* J. APPLIED CORP. FIN., Fall 1996, at 39-51.

Investors or insiders can also have economic ownership that exceeds their formal voting rights, combined with informal access to the corresponding voting rights. This ownership is typically not disclosed under current large shareholder disclosure rules, which focus on voting power rather than economic interest, and do not clearly require disclosure of the informal voting power that often exists. Investors can often engage in what we call "vote morphing," moving at will between informal, undisclosed voting power and actual voting rights. We use the term "hidden ownership" to refer to the combination of undisclosed economic ownership plus probable informal voting power.

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

There are a number of ways to decouple votes from economic ownership. One common method relies on the stock lending market, which lets one investor "borrow" shares from another. Under standard lending arrangements, the stock borrower has voting rights but no economic ownership, while the stock lender has economic ownership without voting rights. A second approach employs an equity swap, in which the person with the long equity side (the "equity leg") of the swap acquires economic ownership of shares without voting rights, while the short side (the "interest leg") often hedges its economic risk by holding shares, thus ending up with

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

votes but no net economic ownership. Finance-savvy readers will quickly see other possibilities, relying on put and call options or, where they exist, on single-stock futures.[6]

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

A second, potentially beneficial use of empty voting involves outside shareholders magnifying an existing long ownership position. Other things equal, this can reduce shareholder collective action problems. For example, an activist hedge fund can borrow shares just before the record date for a shareholder vote, then reverse the transaction afterwards. The first publicly reported instance of this "record date capture" strategy occurred in the U.K. in 2002. Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a major U.K. property company. At the annual general meeting, Laxey emerged with voting power over 9% of British Land's shares, the better to support a proposal to dismember British Land. Just before the record date, Laxey had borrowed 42 million shares. Hedge funds may see this record date capture as a

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

[7] Part II provides further details on this and other new vote buying examples. Table 2 provides source citations.

tool for responding to incompetent or self-serving management. Company managers will have a different view.

Empty voting by institutions is a close cousin to hedging techniques widely used by insiders (zero-cost collars, variable prepaid forward contracts, and the like) by which managers and controlling shareholders retain formal ownership of shares, while shedding some or most of their economic ownership.[8] In the U.S., these strategies have typically been driven by managers' desire to shed risk while deferring taxes, rather than by vote buying motives. But insiders can easily also use empty voting techniques to cement their control. As we discuss in Part II, they are doing so in other countries.

Conversely, investors can have greater economic ownership than voting rights -- but with the *de facto* ability to acquire those rights quickly when they are needed. Under existing disclosure rules, the lack of formal voting rights may let the investor's position remain hidden. Perry's stake in a New Zealand company, Rubicon Ltd., which came to light in 2003, illustrates this. Perry used equity swaps to hold an undisclosed 16% economic stake, despite New Zealand's large shareholder disclosure rules, which are similar to U.S. Section 13(d) and require disclosure by 5% shareholders. When an election came along, Perry in effect exchanged its swap rights for shares held by the swap counterparties, thus morphing its *de facto* voting rights into actual voting rights. Its failure to disclose the swaps was held not to violate New Zealand law.

[8] *See, e.g.*, J. Carr Bettis, John M. Bizjak & Michael L. Lemmon, *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insider*s, 36 J. FIN. & QUANT. ANALYSIS 345 (2001); Rachel Emma Silverman & Jane J. Kim, *IRS Targets Strategy for Wealthy Executives*, WALL ST. J., Feb. 9, 2006 (describing variable prepaid forwards).

The new vote buying is largely unregulated and often unseen. Corporate case law governing "classic" vote buying does not touch it. This case law presumes a transaction between a vote "buyer" and a vote "seller," and assesses the seller's motives. With the new vote buying, there may be no identifiable seller. Federal disclosure rules scarcely touch the new vote buying either. Institutional investors must disclose their share positions in public companies on Form 13F, but need not disclose transactions that offset the voting rights or economic interest conveyed by these positions. Nor must they disclose economic ownership acquired through equity swaps or other OTC derivatives. The Schedule 13D rules governing disclosure by 5% shareholders are more extensive but with some attention to legal niceties, hidden ownership and empty voting positions can often be structured in a way that at least arguably evades 13D disclosure. Even in Perry-Mylan, where Perry filed a Schedule 13D, it made only quite general disclosure of its hedging agreements.[9] Disclosure by insiders and 10% shareholders under Section 16(b) of the Securities Exchange Act is more extensive, but focuses on economic ownership and does not cover empty voting through stock borrowing.

Because the new vote buying is often not captured by disclosure rules, its scale is unknown. We do, however, present in Table 2 below a list of 18 confirmed or publicly rumored examples during the period from 1997-2005. It is no accident that most of these examples are quite recent, nor that most involve hedge funds. The theoretical possibility of decoupling votes from economic ownership is not new.[10] What is new are investor ability to do so on a large

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

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

scale, declining transaction costs due to financial innovation, and a trillion dollar pool of lightly regulated hedge funds willing to make aggressive use of decoupling strategies.

The corporate governance challenges posed by new vote buying are clear, but the remedy is not. In the near term, we believe that enhanced disclosure (crafted with sensitivity to the costs of disclosure) is desirable, to let both regulators and market participants assess how much new vote buying occurs and how often it affects shareholder vote outcomes.

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

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

In proposing disclosure reforms, we take as given the rough economic and political logic behind the current rules. We do not revisit whether large shareholders or major institutions

should disclose their share positions, nor the threshold levels for this disclosure. The optimality of these thresholds is contestable. We believe, however, that whatever the thresholds are, the disclosure rules should be internally coherent, which at present they are not. Moreover, the political history of disclosure, in the U.S. and elsewhere, suggests that, precise thresholds aside, 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 therefore relatively low-cost.

As a response to hidden ownership, disclosure alone may suffice. For empty voting, disclosure will help, but a substantive response may also be needed. Still, we consider it premature to adopt substantive rules to address empty voting.[11] One reason is that empty voting can sometimes be efficient and sometimes not depending on the circumstances. Another is the multiple forms that new vote buying can take, and the need to understand these forms before undertaking to regulate them. As yet, we lack the knowledge of the vote buying terrain to know what rules to write. Yet delegating rule-writing power to companies is problematic, because company managers will predictably write rules that block vote-buying forms likely to be used by outside investors, while allowing forms attractive to insiders. Moreover, some possible substantive responses may well exceed the SEC's statutory authority.

[11] We thus part company with the only other published work we know of to offer policy recommendations related to empty voting. *See* Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775 (2005). Martin and Partnoy propose to ban most forms of what we refer to as empty voting. They do so without analyzing the different ways in which empty voting occurs; exploring alternatives to a flat ban; or grappling with the complexities involved in defining empty voting, ensuring disclosure, or implementing their proposed ban. Martin and Partnoy do not address hidden ownership, the other type of new vote buying. Other articles that discuss new vote buying include David Skeel, *Behind the Hedge – In the Untamed World of Hedge Funds, Rigged Deals and Manipulated Markets Help the Wealthy Thrive While Ordinary Investors Wither*, LEGAL AFFAIRS, Nov.-Dec. 2005, at 28; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (working paper 2006).

Nonetheless, over a longer term, a number of substantive strategies could potentially prove useful in addressing empty voting. We offer a number of possible strategies, and sketch some of their strengths and weaknesses, at the end of this paper.

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

This article has two companions.[12] In one, directed at an academic finance audience, we discuss the theoretical and empirical literature, principally in finance and economics, that bears on the benefits and costs of decoupling voting rights from economic ownership.[13] In the second, directed at an academic legal audience, we present a more detailed discussion of substantive responses to empty voting and reforms in Hong Kong and the U.K. that address new vote buying.[14]

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[12] 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 (held at New York University Law School). *See* Henry T. C. Hu & Bernard S. Black, *Empty Voting: Shareholder Voting Rights and Coupled Assets* (Feb. 2005). A subsequent version was posted on SSRN in January, 2006. *See* Henry T. C. Hu & Bernard S. Black, *Hedge Funds, Insiders and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies* (working paper 2006), at http://ssrn.com/abstract=874098 [hereinafter Hu & Black, *Hedge Funds and Insiders* (2006)].

[13] Hu & Black, *Hedge Funds and Insiders* (2006), supra note 12.

[14] Henry T. C. Hu & Bernard S. Black, *The New Vote Buying: Empty Voting and Hidden Ownership*, 79 S. Cal. L. Rev. -- (forthcoming 2006), at http://ssrn.com/abstract=xxxxxx [hereinafter Hu & Black, *New Vote Buying* (2006)], . We provide fairly limited citations in this Article; readers interested in more should consult the companion law review article.

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, Judge Frank Easterbrook and Professor Daniel Fischel stated that "[i]t is not possible to separate the voting right from the equity interest" and that "[s]omeone who wants to buy a vote must buy the stock too."[15] This was an oversimplification, but only a bit. For the most part, voting rights were linked to shares. With the "new vote buying," in contrast, the economic return on shares can be separated from the decision as to how many votes to acquire. The derivatives revolution in finance, combined with the growth of the stock lending market, is making the decoupling of economic ownership from voting rights ever easier and cheaper.

We begin our analysis 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 equity (each share carrying one vote) and diversified shareholders with homogeneous preferences. We treat shareholder wealth maximization as a corporate goal and do not consider non-shareholder constituencies.[16] 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, regardless of who decides how to vote. By **"voting rights"** or **"voting ownership"** of shares, we mean actual rights to vote shares,

[15] Frank Easterbrook and Daniel Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 397 (1983).

[16] We also leave aside the distinctions between the welfare of the corporation and the welfare of the shareholder and between shareholder welfare and shareholder wealth. See, e.g., Henry T. C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Economics of the Corporate Objective*, 73 TEX. L. REV. 985 (1995).

including the legal power to instruct someone else with formal voting rights on how to vote. Thus, in the common situation where a broker holds shares in street name for a customer, the customer has voting ownership while the broker (or, strictly speaking, the depository which holds shares for the broker) has formal voting rights. The company at which voting takes place is the **"host company."**

By "economic ownership," we mean the economic returns associated with shares. This ownership can be achieved **directly** by holding shares, or **indirectly** by holding a **"coupled asset,"** which conveys returns that relate directly to the returns on the shares. Economic ownership can be either **positive** ("long") -- the same direction as the return on shares -- or **negative** ("short") -- 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 a holding of coupled assets, which can be either long or short. Coupled assets include derivatives (such as options, futures, and equity swaps), contractual rights (such as rights under a stock loan agreement), and other financial products.

By **"net economic ownership,"** we mean a person's combined economic ownership of host company shares and coupled assets. N**et economic ownership** can be positive, zero, or negative (i.e., short). We characterize as an **"empty voter"** a person whose voting rights substantially exceed his net economic ownership. Depending on the nature of the coupled assets, net economic ownership may depend on share price. Suppose, for example, that a company's shares trade at $50, and an executive enters into a zero-cost collar that caps upside on the shares

at $60 and limits the downside to $45. The executive has partial economic ownership, which will be higher for share prices within the $45-$60 range than outside this range.

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

[9.9% full ownership] + [-9.9% indirect economic ownership]

= [9.9% voting + 9.9% direct econ. ownership] + [-9.9% indirect econ. ownership]

= [9.9%voting ownership]

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

If a person has indirect economic ownership that disclosure rules do not cover (or can reasonably be interpreted by the person as not covering), we call this **"hidden ownership."** In practice, hidden ownership will often include informal voting rights, but this will generally not be verifiable by outside observers. Perry's hidden ownership of Rubicon offers an example.

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

Table 1. Some Forms of New Vote Buying

Examples of some of the principal forms of new vote buying. These examples are illustrative only. The Perry-Mylan, Laxey-British Land, insider hedging, and Perry-Rubicon examples are discussed in the text above. The Deutsche Boerse-London Stock Exchange and MONY-AXA examples are discussed below. Footnotes to Table 2 provide source citations. **[BSB: To be updated based on JCF.]**

Example	**Voting Ownership**	**Direct Economic Ownership**	**Coupled Asset**	**Net Economic Ownership**	**Related Non-Host Asset**	**Overall Economic Interest**
Empty Voting						
share ownership hedged with short equity swap (Perry-Mylan)	yes	yes	yes	no	yes (target shares)	negative
record-date capture via stock borrowing (Laxey-British Land)	yes – high	yes - low	no	yes - low	no	low
share ownership hedged with related non-host asset (MONY-AXA)	yes	yes	possible	not known	yes (acquirer bonds)	negative
insider hedging	yes	yes	yes	partial	no	positive but lowered
Deutsche Boerse-London Stock Exchange (for hedge funds that were long acquirer shares and short target shares)	yes	yes	no	yes	yes (target shares)	could be higher **or** lower than direct interest, depending on stake in target

Hidden Voting Ownership						
hidden voting rights (Perry-Rubicon)	formal: no de facto: yes	no	yes	yes	no	high

B. Empty Voting Through Coupled Host Assets

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

1. Empty Voting Through Equity Derivatives

The Perry-Mylan example, discussed briefly in the introduction, offers a good case study of empty voting through the use of OTC equity derivatives. As of late 2004, Perry Corporation owned seven million shares of King Pharmaceuticals, a generic drug maker.[17] Mylan Labs, a rival, agreed to acquire King Pharmaceuticals in a stock-for-stock merger at a significant premium over King's trading price, and thus a large profit for Perry. However, Mylan's shares dropped sharply when the deal was announced, and Mylan needed shareholder approval for the merger. Perry therefore bought a 9.9% stake in Mylan Labs, which it could vote in favor of the merger. At the same time, Perry hedged its economic exposure to Mylan by taking the short or "interest" leg of equity swaps with derivatives dealers and entering into other unspecified transactions. The derivatives dealers who took the long or "equity leg" of the Mylan swaps likely hedged their economic exposure to Mylan by selling Mylan shares short. A second hedge fund, Citadel, acquired another 4.4% of Mylan's shares and was rumored to have followed a strategy similar to Perry's.

Carl Icahn, a major Mylan shareholder, opposed the acquisition. He sued Mylan and Perry under federal securities law, principally Exchange Act § 13(d). He claimed that Perry and other unnamed hedge funds following similar strategies held 19% of the Mylan votes, yet no

[17] Our description of Perry-Mylan is based on Perry Corp.'s Schedule 13D filing, the complaint in Carl Icahn's lawsuit against Perry, and various news stories. For citations, see Hu & Black, *The New Vote Buying* (2006), *supra* note xx.

economic interest. If so, Perry and kindred investors had a negative overall economic interest in Mylan. They wanted Mylan to complete the deal even if Mylan's value suffered. Indeed, the more Mylan overpaid, the better. The lawsuit became moot when Mylan abandoned the acquisition because of accounting problems at King.

The ability of Perry and other investors to cast a large block of votes in an important election while having zero net economic ownership and negative overall economic interest was the first publicly confirmed use of the empty voting strategy, but likely not the first use **[BSB: need to conform to JCF here]**. Also in 2004, holders of both long and short positions in AXA bonds (convertible at a premium into AXA shares *if but only if* AXA acquired MONY) acquired MONY shares, some to vote for the merger, others to oppose it, with neither group's vote turning on whether the merger was good for MONY.[18] Market participants suspect that similar strategies were used in the 2002 proxy fight between Walter Hewlett and Hewlett Packard over Hewlett-Packard's proposed merger with Compaq Computer. These strategies might have affected the outcome of this extremely close vote.[19]

These strategies are troubling. Many acquisitions turn out poorly for the acquirer.[20] The major U.S. stock exchanges require the acquirer's shareholders to approve a large stock-for-stock merger. Yet in practice, the acquirer's shareholders rarely vote down even apparently overpriced mergers. Empty voting on the acquirer's side by the target's shareholders, employed when the

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[18] See In re The MONY Group, Inc., Shareholder Litigation, 852 A.2d 9 (Del. Ch. 2004) and 853 A.2d 661 (Del. Ch. 2004), AXA issued the bonds to finance its acquisition of MONY. The extent to which the holders of AXA bonds hedged their MONY positions is unknown.

[19] *See* Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C1.

[20] *See, e.g.,* ROBERT BRUNER, DEALS FROM HELL (AND LESSONS THAT RISE ABOVE THE ASHES) (2004); Sara B. Moeller, Frederik B. Schlingemann & Rene Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757-782 (2005).

vote on a merger is likely to be close, could reduce the limited constraint the vote requirement now imposes on the acquiring firm's managers.

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

2. Insider Hedging and Entrenchment

Corporate executives are ill-diversified. Both their human capital and much of their financial capital is tied up in the firm they manage. Controlling shareholders, often the founder's family, are similarly undiversified. These insiders often want to reduce their economic exposure to the firm's shares -- hopefully without causing public concern that insiders are bailing out, triggering a tax bill, or, for controlling shareholders, giving up control. High levels of insider ownership are reasonably common. One survey of New York Stock Exchange-listed companies with 2001 revenues between $250 million and $1.5 billion found that more than one in ten had Chief Executive Officers who held more than 10 percent of the shares. About half of those companies had insiders with more than 50 percent of the shares.[21]

Investment banks, for a suitable fee, have developed strategies to accommodate the desire of insiders to hedge their economic exposure while deferring taxes, retaining votes, or both. Multiple techniques have emerged. One is a short equity swap position. Another popular strategy, known as a zero-cost collar, involves buying a put option (to limit downside loss) while

[21] Dennis Simon, *In splitting leadership, look at CEO ownership*, DIRECTORS & BOARDS, Jan. 1, 2004, at 24.

simultaneously selling a call option (thus reducing potential gain).[22] Such a collar sharply reduces economic ownership while preserving voting rights. A 2001 study reports that senior executives in U.S. public companies, on average, use collars for 36% of their holdings and thereby reduced their economic ownership position by 25%.[23]

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. There may be justifications for insiders to use dual-class stock to raise capital without relinquishing control. In particular, the buyers of low-vote shares know what they are getting, and will pay a market price. So too for buyers of shares in companies controlled through pyramids. The new vote buying, however, is more akin to the sharply criticized and now-banned dual-class recapitalizations of the 1980s, in which insiders locked up control without paying a market price for doing so. In one respect, the new vote buying is worse than a dual-class recapitalization -- the recapitalization required a shareholder vote, new vote buying does not.

Empty voting by insiders is not limited to the U.S. In Hong Kong, for example, insiders reportedly often used OTC derivatives to alter economic ownership in their own companies, partly because of, as the head of equity derivatives at a major institution put it, the "non-disclosure factor."[24] In response, Hong Kong regulators broadened disclosure requirements in 2003.[25]

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[22] If the put and call options have the same exercise price and expiration date, this transaction is a complete hedge, economically equivalent to selling shares. More commonly, the call option exercise price is somewhat above the put option exercise price, hence the term "collar" (economic exposure is limited to the range between the call and put exercise prices). In a "zero-cost" collar, the proceeds from selling the call equal the cost of the put.

[23] *See* Bettis, Biszak & Lemmon (2001), *supra* note xx.

[24] Melvyn Westlake, *Rules of the game*, AsiaRisk, Apr. 2002, at 20.

[25] See Hong Kong Securities and Futures Commission, Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance (Jan. 2005); Hong Kong Securities and

Thus far, most insider hedging has involved reducing economic ownership while retaining control. But insiders can also use new vote buying to boost their voting control, by buying shares and hedging their share position, thus reducing or even eliminating the risk of a hostile bid.

3. Record Date Capture

Thus far, we have focused on empty voting strategies that involve holding shares and hedging one's economic ownership. A second strategy, known as *record date capture*, involves borrowing shares in the stock loan market. In a typical stock loan, the borrower obtains shares (and accompanying votes). The borrower contracts with the stock lender to: (i) return the shares to the lender at any time at the election of either side; and (ii) pay to the lender the value of any dividends or other distributions on the shares during the borrowing period. The loan is secured with cash or Treasury securities. Taxes aside, this borrowing contract (a coupled asset in our terminology) leaves the economic risk of the shares with the lender. The borrower holds only votes, emptied of economic ownership. The lender has economic ownership without votes.

The shares of most publicly traded stocks in the U.S. can be borrowed. A study by D'Avolio of which shares were available from just one large financial institution found that the stocks that could not be borrowed accounted, in the aggregate, for less than 1% of market capitalization.[26] Borrowing shares is generally cheap: 91% of the stocks lent in this sample cost

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Futures Commission, Outline of Part XV of the Securities and Futures Ordinance (Cap. 571) – Disclosure of Interests (Aug. 6, 2003) [hereinafter Hong Kong SFC, *Part XV Outline*].

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

less than 1% per year to borrow. The number of borrowable shares is often large -- during some recent corporate battles, up to 20% of a company's shares were held by borrowers.[27]

A traditional use of stock borrowing is to facilitate short selling. The borrower sells the borrowed shares in the market, ending up with no votes and negative net economic ownership. Later, the short-seller closes out the short position by buying shares in the market and delivering these shares back to the stock lender. But, omit the short sale, and stock borrowing becomes an easy route to empty voting. Here is how the strategy works. Before a shareholder meeting, a company's board of directors establishes a voting record date.[28] Shareholders who hold shares on the record date have the right to vote at the meeting, typically a month or so away. The empty voter simply borrows shares before the record date, and returns them afterward. The efforts by pension funds and other stock lenders in the U.K. to respond to record date capture suggests that the practice is reasonably widespread in the U.K.[29] A recent working paper by Christoffersen, Geczy, Musto and Reed provides quantitative, albeit dated, evidence for the U.S. market. They report, based on stock loan data from a custodian bank in 1999 and a broker-dealer from 1996-2001, that stock loans spike on the record date, increasing on average from 0.21% to 0.26% of outstanding shares. The spike in borrowing is higher for firms that have had poorer financial performance, for meetings with the apparent potential to result in close vote, and for firms that experienced higher support for shareholder proposals. They estimate the average cost of vote buying through record date capture at 0.6 basis points (0.006%) per *year* (insignificantly

[27] See Kate Burgess & James Drummond, *Transparency finds a high-level champion*, Fin. Times, Apr. 22, 2005, at 1.

[28] *See, e.g.,* Del. Gen. Corp. L. § 213(a) (2005).

[29] We discuss these efforts in Part V.x *infra*.

different from zero)! This estimate implies that a one-day stock loan for $10 million worth of shares costs the borrower $2.40.[30]

The Laxey Partners-British Land incident, discussed in the Introduction, is a rare public instance of record date capture. Laxey sought a breakup of British Land. To that end, it opposed the reelection of British Land's chairman.[31] British Land's chairman was none too happy with what he called Laxey's "rent-a-vote" strategy.[32] There was irony all around. The chairman was upset with what he viewed as Laxey's abuse of the corporate voting system, while Laxey perceived itself as calling weak management to account. To top this off, fund manager Hermes, one of the City's foremost champions of good corporate governance, was (unknowingly) one of the stock lenders. Hermes did apologize.

C. Hidden Ownership Through Coupled Assets

1. Hidden Ownership and Vote Morphing Between Legal and *De Facto* Voting Rights

Equity derivatives can also be used to conceal ownership, against the background of disclosure rules that, as we discuss in Part IV, turn largely on voting rights rather than economic ownership. Perry has used equity derivatives for this purpose as well as for empty voting. In early 2001, Perry was a major holder of Rubicon Ltd., a New Zealand public company. New Zealand has large shareholder disclosure rules, similar to Exchange Act Section 13(d), which required Perry to disclose its ownership if over 5%.[33] In June 2001, Perry gave notice that it had

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[30] Susan Kerr Christofferson, Chris Geczy, David K. Musto, & Adam V. Reed, *Vote Trading and Information Aggregation* (working paper 2006, http://ssrn.com/abstract=686026.

[31] Our description is based on news stories. For citations, see Hu & Black, *The New Vote Buying* (2006), *supra* note xx. For a critical overview of hedge funds, including their role in Perry-Mylan, see David Skeel, *Behind the Hedge – In the Untamed World of Hedge Funds, Rigged Deals and Manipulated Markets Help the Wealthy Thrive While Ordinary Investors Wither*, LEGAL AFFAIRS, Nov.-Dec. 2005, at 28.

[32] John Ritblat, *British Land buy-back well under way*, Fin. Times, Jan. 13, 2003, at 18 (letter).

[33] *See* New Zealand Securities Amendment Act 1988, § xx.

ceased to be a 5% holder. Then -- to everyone's surprise -- on July 11, 2002, Perry suddenly 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 shareholder meeting on July 19, 2002.[34]

What had happened? On May 31, 2001, Perry shed its voting rights but not its economic interest. It sold 14 million shares to Deutsche Bank and 17 million shares to UBS Warburg and simultaneously acquired a long equity swap covering these shares. Perry stopped reporting as a 5% owner because, it claimed, its equity swap position fell outside the New Zealand disclosure rules. When Perry needed voting rights, it terminated the swaps and bought the shares back from Deutsche Bank and UBS Warburg. Another major Rubicon shareholder challenged Perry's right to vote. Perry lost at trial but won on appeal.

In Mylan, Perry coupled the *purchase* of Mylan shares with a short equity swap position to achieve voting rights without economic ownership. With Rubicon, Perry held long equity swaps in Rubicon shares to achieve economic ownership without formal voting power. At the same time, Perry retained *de facto* voting rights exercisable at Perry's discretion, because it could return to the investment banks, unwind its swap position, and reacquire Rubicon shares at any time.

How did Perry know that it had *de facto* access to the shares? The two banks needed to hedge their exposure on the swaps. Perry could expect them to do so by holding the shares they had bought from Perry. Another means of hedging was unlikely, given the thin market for Rubicon shares and the transaction costs to hedge in another way. Perry could also expect the

[34] Our discussion of the facts is based on Ithaca (Custodians) Ltd. v. Perry Corporation, [2003] 2. N.Z.L.R. 216 (High Court – Auckland), [2003] 1 N.Z.L.R. 731 (Court of Appeal – Wellington) (appeal allowed; orders by High Court set aside), [2004] 2 N.Z.L.R. 182 (Court of Appeal – Wellington) (conditional leave to appeal refused).

banks to sell the shares back to Perry when Perry chose to unwind the equity swaps. Even the Court of Appeal, which ruled in Perry's favor, stated that:

> [I]t was almost certain that the shares would be sold to Perry Corporation upon the termination of the swaps if Perry Corporation wished to buy, provided the counterparties held the shares (. . . [which] was highly likely). We consider that this market reality would have been obvious to any reasonably informed market participant. Mr Rosen, head trader of Perry Corporation, said in evidence that he had always thought it likely that the shares would be held by the counterparties as a hedge. He also said that, if he wanted to terminate the swaps and purchase the shares, it would have been commercially sound for the . . . counterparties to sell him those shares.[35]

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

Holding "matched shares" is a common though not the only way for a derivatives dealer to hedge the short side of an equity swap. Especially when the equity swap involves a large number of shares in a thinly traded company, alternative hedging strategies may be limited. When the derivatives dealer hedges through share ownership, a *de facto* practice is apparently emerging in which the dealer, if asked, will either unwind the swap and sell the shares to its client (as in Perry-Rubicon) or vote the shares as its client wants (we cite some examples in Table 2). Moreover, it was more than just "commercially sound" for Deutsche Bank and UBS Warburg to sell Rubicon shares to Perry to unwind Perry's swap. To refuse would risk their business relationship with Perry. The commercial practice between derivatives dealers and clients may include dealers' practice of hedging short equity swap positions by holding matched

[35] [2003] 1 N.Z.L.R. 731, at ¶ 66 (Court of Appeal – Wellington).

shares, rather than in another manner. Heding with matched shares may be a preferred strategy precisely because doing so lends itself to vote morphing. As evidence of this practice, the Code Committee of the U.K.'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 the shares are available to be voted by its customer and/or sold to the customer on closing out the contract.[36] If the dealer hedged in another way, the holder would "normally expect" the dealer to acquire the necessary shares, even if this resulted in cost to the dealer.[37]

Hidden voting is emerging as a troublesome issue worldwide. In July 2005, the Australian Takeovers Panel faced a situation similar to Perry-Rubicon and concluded that disclosure was required; its decision is currently on appeal.[38] In the United Kingdom, the Panel on Takeovers and Mergers adopted a new rule in late 2005 to require disclosure by persons with significant positive economic ownership, similar to that required for significant shareholders, regardless of their voting rights.[39] Hong Kong, as noted above, has also expanded its disclosure requirements in response to the new vote buying.[40]

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[36] See Panel on Take-Overs and Mergers, Consultation Paper Issued by the Code Committee of the Panel – Dealings in Derivatives and Options: Outline Proposals relating to Amendments Proposed to be Made to The Takeover Code and the SARS, ¶ 3.3 (PCP 2005/1 Issued on Jan. 7, 2005).

[37] Id. ¶ 3.3 **[check pinpoint cite]**. For a U.S. example where a customer was unhappy enough that Citibank had hedged equity swaps in another way to bring a suit, see Caiola v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002).

[38] *See* Takeovers Panel, Austral Coal Limited 02 – Decision and Review Application (July 1, 2005) http://www.takeovers.gov.au/display.asp?ContentID=956 [hereinafter Austral Coal Decision] (discussed in Part V.B). The Panel's decision and order that the hidden owner pay compensation are on appeal with the Federal Court of Australia, with a hearing set for February 2006. See Matthew Boyle, *Glencore gains reprieve from Australian fine over Austral*, Platt's International Coal Report, Nov. 28, 2005. **[BSB: need to update this and the text, see JCF]**

[39] See, e.g., Panel on Takeovers and Mergers, *Dealings in Derivatives and Options: Statement by The Code Committee of the Panel Following the External Consultation Processes on Disclosure Issues in PCP 2005/1 and PCP 2005/2* (Aug. 5, 2005); Panel Executive, *Summary of Changes to the Takeover Code* (Oct. 2005); Panel on Takeovers and Mergers, *Consultation Paper Issued by The Code Committee of the Panel – Dealings in Derivatives and Options: Detailed Proposals Relating to Amendments Proposed to be Made to the Takeover Code – Part 1: Disclosure Issues* (May 13, 2005), ¶¶ 5.1-5.2 (May 13, 2005) [hereinafter U.K. Takeover Panel, *May 2005 Proposal*].

[40] See Part II.B.2 *supra*.

2. Toeholds

Another potential use of hidden ownership involves "toehold" stakes in target companies, which bidders sometimes acquire in advance of a takeover proposal. An unresolved puzzle in finance is why more takeover bidders do not acquire toeholds, even though doing so would appear to be highly profitable.[41] The most plausible explanations are concern about prompting a price run-up, which could increase eventual acquisition cost, and concern that the toehold may increase the likelihood of bidder resistance. An equity swap offers a quiet toehold that need not be publicly disclosed. Nondisclosure might reduce market impact cost, or simply avoid bidder resistance

D. Related Non-Host Assets

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

1. Mergers

One recurring situation in which related non-host assets form an important part of an investor's overall economic interest involves a proposed merger. We have already seen how, in Perry-Mylan, Perry used an empty voting position in Mylan to profit, it hoped, from owning King shares. It had voting ownership in Mylan but zero economic ownership and, including its related non-host asset (King shares), a negative overall economic interest. But there can also be situations in which economic ownership in both bidder and target can increase a shareholder's economic interest, which can help to offset the collective action problems that often lead to

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

shareholder passivity when an acquirer proposes an overpriced acquisition. Actions by hedge funds to oppose Deutsche Boerse's proposed acquisition of the London Stock Exchange (LSE) illustrate the context-specific nature of an assessment of the desirability of empty voting.

In December 2004, Deutsche Boerse proposed buying the LSE.[42] In January 2005, two hedge funds (Children's Investment Fund (CIF) and Atticus Capital (Atticus)), together holding 8% of Deutsche Boerse's shares, publicly opposed the bid as against shareholder interests. The acquisition was opposed by other major holders and was eventually abandoned. What connects this story to vote buying is that certain hedge funds – perhaps including CIF and Atticus -- shorted a significant number of LSE shares soon after the opposition was announced. Let us assume, we think plausibly, that some hedge funds went long Deutsche Boerse and short LSE, thus betting that the acquisition would fail -- in which case Deutsche Boerse shares would rise and LSE shares would fall. If so, these hedge funds' net economic interest in the Deutsche Boerse vote was larger than if they held only Deutsche Boerse shares. If the acquisition was in fact a bad idea, this additional incentive might make it cost justified for them to undertake the cost of a public campaign against the acquisition.

However, other combined positions in Deutsche Boerse and LSE could have the opposite effect. If an investor held a short position in LSE that was large relative to its long Deutsche Boerse position, it would be more interested in seeing LSE shares drop in price than in seeing Deutsche Boerse shares rise. Such an investor would have an incentive to oppose an acquisition that would benefit Deutsche Boerse, or indeed both companies combined. The investor would have positive economic *ownership* of Deutsche Borse yet negative net economic *interest* in the success of the acquisition. Meanwhile, merger arbitrageurs who followed the "classic" strategy

[42] Our discussion relies on various news reports.

of betting on completion of a stock-for-stock acquisition by going long the target and short the acquirer (the opposite of the posited CIF and Atticus strategy) would have an incentive to engage in new vote buying to support the merger, even if it was bad for Deutsche Boerse or the combined firms. Thus, the new vote buying could, at the same time, empower CIF and Atticus as they try to pressure Deutsche Boerse to make a "good" decision, and empower classic merger arbitrageurs to support deal completion regardless of the merits.

It is not much of a stretch to imagine a subterranean battle for votes between sophisticated hedge funds and other investors with differing overall economic interests. In such a battle, it might be little more than happenstance if the outcome of a vote on the acquisition reflected the acquisition's expected value to Deutsche Boerse (or to both companies together). Indeed such a battle appears to have taken place at least once, in connection with AXA's acquisition of MONY. AXA funded the acquisition by issuing convertible bonds whose value depended on whether the acquisition was completed or not. The protagonists in MONY's vote on the acquisition included MONY shareholders (some of whom favored the acquisition, some of whom didn't), holders of long (short) positions in the AXA convertible bonds, who didn't care about MONY but would gain (lose) if the merger were completed, and the MONY board, which postponed the shareholder meeting when the merger initially appeared headed for defeat. In the end, the merger barely squeaked through.

2. Indirect Hedges

Other plausible related non-host assets can exist, in addition to positions in the other party to a takeover bid. The essential characteristic of a related asset is that its value relate in some way to the value of host shares. Thus, an executive at Ford who is concerned about the

future of Ford and other American car companies, might buy put options on shares of General Motors or a supplier heavily dependent on Ford business, rather than put options on Ford (which would raise legal and perception issues).[43]

Consider next a variant on record date capture, if shares cannot be borrowed. An investor can buy shares just before the record date and sell them soon thereafter. The investor has economic ownership for only a short period of time, and can hedge much of his ownership risk by shorting an appropriate combination of a broad share index and a narrower industry index. Such a practice entails substantially empty voting. The timing of the remaining economic exposure 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. Thus, an indirect hedge by shorting an industry index is likely to be effective. By the meeting date, when the voting outcome becomes known, the investor will have shed his economic exposure.[44]

E. Public Instances of New Vote Buying

We have offered a number of vote buying examples already. But there is value in collecting the known instances of decoupling of economic and voting ownership in one place, to show the extent of decoupling that is known to exist. Table 2 lists all publicly disclosed (or in some cases rumored) decoupling examples that we have been able to find, in rough

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

[44] 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 xx, at 411 n. 41. This is simply not so.

chronological order. The list is surely partial. Still, its extent suggests the scale of decoupling, while the dates suggest its recent advent.

Table 2. Decoupling Examples

This table lists, roughly in reverse chronological order, the known (or publicly rumored) instances of new vote buying we were able to collect. The list is surely partial. If readers know of instances not on this list, we would be grateful to learn of them. **[BSB: Tobe updated based on JCF, add column labelled "Source" which will link to footnotes.]**

Date (source)	Host Company	Vote Buyer	Empty Voting	Hidden Ownership	Coupled or Related Asset	Description
2005	Austral Coal	Glencore [commodities trader]		X	equity swaps	See Part IV.B
2005	Fuji TV	Nippon Broadcasting		X	stock lending	Nippon lent its shares in Fuji TV to others as a defense to atakeover bid by Livedoor, producing a variant of hidden ownership in which Nippon had economic ownership, but would recapture voting rights only if the Livedoor bid failed.
2005	Deutsche Borse	Hedge funds	X		target shares	See Part II.D
2005	Portman Mining	Seneca (hedge fund)		X	equity swaps	Seneca held 9% economic interest in Portman through equity swaps provided by CSFB.
2004-2005	WMC Resources	BHP Billiton		X	equity swaps	BHP Billiton acquired 4.3% economic interest in WMC through equity swaps with Deutsche Bank; which in turn bought WMC shares.
2004-2005	Mylan	Perry Corp. (hedge fund)	X		equity swap	See :Part II.B

Date (source)	Host Company	Vote Buyer	Empty Voting	Hidden Ownership	Coupled or Related Asset	Description
	Laboratories	Citadel (hedge fund) (possible case)	X		unknown	
2004	DFS	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).
2004	Alvis	Hedge funds (helping BAe Systems to acquire Alvis)		X	equity swap	BAe obtained commitments from hedge funds holding long swap positions in Alvis to either obtain shares or direct the voting of shares to support BAe's offer.
2004	Marks & Spencer	Hedge funds (helping Philip Green to acquire Marks & Spencer)		X	equity swap	Acquirer announces support by 8.3% of target shares held by derivatives dealers as “matched shares” to support equity swaps
2004	Canary Wharf	“Songbird” consortium (seeking to acquire Canary Wharf)		X	equity swap	Derivatives dealer UBS held 7.7% of Canary as matched shares to support equity swaps. British Land, a Songbird member, had close relationship with UBS.
2004	MONY Group	Highfields Capital (hedge fund)	X		acquirer's convertible bonds	Highfields held short position in convertible bonds issued by acquirer (AXA)
2004	News Corp.	Liberty Media	X	maybe	forward contract	Liberty Media acquired both voting and nonvoting News Corp. shares, then used swaps to increase its % voting stake to roughly equal its economic stake

Date (source)	Host Company	Vote Buyer	Empty Voting	Hidden Ownership	Coupled or Related Asset	Description
2002	Rubicon	Perry Corp.		X	equity swaps	See Part II.C
Mid-2002	British Land	Laxey Partners	X		share borrowing	See Part II.B

III. Current Ownership Disclosure Rules

A. General Considerations

We turn now to how current law treats the new vote buying. This Part III addresses the extent to which current share ownership disclosure rules require disclosure of empty voting or hidden ownership. Part IV presents our disclosure reform proposal. Part V discusses substantive regulation of empty voting. The immediate need is for disclosure of both economic and voting ownership.

Currently there are five discrete ownership disclosure systems: for active 5% shareholders on Schedule 13D, passive 5% shareholders on Schedule 13G, institutional investors on Form 13F, insiders under Exchange Act Section 16, and mutual funds. These systems, taken together, are bewilderingly complex. Different rules often apply in determining what triggers the disclosure requirements and what must be disclosed once the disclosure requirements have been triggered. Economically identical situations are often 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 sometimes requires disclosure, but (nearly equivalent) sale of put options does not. And so on. A derivatives-savvy hedge fund can often avoid disclosure.

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

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

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

Disclosure Requirement	**Long Shares and Share Equivalents (Host Assets)**				**Short Shares or Share Equivalents (Host Assets)**						**Stock Lending and Borrowing**	
	As Trigger		***If Filing Required***		***As Trigger***			***If Filing Required***				
	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 of Shares	Equity Swaps; other OTC Derivatives	Exchange-traded Derivatives	Short Sales of Shares	Lending	Borrowing
13D	generally no	yes	partial	yes	no	yes	no	partial	yes	partial	unclear	yes
13G	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)

<table>
<tr><td>13F</td><td colspan="2">status-based: $100M in 13F securities</td><td>no</td><td>partial</td><td colspan="2">status-based: $100M in 13F securities</td><td>no</td><td>partial</td><td>no</td><td colspan="2">no</td></tr>
<tr><td rowspan="2">Section 16 (director or officer)</td><td colspan="2" rowspan="2">status-based</td><td colspan="2" rowspan="2">yes</td><td>status-based</td><td rowspan="2">illegal</td><td colspan="2" rowspan="2">yes</td><td rowspan="2">illegal</td><td rowspan="2">no</td><td>no</td></tr>
<tr><td>no</td><td>shares but not derivatives</td><td>no</td><td>yes (as trigger); no (disclosure)</td></tr>
<tr><td>Section 16 (10% holder)</td></tr>
<tr><td>Mutual Funds</td><td colspan="2">yes</td><td colspan="2">yes</td><td colspan="2">yes</td><td colspan="3">yes</td><td colspan="2">no</td></tr>
</table>

B. Existing Disclosure Requirements

We review here the current disclosure requirements that affect the new vote buying. To avoid clutter that might obscure our main themes, we gloss over some complexities. Thus, our discussion should be understood as roughly but not wholly accurate. Outside investors, including hedge funds, are governed by large shareholder rules -- any shareholder holding a 5% stake in a public company must make a Schedule 13D or 13G filing.[45] Institutional investors, including hedge funds, are also subject to status-based disclosure rules: an investment manager holding $100 million or more in U.S. equities must disclosure its holdings every quarter on Schedule 13F.[46] Corporate insiders (directors, officers, and 10% shareholders) are also subject to separate disclosure of ownership on Forms 3, 4, or 5 under Exchange Act § 16.[47] Finally, mutual funds must list all portfolio positions quarterly, and break down their holdings into various categories.[48]

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

a. Basic Requirements

Any person who "directly or indirectly" acquires "beneficial ownership" of more than 5% of a public company's shares is generally required to file Schedule 13D with the SEC within 10 days after crossing the 5% threshold.[49] Certain types of institutional investors who invest "passively" (in the ordinary course of business and without intent to influence control) and own

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[45] See Exchange Act §§ 13(d), (g); Rules 13d-1 – 13d-7; Schedules 13D, 13G ***[USC and CFR cites to come]***.

[46] See Exchange Act § 13(f); Rule 13f-1; Schedule 13F **[USC and CFR cites to come]**.

[47] See Exchange Act § 16; Rules 16a-1 to [16e-1]; Forms 3, 4, and 5 ***[USC and CFR cites to come]***.

[48] *See generally* Securities and Exchange Commission, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 8393 (Feb. 27, 2004), 69 Fed. Reg. 11,244 (Mar. 9, 2004); Securities and Exchange Commission, Form N-1A, at Item 22, *available at http://www.sec.gov/about/forms/formn1-a.pdf*.

[49] Rule 13d-1(a) and 13-1(i).

between 5% and 20% of a company's shares can instead file a more abbreviated Schedule 13G (generally on February 15 of each year, reporting year-end positions with a 45-day lag).[50] Both Schedules are publicly available.

For both Schedules, disclosure is based on "beneficial ownership" of shares, as defined by Rule 13d-3, which includes sole or shared voting or investment power, which can be held "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise." Beneficial ownership of shares includes "the right to acquire beneficial ownership within sixty days, including . . . through the exercise of any option or warrant." The SEC seeks to discourage gaming by providing that any person who uses any "contract, arrangement, or device" to evade the 13(d) reporting requirements is deemed to be a beneficial owner.[51]

Both Schedules require disclosure of the number and percentage of the shares beneficially owned, and any purchases or sales within the past 60 days.[52] 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[53] as well as filing of certain related "written agreements" as exhibits. The scope of the exhibit requirement is not entirely clear.

Short positions, whether in shares or derivatives, do not trigger disclosure. If disclosure is triggered by a large long position, some disclosure is required for partially offsetting short positions.

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[50] Rule 13d-1((b). If ownership exceeds 10%, Schedule 13G must be filed by the 10th day of the next month.

[51] Exchange Act Rule 13d-3, 17 C.F.R. § 240-13d-3 (2005).

[52] Schedule 13D, Item 5; Schedule 13G, Item 4.

[53] Schedule 13D, Item 6.

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

b. Application to Hidden Ownership

Consider now whether the 13D and 13G rules would capture hidden voting. We will use Perry-Rubicon as an example. Perry held just under 5% of Rubicon's shares, plus equity swaps conveying an additional 11% economic ownership. Its direct shareholding alone would not trigger disclosure. Nor is it likely that the equity swaps, by themselves, trigger disclosure. The equity swaps in Perry-Rubicon were presumably cash-settled, so that they 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. This would depend on whether it had a sufficiently firm expectation that it could exchange its equity swap position for shares at any time. On this point, there is no clear guidance in SEC rules or no-action letters. Practitioners at law firms prominent in the OTC derivatives market have stated that in their view, disclosure is normally not required. A partner at Allen & Overy, the primary outside law firm of the International Swaps and Derivatives Association (the main trade association for the OTC derivatives industry), has stated that disclosure is not required for cash-settled derivatives.[54]

[54] Chin-chong Liew, *Disclosure Requirements for Purely Cash-Settled Derivatives*, Hong Kong Lawyer, June 2000 <http://www.hk-lawyer.com/2000-6/June00-59.htm>.

Similarly, partners at Cleary Gottlieb have written that "a long position under an equity swap would generally not be treated as beneficial ownership" under Rule 13d-3.[55]

Non-disclosure of cash-settled equity swaps can be questioned, if one looks beyond the swap itself to the economic dynamic surrounding it. The derivatives dealer that enters into the swap will almost surely want to hedge its exposure. A principal way to hedge is to hold shares. This hedging choice was especially likely in Perry-Rubicon because Perry initiated the equity swap by selling Rubicon shares to Deutsche Bank and UBS Warburg. Thus, there was an excellent chance that Perry could return to its dealers, pretty much whenever it chose, and exchange its swap position for shares, even without a prior discussion with its dealers.[56] Is this a sufficient "arrangement, understanding, or relationship (legal or otherwise)", especially in light of the extension of beneficial ownership to any person who uses any "arrangement, or device" to evade reporting?

Perry claimed not under New Zealand rules – rules that were, on the whole, similar to U.S. rules. Perry lost at trial and won on appeal. The Australian Takeover Panel, however, came out the other way in 2005, under Australian rules on large shareholder disclosure, which are similar to Section 13(d) and to New Zealand's rules. Glencore International, which held just below 5% of Austral Coal, entered into equity swaps with two derivatives dealers, comprising another 6.5% in economic ownership, before disclosing its overall position. The Takeovers Panel held that Glencore should have disclosed its combined position as soon as its economic ownership crossed 5%.[57] The Panel found that Glencore expected the derivatives dealers to

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[55] 2 Edward F. Greene, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, & Sebastian R. Sperber, U.S. Regulation of the International Securities and Derivatives Markets § 13.02[2] n.25 (2004).

[56] See the discussion of Perry-Rubicon in Part II.C *supra*.

[57] See Takeovers Panel, Austral Coal Limited 02 – Decision and Review Application (July 1, 2005) http://www.takeovers.gov.au/display.asp?ContentID=956 [hereinafter Austral Coal Decision]. The Takeovers Panel

acquire shares to hedge the equity swaps and the dealers understood that Glencore sought to acquire holdings over 5% while avoiding disclosure. The Panel felt that the dealers' incentive to hold the matched shares gave Glencore "a real degree of effective negative control" over disposal of these shares. Glencore's having "worked diligently" to avoid disclosure was part of the justification for requiring disclosure. An analogous argument that disclosure should be required in the U.S. could be based on the anti-gaming provisions of Rule 13d-3(b). **[BSB: need to update for Australian court decision, see JCF]**

c. Application to Empty Voting

Consider next how Schedules 13D and 13G affect empty voting, using Perry-Mylan as an example. If Perry held less than 5% of Mylan, disclosure would not be triggered. Perry chose, however, to acquire 9.9% of Mylan's shares. Had Schedule 13G been available, no disclosure of the hedges would have been needed. Perry initially took the position that Form 13G was available, and filed a Schedule 13D only after Icahn filed his own 13D, indicating an intent to acquire control of Mylan, a step that Perry opposed.[58] Perry's view that its own intent to oppose the merger did not involve a control intent is debatable. But assume a Schedule 13D filing was required. What did Perry have to disclose about the hedges that offset its direct economic ownership?

Not much, or so Perry 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 other "hedging transactions"

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based this decision on the policy concerns underlying the large shareholder disclosure rules, rather than on the specific language of the statute. As discussed in note xx *supra*, this Panel decision is on appeal. **[to be updated]**

[58] *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.

and that "to execute . . . certain hedging transactions," it had entered into stock loan transactions with Bear Stearns and Goldman, Sachs. It disclosed neither the terms of the hedges nor the number of shares to which they pertained.

Consider next the proposed Deutsche Boerse/LSE merger, which involved possible voting of Deutsche Boerse shares despite a negative overall economic interest due to a short position in LSE, or the HP-Compaq merger, in which investors with long positions in Compaq were rumored to have acquired empty voting positions in HP to support the transaction. Assume that a hedge fund owns over 5% of a host company: would Schedule 13D require disclosure of its position in the target's shares? Here the answer is clear -- no disclosure is required. For example, Item 6 requires disclosure of contracts or arrangements with respect to "any securities *of the issuer*" (emphasis added).

In sum, Schedules 13D and 13G provide only limited disclosure of the existence and nature of the new vote buying. One can quibble with level of detail that Perry provided, its initial decision that Schedule 13G was available, and its failure to attach the hedging agreements as exhibits to its 13D filing.[59] But from a policy perspective, picking at the language of disclosure rules that weren't written with empty voting in mind is beside the point. The real problem is that the 13D and 13G rules were written in the 1970s, when equity swaps and the business practices surrounding them did not yet exist.

[59] Item 7 of Schedule 13D requires filing of "all written agreements, contracts, arrangements, understandings, plans or proposals relating to . . . (3) the transfer or voting of the securities, finder's fees, joint ventures, options, puts, calls, guarantees of loans, guarantees against loss or of profit, or the giving or withholding of any proxy as disclosed in Item 6." **[CFR cite to come].** Perry's counsel presumably decided that its hedges were none of these.

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

The third ownership disclosure regime is under Exchange Act § 13(f). Institutional money managers must disclose their holdings at the end of each quarter by filing Form 13F with the SEC.[60] The Form 13F filing, like Schedule 13G, is filed with a 45-day delay. But, for new vote buying, Form 13F offers little help. Form 13F requires disclosure of holdings of "section 13(f) securities" by every "institutional investment manager" who holds $100 million or more in these securities.[61] The term "institutional investment manager" is defined broadly to include (a) any person, other than a natural person, who invests in or buys or sells for its own account; and (b) any person, whether or not a natural person, who exercises investment discretion with respect to the account of any other person.[62] This captures hedge funds (whether located in the U.S. or offshore) but not Joe Zillionaire, unless he exercises investment discretion over the accounts of others.[63] "Section 13(f) securities" are publicly traded U.S. equity securities included in the SEC's "Official List of Section 13(f) Securities." This list includes common shares and exchange-traded options.[64] Anything not on the list need not be disclosed. Form 13F is quite narrow in what it calls for. The "Information Table" at its heart is simply a list of each security

[60] Form F is due 45 days after the end of the quarter. 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, Instructions For Confidential Treatment Requests, **[cite to come]**.

[61] See Securities Exchange Act §§ 13(f)(1), 13(f)(5)(A), **[USC cite to come]**; Exchange Act Rule 13f-1, [**CFR cite to come]**.

[62] See Securities Exchange Act § 13(f)(5)(A), **[add USC cite]**. ***[need to confirm that there are no exemptions for particular classes of institutions, such as banks, broker-dealers, insurers, pension funds, etc.]***

[63] See Securities Exchange Act § 13(f)(1), **[USC cite to come]**; Securities and Exchange Commission Division of Investment Management, Frequently Asked Questions About Form 13F (Question 4) (May 2005). For an example of the use of Form 13F information to track hedge fund trading, see Markus K. Brunnermeier & Stefan Nagel, *Hedge Funds and the Technology Bubble* (working paper 2003) **[check for ssrn cite]**.

[64] See Exchange Act Rule 13f-1(c); Securities and Exchange Commission Division of Investment Management, Frequently Asked Questions About Form 13F (May 2005). **[add CFR cite]**

the managers owns, its CUSIP number (a standard means for identifying publicly traded securities), its type (for instance, shares, puts, or calls), and the number of securities held.[65]

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. Even for exchange-traded options, money managers need not report options they have *written* rather than bought, even if the written position is economically equivalent to a disclosable purchased position. Long share positions are reported; short positions are not. Indeed, a managers who holds 1,000,000 shares and has separately sold 500,000 short will report owning 1,000,000 shares, and never mention the short position.[66] If shares have been lent, both the lender and the borrower ignore the loan in their reports -- that is, the lender reports owning the shares, while the borrower reports nothing.[67]

Form 13F requires reporting of voting power, and whether it is sole or shared. However, if a manager has voting authority over "routine" matters and no authority to vote on "non-routine" matters, the manager reports as if it had no voting authority. Non-routine matters include a "contested election of directors, a merger or sale of all or substantially all assets, a charter amendment affecting shareholders' rights, and a change in fundamental investment

[65] See Form 13F, Special Instructions 9-12, **[CFR cite to come]**. There are exceptions for de minimus holdings.

[66] See, e.g., Securities and Exchange Commission Division of Investment Management, Frequently Asked Questions About Form 13F (Question 41) (May 2005), **[cite to come]** ("You should not report short positions on Form 13F. You also should not subtract your short position(s) in a security from your long position(s) in that same security; report only the long position.").

[67] Securities and Exchange Commission Division of Investment Management, Frequently Asked Questions About Form 13F (Question 42) (May 2005), **[cite to come]**.

policy" while routine matters "include" selection of an accountant, uncontested election of directors, and approval of an annual report.[68]

Consider now how 13F affects hidden ownership positions. These positions commonly rely on OTC derivatives, which fall under the radar of 13F disclosure. 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 when it comes to empty voting. Empty voting through share borrowing will never be seen. If an investor holds shares directly, while hedging its economic ownership, the direct ownership will be reported, its empty character will not. Moreover, it is usually a simple matter to hide a voting stake altogether. All the investor need do is shed its direct holdings before quarter end. For example, a hedge fund could, in effect, exchange its shares for economically equivalent swap positions before quarter end, and then exchange the swaps for shares in time to vote at the next shareholder meeting.

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

The fourth principal source of disclosure is Exchange Act Section 16. Section 16 disclosure covers only officers, directors, and 10% shareholders of U.S. public companies.[69] Outside shareholders are rarely covered; indeed they studiously avoid crossing the 10% threshold, partly because doing so triggers recapture of "short-swing profits" from buying and selling (or selling and buying) within a 6-month period. Avoiding coverage is straightforward. The 10% ownership threshold for triggering the obligation to disclose is based on "beneficial

[68] Form 13F, Special Instruction 12(b)(viii), **[CFR cite to come]**.

[69] Exchange Act § 16(a)(1), **[USC cite to come]**; Exchange Act Rule 16a-2, **[CFR cite to come]**.

ownership" in the 13D sense.[70] Thus, the same cash-settled equity swap that lets a hedge fund avoid "beneficial ownership" for 13D purposes also lets it avoid Section 16 disclosure.

If disclosure is required, the positions to be disclosed are based on "beneficial ownership" in the separate 16(b) sense, and is reasonably extensive. The 13D definition of beneficial ownership focuses on voting power. In contrast, the 16(b) definition focuses on economic ownership.[71] The relevant forms (Forms 3, 4, and 5) require disclosure of most economic interests, regardless of their form. An initial filing must be made on Form 3 and changes reported on Form 4. Form 5 is an annual statement of changes. All Forms are publicly available. Form 3 covers "beneficial ownership" (in the 16(b) sense) of any equity securities of the issuer, and must be filed with the SEC within 10 days after the event which triggers coverage.[72] Equity derivatives, whether exchange traded or OTC, must be disclosed. These include:

> any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security.[73]

This definition is quite broad. The derivative's value need not precisely track share value; disclosure is required as long as the derivative's value is "derived from the value of an equity security." There is an exception for "broad-based" index options, futures, and market baskets of

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[70] Exchange Act Rule 16a-1(a), **[CFR cite to come]**. Registered broker-dealers, banks, and certain other persons are exempt so long as they hold shares without the purpose or effect of changing or influencing control of the issuer or entering into an arrangement that would violate the anti-gaming provisions of Exchange Act Rule 13d-3(b), **[CFR cite to come]**.

[71] Exchange Act Rule 16a-(2), **[CFR cite to come]**. For non-experts in securities law, yes, the SEC has indeed defined the same term -- beneficial ownership -- in two different ways, once under Exchange Act § 13(d) and once under § 16(b).

[72] Exchange Act Rule 16a-3, **[CFR cite to come]**; Form 3 – Initial Beneficial Ownership of Securities, General Instruction 3, **[CFR cite to come]**.

[73] Exchange Act Rule 16a-1(c), **[CFR cite to come]**.

stocks.[74] By implication, derivatives whose value is based on a narrow index are covered. Thus, some related *non-host* assets are covered by Section 16 -- albeit with some ambiguity about which ones. There is no disclosure of short sales of shares, but no need for any, because short sales are banned outright by Section 16(c). The information required for each derivative is also extensive, and includes the title, exercise or conversion price, date exercisable, expiration date, and the title and amount of securities underlying the derivative security.[75] Changes in ownership must be reported on Form 4 using specific transaction codes. For instance, "S" indicates a sale, "C" indicates conversion, "O" indicates exercise of an out-of-the-money derivative, "X" indicates exercise of an in-the-money or at-the-money security, "K" indicates an equity swap or similar security.[76]

Because Section 16 disclosure focuses on economic ownership, it is much less developed for voting ownership unaccompanied by economic ownership. It is unclear whether or how one would report share lending or borrowing. Lending is likely not disclosable. Borrowing would likely count toward the 10% threshold for reporting by a 10% shareholder. Yet, its triggering function aside, borrowing might well escape disclosure because it does not convey economic ownership.[77].

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

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[74] Exchange Act Rule 16a-1(c)(4) **[CFR cite to come]**.

[75] Form 3, Initial Statement of Beneficial Ownership of Securities, General Instruction 5(c)(iii) **[CFR cite to come]**.

[76] Form 4, Statement of Changes of Beneficial Ownership of Securities, General Instructions 1(a), 4(a), 8 **[CFR cite to come]**.

[77] ***[need to check for SEC guidance on 16(b) disclosure of stock lending and borrowing]***

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.[78] These disclosures are due 60 days after the end of each quarter. Disclosure focuses on economic ownership and covers both long and short positions. For options, disclosure includes value, exercise price, and maturity date. There are no rules on what details to report for equity swaps and other OTC derivatives, but our spot check of several disclosure filings suggests that disclosure of notional amounts and certain other numerical information as well as counterparties is common. There is no requirement to disclose stock lending **[or borrowing]**, as long as this activity affects only voting rights, not economic ownership.[79]

Thus, while the details are different, mutual fund reporting is similar to insider Section 16(b) reporting in: (i) its focus on economic ownership; (ii) its coverage of all positions, both long and short, whether or not they convey voting rights; (iii) its coverage of both exchange-traded and OTC derivative positions; and (iv) its failure to cover share lending and borrowing. Both systems thus cover hidden ownership reasonably well, as well as some flavors of empty voting. However, mutual fund disclosure captures only quarter-end positions.

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[78] The basic forms for mutual fund portfolio disclosure are Forms N-1A, N-CSR, and N-Q. *See* Securities and Exchange Commission, *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Securities Act Rel. No. 33-8393 (Feb. 27, 2004), 69 Fed. Reg. 11,244 (Mar. 9, 2004)\ [hereinafter, SEC Mutual Fund Reports Adopting Release]; Form N-1A, *Registration Statement Under the Securities Act of 1933*, Items 22(b)-(c), **[CFR cite to come]** (discussing annual and semiannual reports); Form N-CSR, *Certified Shareholder Report of Registered Management Investment Companies*, Item 6 (Schedule of Investments), **[CFR cite to come]**; Form N-Q, *Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company*, **[CFR cite to come]**. The format for disclosure is specified in Regulation S-X, §§ 210.12-14, **[CFR cite to come]**.

[79] ***[need to confirm how mutual fund rules address disclosure of stock lending and borrowing]***

IV. A Proposal for Integrated Ownership Disclosure

A. General Considerations

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

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

We believe the new information will be useful to investors, as well as to corporations, judges, banking and securities regulators, and legislators as they contemplate if and how else to respond

to new vote buying. But even if this new disclosure had no other value, our proposal to simplify the disclosure system – in essence, integrating what are now five discrete ownership disclosure systems -- would likely be worthwhile.

Our proposal would (i) move toward commonality between the standards for triggering disclosure and for disclosing positions once disclosure is triggered; (ii) provide a single set of rules for which ownership positions to disclose and how to disclose them, which would replace all five current sets; (iii) require disclosure of both voting and economic ownership, whatever form this ownership takes; and (iv) require symmetric disclosure of long and short economic ownership. We mostly leave for another day disclosure of related non-host assets. However, our proposals would often require disclosure of holdings in both acquirers and targets, thus shedding light on one important instance of new vote buying with related non-host assets.

Our disclosure proposal should capture empty voting and hidden ownership reasonably well for current 13D and 16(b) filers, because these filers must report ownership, and changes therein, promptly. Disclosure will be patchier for other filers, especially with regard to empty voting positions, due to the periodic nature of the reporting requirements, which allow filers to sell down their positions before the filing date.

In offering these proposals, we do not reassess here the current disclosure thresholds, disclosure frequencies, delay periods, nor which investors must disclose their ownership positions. Implicitly, then, we assume that there is at least rough economic or political logic supporting the current rules. We believe, however, that whatever the thresholds, delay periods, etc. are, the ownership disclosure rules should be internally coherent. Moreover, the political history of ownership disclosure, in the U.S. and elsewhere, 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 aim is to make that disclosure coherent, simple, and therefore relatively low-cost.

Our proposed disclosure reforms build largely on the Section 16 rules. For long and short derivative positions, we would extend Section 16-type disclosures to institutions and other shareholders who now report on Schedules 13D, 13F, and 13G. Short sales of shares should generally be disclosed in a manner similar to long positions, with a possible exception for "pure" short sales, discussed below. Purchase and sale prices and trade dates would be required, as at present, only for Section 16 reports. We would modestly expand the institutions who must report on Schedule 13F by counting any economic ownership of equity securities or equity derivatives (whether exchange-traded or OTC) toward the $100 million threshold. We would count on a gross basis all long and short positions toward the 5% triggering threshold for Schedules 13D and 13G, subject perhaps to the limited exception described below for "pure" short positions. For banks, broker-dealers and others who both hold proprietary positions and positions managed for clients, we would require separate reporting of each; subject perhaps to limited exceptions for short-term positions held in connection with market-making activities.

We would also require more complete disclosure of stock lending activities and the nature of voting power. Stock lenders would report their loans; stock borrowers would report their borrowings. Money managers who have voting discretion for routine matters but not non-routine matters would so indicate. If share lenders retain voting rights, or share borrowers convey these rights to others, that too would be disclosed.

We propose symmetric disclosure of positive and negative economic ownership. We regard as a quite close question whether a large "pure" short economic position, defined as negative economic ownership with no accompanying voting ownership, should trigger 13D/13G

disclosure or require 13F disclosure, but have chosen to err on the side of simplicity and symmetry. Accordingly, in our proposal, pure short positions would count for both purposes,[80]

For OTC derivatives, current mutual fund practice can provide a guide as to what level of reporting detail is appropriate. Regulators will need to develop guidelines for reporting of derivative positions that are not addressed by the current Section 16 and mutual fund rules. As a lodestar principle, we believe that reporting persons should disclose information sufficient to allow a derivatives dealer, with access to market information on volatility and other pricing parameters, to estimate the derivative's value and 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. This principles-based approach should be more robust to financial innovation than a traditional "cubbyhole" approach,[81] of the sort reflected in the current 13F rules.

These proposals would expand disclosure, but would also integrate and substantially simplify the current multi-headed disclosure regime. The limited exception for pure short positions aside, economically equivalent positions would be treated consistently. The distinction between positions that trigger disclosure, and positions that must be reported once disclosure is triggered, would disappear.

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[80] 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. On 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).

[81] For analyses of how financial innovation subverts traditional classification-based regulation, see Henry T. C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 Yale L.J. 1457 (1993); Henry T. C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. Pa. L. Rev. 333 (1989); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 Tex. L. Rev. 1319 (1991).

Our proposals for disclosure of economic ownership are consistent with recent regulatory changes made in the U.K. and Hong Kong in response to aspects of new vote buying. In November 2005, the U.K. began requiring large shareholder reporting by persons who have long economic ownership through derivative positions. In 2003, Hong Kong similarly extended large shareholder disclosure to persons with both long and short equity derivatives positions. The most important difference between the U.K. and Hong Kong approaches is that Hong Kong does (as we do), while the U.K. does not, require disclosure of a pure *short* economic position.

Table 4 summarizes our integrated ownership disclosure proposal. Comparing Table 4 to Table 3 visually shows the simplification compared to current rules. It takes 12 columns in Table 3 to summarize the current rules, but only 5 columns in Table 4 to summarize our proposals.

Table 4. Proposed Integrated Ownership Disclosure

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

Proposed Disclosure Requirement	**Long Shares, Equity Swaps, other OTC and Exchange-traded Derivatives**		**Short Shares, Equity Swaps, other OTC and Exchange-traded Derivatives**				**Stock Lending and Borrowing**
	As trigger	If filing required	As trigger		If filing required		
			Equity Swaps, other OTC and Exchange-traded Derivatives	Short Sales	Equity Swaps, other OTC and Exchange-traded Derivatives	Short Sales	Lending Borrowing
13D	yes	yes	yes		yes		yes
13G	yes (if held on reporting date)	yes	yes (if held on reporting date)		yes		yes (if held on reporting date)

13F (expanded to include stock lending and borrowing	status-based: $100M in economic ownership	yes	status-based: : $100M in economic ownership		yes		yes
Section 16 (director or officer)	status-based	yes	status-based	illegal	yes	illegal	yes
Section 16 (10% holder)	yes		yes				
Mutual Funds	yes	yes	yes		yes		yes

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

As we have seen, large shareholder disclosure under Schedules 13D or 13G is based on "beneficial ownership" under Rule 13d-3, which requires sole or shared voting or investment power over shares or securities convertible into shares. Our proposed extension is simple: filers should report both voting and economic ownership; either form of ownership can trigger the reporting obligation. The Section 16 concept of economic ownership can be carried over to Schedules 13D and 13G. We would expand the current Section 16 reporting to provide that stock borrowing and lending positions would be reported, since these positions affect voting ownership. Each position would be separately disclosed using transaction codes adapted from Section 16 reporting. New codes would be needed for borrowing and lending positions. Schedule 13D filers would have to attach any contracts that convey or relate to their economic or voting ownership. We would also modestly move the line between 13D and 13G reporting, which currently turns on control intent, and require 13D reporting if a position is held with a view to affecting a shareholder vote, even if, as in Perry-Mylan, the vote does not affect control.

To 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 Mylan's vote on acquiring King. It would separately 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, 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 since most institutions will have to report their positions quarterly on Schedule 13F.

In determining whether the 5% reporting threshold has been crossed, we would not allow netting of long and short positions. An example can show why. Assume that a hedge fund takes a 10% net short position and also enters into an equity swap conveying a 6% long position, so that its net short position is 4%. With netting, no filing would be required. But we would want the hedge fund to file a Schedule 13D or 13G. The fund would like to see the company's share price drop because its overall position is net short, and likely has de facto access to 6% voting rights if a shareholder vote arises.

For some derivative positions, questions will arise as to how to measure effective economic exposure. An equity swap conveying the economic return on 1,000,000 shares should count as economic ownership of 1,000,000 shares. That is simple enough. But how about a call option? The option holder's economic exposure depends both on the number of options held and on the share price. In derivatives terminology, δ (delta) is the change in option value for a small change in the price of the underlying asset.[82] 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 then should this position be reported?

We believe that reporting of economic exposure for call options and other derivatives with deltas that vary with share price or other factors would add undue complexity and cost. We propose instead a cruder approach. Current Rule 13d-3 provides a simple rule for counting beneficial ownership for call options: one reports the number of shares that would be acquired on exercise of the option, which is equivalent to assuming $\delta = 1$. We believe the number of

[82] More technically, delta is the partial derivative of option price with respect to the price of the underlying asset. See E. BRIYS, M. BELLALH, H.M. MAI, F. DE VARENNE, OPTIONS, FUTURES, AND EXOTIC DERIVATIVES 124 (1998).

"matched shares" for a derivative position should be computed in parallel fashion. This approach is consistent with the recent Hong Kong reforms.

C. Institutional Money Managers and Mutual Funds

We propose that 13F disclosure of economic and voting ownership should use the same format and contain the same information as Schedules 13D and 13G. The principal difference would be the trigger for 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 or equity derivatives. Otherwise, an institution could avoid disclosure by holding equity derivatives and keeping its direct equity holdings under $100 million.

Cost concerns are more important for Form 13F reports than for Schedules 13D and 13G because almost every institutional investment manager has to file Form 13F on a quarterly basis, as to all positions held. In contrast, Schedules 13D and 13G apply to a much smaller number of holdings. However, institutional money managers should have ready access to the basic portfolio information we propose to collect. Some hedge funds, for example currently provide quite detailed reports to investors.[83] Thus, there will be a one-time cost in revising internal reports to match the new reporting format, but ongoing 13F filing cost should be similar to current cost, and similar to the costs that mutual funds now incur, without howls of outrage at compliance cost.

For mutual funds, our proposed 13F reports will be sufficiently similar to current reporting so that large portions of the separate mutual fund rules can be eliminated for mutual funds' equity positions. Mutual funds will still need separate disclosure rules for debt securities.

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

We also do not propose to change the current rules requiring summary portfolio schedules and breakdowns of holdings by category, geographic region, and so forth. An fund management firm (such as Fidelity or Vanguard) that manages a number of separate mutual funds would continue to disclose fund-by-fund holdings under the mutual fund rules, as well as aggregate holdings on Form 13F.

The 13F and mutual fund disclosure is quarterly, and thus will not reach all instances of new vote buying. We also would not change the current reporting delays, in which 13F, 13G, and mutual fund reports are due with a substantial lag after the end of the reporting period. These limitations on reporting speed and frequency seem to us to offer an acceptable tradeoff between disclosure completeness and cost. The disclosures should be sufficient to offer an overall picture of the extent of new vote buying, even if they do not capture all instances.

An important fringe benefit of our proposal is that Form 13F reporting covers a large fraction of the universe of stock lenders and borrowers. Currently, stock lending data is sparse. Even the aggregate size of the market can only be estimated.[84] The largest borrowers of stocks are prime brokerage firms; the largest lenders are major institutions. Beyond that, little is known, beyond individual anecdotes.[85] Simply aggregating 13F reports of lending and borrowing will provide valuable data, both in the aggregate and for particular firms.

The primary cost to investors will be indirect, from disclosing trading positions that are currently concealed. Yet, to some extent, we have already crossed the bridge. The intent of Form 13F was to require institutional money managers to disclose their equity holdings.

[84] Thus, one recent estimate of the size of the U.S. institutional securities lending market drew on a combination of the firm's own internal client surveys and Federal Reserve statistics. *See* Phyllis Plitch, *Funds' Lending Sparks' 'Short' Debate*, WALL ST. J., May 25, 2005, at B2D; cf. Dan Barnes, *Learning the Cost of Stock Lending*, BANKER, May 2, 2005, at 62 (the size of the global securities lending market is "fairly unclear").

[85] *See* Jeffrey Cohen, David Haushalter & Adam V. Reed, *Mechanics of the Equity Lending Market*, in SHORT SELLING: STRATEGIES, RISKS, AND REWARDS 13-14 (Frank J. Fabozzi ed. 2004) at 13-14.

Reporting is delayed 45 days after quarter end to reduce the competitive impact of disclosure. Changes in the derivative markets have undermined the completeness of reporting, but we do not believe that the basic tradeoff between disclosure and competitive secrecy was seriously misdrawn. **[To be expanded based on JCF]** -- Investors need to retain some ability to trade on private information about value, to encourage search for this information. At the same time, the social value of privacy is substantially less than its private value.

D. Disclosure of Record Date Capture (Expansion of Form 13F)

Our proposed stock lending and borrowing disclosure will provide a good aggregate picture of the stock lending market. But 13F and mutual fund disclosure, because it is made only quarterly, will miss most record date capture, which is concentrated in a limited period around the record date for a shareholder vote. An institution could borrow up to 5% of a company's shares, vote them, reverse the borrowing before the quarter ends, and report nothing. To address record date capture strategies, we propose that Form 13F separately require reporting of positions held around a record date for the purpose of voting, whether or not these positions are held at quarter's end. The disclosure rules should cover any strategy, through share borrowing or otherwise, designed to provide voting power that departs significantly from economic ownership.[86]

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

[86] We do not propose similar changes to the mutual fund rules because fund advisors have to report their aggregate positions on Form 13F. Schedule 13G also calls for periodic reporting, but no additional change to 13G is needed because, under our proposal, the effort to capture votes will trigger an obligation to file Schedule 13D instead of Schedule 13G.

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

This reporting should not be onerous. It will apply only to institutions that consciously engage in vote capture. These are likely a small faction of the universe of 13F filers. If vote capture is widespread, the filing burden will be higher, but then so will be the need for the information. The reporting would be on the usual 13F Form, and thus would occur some time after the vote.

E. Summary

As a response to hidden ownership, the disclosure enhancements we propose above may well be sufficient. For empty voting, disclosure will be valuable, but may in the end be only a first step. Disclosure may reduce the incidence of empty voting, and should also provide the information base needed to assess the need for substantive reforms. At the same time, much of the disclosure will be delayed, which limits its value to directors, shareholders, and courts for a contest at an individual company. It will often be possible to reconstruct, after the fact, instances in which vote buying may have affected voting outcomes, but this information will usually emerge too late to alter those outcomes. Delayed reporting is a tradeoff of disclosure cost against timeliness. If empty voting proves widespread, the decision to allow delayed reporting can be revisited.

The new information will also prove useful for efforts at international coordination. The new vote buying is international in scope, so international coordination will be important for any

regulatory response. The need for information and for international coordination has been recognized in a current private effort to address new vote buying undertaken by the International Corporate Governance Network (ICGN), a group of major institutional investors drawn from the U.S. (including CalPERS), U.K. (including Hermes), France (including Credit Agricole), and elsewhere.[87]

V. Toward Substantive Responses to Empty Voting

A. General Considerations

We develop in our companion "finance" paper the theory and evidence bearing on whether shares should be linked to votes, and on how a market for votes, decoupled from shares, might operate.[88] There are circumstances in which such a market could be problematic, and circumstances in which it could foster stronger shareholder oversight of managers. For this and other reasons, including the difficulty regulating an activity that can take many forms, about which little is yet known, we consider it premature to adopt substantive rules to address empty voting.

Still, a simple example can illustrate why some substantive regulation will eventually 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 lower value thereafter ascribed to remaining shares. These problems have led to regulation of takeover bids, including a minimum offer period and a ban on two-tier offers.

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[87] *See* International Corporate Governance Network – Securities Lending Committee, *ICGN Stock Lending Code of Best Practice* (Draft of July 2005) [hereinafter ICGN, *July 2005 Draft Stock Lending Code*]; Lintstock, *Share lending vis-à-vis voting – A report commissioned by the International Corporate Governance Network* 3 & 22 (May 28, 2004) [hereinafter Lintstock, *Share Lending Survey*].

[88] See Hu & Black, *Hedge Funds and Insiders* (2006), *supra* note xx.

Consider now a proxy fight for control. Similar problems would afflict a proxy fight waged through efforts to buy votes decoupled from shares. Thus, an unregulated market for votes, decoupled from shares, seems unlikely to work well. We therefore develop below a menu of regulatory options, and say a bit about their merits.

There are three families of strategies. The most obvious strategies focus directly on voting rights (Section B). A second family focuses on improving a "voting architecture" that was developed before the emergence of equity derivatives and large-scale stock lending (Section C). A third family involves regulatory interventions that affect supply and demand forces in the markets that support decoupling, especially involving the responsibilities of institutional investors to vote shares they own (Section D).

A further issue, which we do not detail here, is the locus of regulation. Some responses are potentially federal in nature, while others are likely to be implemented either by the stock exchanges, by states, or by individual companies. In particular, federal securities law focuses on disclosure. The SEC likely cannot, within its current statutory authority, directly regulate empty voting. Such an effort would affect the "internal affairs" of corporations, traditionally governed by state law.[89] 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. Especially in an area where the right response is uncertain, a federal response could lock in overregulation -- as

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

some scholars believe may be the case with Sarbanes-Oxley.[90] 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: The Martin-Partnoy Proposal

One way to address empty voting is to limit the voting rights of shareholders who hold greater voting than economic ownership. This is the approach taken in a recent article in which Professors Martin and Partnoy suggest that "shareholders with substantial short positions should not be entitled to vote" and that "corporations and their regulators should strongly consider taking away the votes of [shareholders who are also] options buyers and sellers."[91]

One problem with their proposal is that the technology for enforcing such a rule is not obvious. Martin and Partnoy address only short sales and option positions. They do not discuss record date capture, equity swaps, and other alternatives. If the technology problem can be solved, there is appeal to a rule that would disallow voting for the extreme case in which a shareholder has negative economic ownership.

There could also be appeal, despite the potential benefits of empty voting in some cases, to a rule that lets shareholders vote only to the extent that they hold economic ownership. Yet once one moves from a simple, rarely triggered on-off switch (does an investor have negative economic ownership), to a general rule that limits voting rights that would otherwise exceed economic ownership, the technical difficulties in measuring economic ownership become

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

[91] Martin & Partnoy (2005), *supra* note xx.

fearsome. One must grapple with complex derivative positions, in which the effective economic exposure depends on share price. One must deal with indirect, partial hedges, through related non-host assets (as in the Deutsche Boerse-LSE situation). One must decide what to do with ownership levels that change on a daily basis, simply because share price changes. In developing the integrated disclosure proposal presented above, we initially attempted to invent a workable scheme for 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.

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

In the end, a combination of factual uncertainty about when and how new vote buying occurs, when it is beneficial or harmful, and practical concerns about how one might draft and enforce such a rule, persuade us to err on the side of caution. We are ready neither to recommend limiting voting rights when they would otherwise substantially exceed economic ownership, nor to argue that such a rule would be a serious error.

2. Voting By Record Owners: Extension to Equity Swaps

Empty voting by shareholders with zero economic ownership deserves special attention, because it is both common and, in part, already regulated. Our complex system of record ownership already decouples economic ownership from formal voting rights. The record owner is typically at least two persons removed from the economic owner of the shares.[92] Shares held in "street name" are generally held "of record" by Depository Trust Company or another securities depository, which holds the shares on behalf of another intermediary (such as a broker-dealer or bank), which holds the shares for customers-economic owners. Our legal system has responded by partly recoupling voting and economic ownership. Depositories pass voting rights to their bank and broker clients, who must request voting instructions from economic owners. If the customer does not provide instructions, New York Stock Exchange (NYSE) Rule 452 allows a bank or broker to vote only on routine, uncontested matters such as a director election or approval of the company's auditor. The record owner cannot vote on a contested matter or on a merger or similar transaction which may substantially affect the value of the shares.[93]

These rules on when record owners can vote provide precedent for an effort to reconnect voting rights to economic ownership, when technology has severed them. Consider, for example, a derivatives dealer who holds shares to hedge the interest leg of an equity swap. As we discuss in Part III, the dealer will often unwind the swap to allow the holder of the equity leg of the swap to vote, or simply vote as the equity leg holder directs. These implicit understandings reconnect voting and economic ownership in a manner analogous to the rules governing record owners. In this situation, we should require disclosure of ownership that is

[92] On the current system and its origins, see, e.g., Securities and Exchange Commission, Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, Rel. No. 34-50785A, notes 1, 2, & 21 (Dec. 7, 2004); Michael T. Reddy, Securities Operations – A Guide to Operations and Information Systems in the Securities Industry 127-64 (2d ed. 1995).

[93] *See generally* Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, *Symposium on Corporate Elections*, 59 Bus. Law. 109 (2003). ***[add cite to parallel NASD rule; how about banks?]***

currently hidden, but otherwise recognize that the market is placing voting rights where they ought to be, so that further intervention is not needed.

3. Corporation Opt-In

An alternative to mandatory limits on voting rights would be to let corporations decide for themselves whether to require a link between economic and voting ownership.[94] One option is a board-adopted bylaw; a second is a charter amendment.

Corporate opt-ins, such as only allowing shareholders with positive net economic ownership to vote, fall prey to many of the kinds of concerns we raised about the Martin-Partnoy proposal. There are additional concerns specific to opt-ins. Board action without shareholder approval -- say through a bylaw -- is problematic from a policy perspective because it can easily be structured to entrench insiders. It also is not clear whether or to what extent a board-adopted bylaw that restricted voting rights would be valid, given that state corporation laws currently grant voting rights to record owners, whether or not they are economic owners.

As a legal matter, a charter amendment is more likely to succeed. Delaware Section 212(a) states that "unless otherwise provided in the certificate of incorporation" and subject to certain record date limitations, "each stockholder shall be entitled to one vote for each share of capital stock." The one share-one vote rule is merely a default rule and the corporation is not explicitly constrained in how it departs from this rule. Moreover, the most closely relevant case, *Williams v. Geier,* suggests that a charter amendment affecting voting rights will receive only

[94] We discussed the opt-in approach in the draft presented at the May 2005 ALEA conference and in detail in the version posted on SSRN on January 6, 2006. *See supra* note – (referring to these earlier versions). In a draft presented at a conference on February 25, 2006, Professors Kahan and Rock explore the possibility of an opt-in approach but conclude that "in the context of empty voting, regulatory intervention should be limited to requiring additional disclosure…" *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (presented at the Second Annual Penn / NYU Conference on Law and Finance, Feb. 25, 2006).

deferential business judgment review.[95] Stock exchange rules that limit dual-class recapitalizations would likely block some potential charter amendments. Consider, for example, a time-phased voting plan, similar to the one approved in *Williams v. Geier*, which limits the voting rights of shareholders who have held their shares for less than, say, six months. This would likely run afoul of NYSE rules, which state that voting rights cannot be "disparately reduced or restricted through any corporate action or issuance" and offers as examples "time phased voting plans" and "capped voting rights plans."[96]

Some vote-limiting strategies could also run afoul of the federal proxy rules. Consider, for example, a charter provision requiring a shareholder to attest that he has economic ownership "substantially equal" to the number of votes he proposes to cast. Given the SEC's broad power under Exchange Act section 14(a) to regulate the proxy process, such a provision would probably require SEC assent.[97]

Beyond the positive question of what charter amendments are permissible are the policy questions: What limits should there be on charter amendments that limit voting rights? Within those limits, what should companies do? The core problem is that for shareholders, voting rights are collectively valuable but individually worth little. Thus shareholders can sometimes be persuaded, as in the dual class recapitalizations of the 1980s, to part with these rights for little consideration.

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

[96] New York Stock Exchange, *Listed Company Manual*, paragraph 313.00(A).

[97] Exchange Act § 149a), **[USC cite to come].**

More generally, the usual arguments for the efficiency of corporate choice do not apply to midstream charter amendments, because of their potential to entrench management.[98] Simply leaving companies free to adopt charter amendments could lead to bias – to rules that allow vote buying by insiders while blocking techniques used by outsiders. Time-phased voting is a good example of a rule that limits vote buying but also entrenches insiders. One could reduce the bias in the charter amendment process by changing corporate law to let shareholders unilaterally amend company charters. But the shareholder vote on a charter amendment can itself potentially be bought. In the end, 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 carefully cabined. Yet it seems premature to assess what the limits on charter amendments should be without knowing either the dimensions of empty voting or how companies might seek to respond. As we suggested above, the initial need is for disclosure, to provide a base of knowledge against which substantive responses can be judged.

4. State Corporate Law

A separate question from whether companies can use charter amendments to limit vote buying by outside shareholders is whether corporate law limits vote buying by insiders. At one extreme, the rigor with which courts police shareholder elections make 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.[99] In the Hewlett v. Hewlett-Packard proxy fight

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[98] *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. 542-597 (1990).

[99] **[citations to come from SCLR version: Blasius, Liquid Audio; what else?]**

case, for example, Walter Hewlett claimed that HP management had procured a favorable vote by Deutsche Bank through promises or threats related to future business dealings between the two companies. HP defended on the grounds that it had persuaded Deutsche Bank to support the merger on the merits, and effectively conceded that procuring votes through a promise or threat would violate management's duty of loyalty, as well as constituting classic vote buying.[100] Suppose, instead, that HP management had engaged in new vote buying to swing the outcome. There is no identifiable seller, and hence no classic vote buying, but the breach of fiduciary duty would be the same, and the courts would likely disallow the procured votes.

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

It seems likely, then, that judges will face pressure to update current doctrine on vote buying, which is primarily about vote *selling*. They might well disallow voting by an empty voter such as Perry with negative net economic interest. This situation is analogous to voting **[at a board meeting]** by directors whose personal interests conflict with the corporation's interests.[101] In both situations, the usual presumption that votes will be cast with the goal of increasing the firm's value is thrown into doubt by other economic interests. Negative net

[100] *See* Hewlett v. Hewlett-Packard Co., 2002 WL 818091, at *9 (finding that "no one from HP used any threats or inducements regarding future business relationships.")

[101] See Lon L. 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, 108 Mont. 569 (1939) (outside director who was a competitor).

economic interest aside, it seems premature to speculate as to how courts should address empty voting, given the multiple factual contexts in which it can be used.

Another possible response is to reduce the importance accorded to shareholder votes as a guide to shareholder preferences. Ronald Gilson and Alan Schwartz have argued that elections are inferior to tendering decisions as a guide to shareholder preferences in a control battle.[102] The potential for empty voting strengthens their case. When some directors are conflicted, the Delaware courts channel decision-making to non-conflicted directors. Similarly, if some shareholders hold more votes than economic ownership, judges can give less deference to a voting outcome influenced by the votes of these shareholders. The degree of deference could change both for control contests and for shareholder proposals, for which an open question is how much attention a board should pay to a nonbinding shareholder proposal favored by a majority shareholder vote.[103]

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 stock lending. One result is that even large institutional investors often misunderstand the voting rights they have. Some institutional investors do not know when their shares have been lent, or that they lose their voting rights when they lend shares.[104] For example, in January 2004, the International Corporate Governance

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

[103] See, e.g., Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23 (2004).

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

Network (ICGN) circulated among its members a questionnaire on their securities lending practices.[105] Of the 39 institutions which responded (including pension funds, mutual funds, banks, insurance companies, and other asset managers), 31 had lent shares. Most reported that stock lending is done by agents (such as custodians) rather than by the respondents themselves. Half reported that the custodian or other agent can lend without the respondent's knowledge. A substantial majority (21 of 31) "[r]arely, only in special circumstances" recall shares in order to vote them; moreover, attempts to recall shares for voting purposes sometimes failed.

Full information may change lender behavior. CalPERS, a major lender which earns about $110 million a year from this activity, illustrates. Beginning in 2003, CalPERS has sought to balance the income it receives from securities lending with its "shareholder responsibility" to vote shares. CalPERS currently will not lend shares of certain companies around voting record dates and claims that it will only lend shares to "those who have a legitimate right to the proxy as a benefit of true ownership."[106] At the same time, any one investor faces a collective action problem: it can profit from lending and its vote probably won't matter.

A further step for stock lenders, beyond knowing that they've lent and the consequences for their voting rights, is knowing to whom they have lent. This too has not been common today. Lenders often lend through agents, or lend to broker-dealers who act on behalf of clients who are unknown to the lender. New (February 2006) rules require lending agents to provide to their

[105] See Lintstock, Share lending vis-à-vis voting – A report commissioned by the International Corporate Governance Network (May 28, 2004).

[106] See CalPERS, Securities Lending as It Relates to Proxy Voting (report prepared by CalPERS staff in response to May 16, 2005 Investment Committee meeting). We confess to being a bit skeptical about CalPERS' ability to know its borrowers well enough to implement this goal.

clients details on each stock loan.[107] What stock lenders do with this still-partial information about the ultimate borrowers remains to be seen.

Another concern is mechanical problems associated with voting. Currently, the simple act of counting votes would fail if all shareholders entitled to vote did so. Growth in short selling and stock lending are contributing to an increasingly serious problem of "over-voting" by brokerages. Currently, brokers who hold shares in street name vote in accordance with voting instructions from their clients. Suppose that a broker holds 2 million shares in a pooled account on behalf of margin customers, of which it has lent 1 million, but receives voting instructions from holders of 1.5 million shares. There is at present no coherent way of ensuring that such a broker will cast only 1 million votes, nor of deciding whose voting instructions count if the broker casts only 1 million votes. Instead, brokers follow ad hoc procedures, with uncertain impact on proxy fights. The New York Stock Exchange issued a warning on over-voting in 2004, suggesting that a previously theoretical concern may be becoming real.[108] Over-voting has come up in at least one lawsuit over the results of a proxy fight.[109]

Yet if one is concerned with empty voting, the solution to over-voting is not obvious. Limiting the broker in our example to 1 million votes (presumably cast in proportion to the voting instructions the broker receives) would disenfranchise individual shareholders and

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[107] *See* DTC Begins Testing for Agency Lending Disclosure, Securities Industry News, July 13, 2005; These changes were driven by concerns about credit risk, not vote buying. See Mark C. Faulkner, *Quantifying Risks in Securities Lending Transactions*, in SECURITIES FINANCE – SECURITIES LENDING AND REPURCHASE AGREEMENTS 150 (Frank J. Fabozzi & Steven V. Mann eds. 2005); Gene Picone, *Widespread Changes to Disclosure in 2005*, Securities Lending Quarterly-JP Morgan 2 (4th qtr. 2004).

[108] *See* Chris Kentouris, Decisive Moment on Proxy Miscounts, Securities Industry News, Dec. 31, 2004.

[109] See Robert C. Apfel, John E. Parsons, G. William Schwert, & Geoffrey S. Stewart, *Short Sales, Damages, and Class Certification in 10b-5 Actions*, Univ. of Rochester, Simon School of Business Administration, Bradley Policy Research Center Financial Research and Policy Working Paper No. FR 01-19 (July 2001) (discussing a proxy contest at Integrated Circuit Systems and associated voting actions taken by brokers). For discussion of the voting mechanics that make overvoting possible, see Martin and Partnoy, *supra* note xx. **[add Berni's overvoting case]**

increase the disparity between economic ownership and voting rights. A better solution might be a change in business practice in which stock lenders could elect whether to retain voting rights. Borrowers who needed voting rights would then have to borrow from lenders who were willing to part with them. Borrowers for whom voting rights were unimportant could borrow (presumably at lower cost), in effect, only the economic return on shares.

D. Strategies Focused on Participants in the Markets for New Vote Buying

A third family of regulatory interventions would focus on participants in the markets that support new vote buying. On the "supply" side of the market, one could regulate stock lenders such as mutual funds and pensions as well as lending intermediaries. On the "demand" side, one could regulate the purposes for which hedge funds and other investors could acquire voting rights decoupled from economic ownership. The primary actors here would be the SEC, the Federal Reserve Board, the U.S. Department of Labor, and other federal authorities.

Empty voting through stock lending depends on two basic groups: stock lenders and financial intermediaries who connect lenders with borrowers. Conveniently, most lenders and intermediaries are subject to federal regulation.

1. Encouraging Institutional Shareholders to Vote on Important Matters

One approach would be to encourage institutional shareholders to vote on important matters. They could be made subject to rules that make voting part of their obligation to clients, perhaps with an exception for routine matters.

For example, mutual funds must comply with Investment Company Act Section 17(f), which requires the fund to keep its shares and other assets in the custody of a bank or another

specified entity.[110] In a series of no-action letters dating to 1972, SEC staff has taken the position that securities lending by mutual funds violates Section 17(f) unless specified guidelines are met. One guideline is that a fund may not lend at any time securities representing more than one-third of its total assets.[111]

Regulators could also encourage stock lenders to recall shares for voting purposes. Thus, another SEC guideline states that:

> We would not object if voting rights pass with the lending of securities. However, this does not relieve the directors of a fund of their fiduciary obligation to vote proxies. If the fund management has knowledge that a material event will occur affecting an investment on loan, the directors would be obligated to call such loan in time to vote the proxies.[112]

In contrast, the controversial rules that the SEC adopted in 2003 requiring disclosure of voting practices by mutual funds and registered investment advisers are silent on stock lending. The adopting release states that mutual funds and investment advisers can choose not to vote if the costs of doing so outweigh the benefits (offering examples involving voting of foreign shares).[113]

The approach of the Department of Labor (DoL) to voting by pension plans subject to ERISA (basically, company pension plans but not public sector pension plans) is similar to the

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[110] See Peter A. Ambrosini & Karen B. Clark, Custody of Mutual Fund Assets, in Mutual Fund Regulation 10-1 to –14 (Clifford E. Kirsch ed., 2d ed. 2005).

[111] See, e.g., The Brinson Funds, 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); State Street Bank & Trust Co., SEC No-Action Letter, 1972 SEC No.-Act. LEXIS 4798 (Jan. 29, 1972).

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

[113] See Securities and Exchange Commission, *Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Investment Companies*, Investment Company Act Rel. No. 33-8188 (Jan. 31, 2003); Securities and Exchange Commission, *Proxy Voting by Investment Advisers*, Investment Advisors Act Rel. No. IA-2106 (Jan. 31, 2003). On the circumstances when investment advisors need not vote, see Rel. No. IA-2106, § II(A)(2)(a) & n. 3.

SEC's approach to mutual funds. Interpretive Bulletin 94-2, its most comprehensive statement on voting, encourages but does not require voting. For shares of foreign corporations, the Department interpreted ERISA fiduciary duties:

> to require the responsible plan fiduciary to weigh the costs and benefits of voting on proxy proposals relating to foreign securities and make an informed decision with respect to whether voting a given proxy proposal is prudent and solely in the interest of the plan's participants and beneficiaries.[114]

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

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

> a breach of fiduciary responsibility . . . might result if the plan trustees do not terminate the loan in time to vote proxies in the event of an occurrence affecting the plan's interest in the security.[115]

It is not hard to imagine regulators strengthening this informal guidance, and extending to other classes of institutional investors a requirement to recall lent shares in order to cast important votes.

2. Safe Harbor for Voting Instead of Lending Shares

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[114] See Department of Labor, Interpretive Bulletin 94-2 (July 29, 1994); cf. Clifford E. Kirsch, *[chapter title to come]*, in Mutual Fund Regulation (2005), supra note xx (describing the Labor Department's approach to proxy voting).

[115] Department of Labor – Pension & Welfare Benefit Programs, Opinion 79-11A, 1979 ERISA LEXIS 81 (Feb. 23, 1979). The DoL has also informally advised pension fiduciaries to consider carefully whether to lend shares of a company at which a proxy vote might arise that could affect the value of the stock. *See* Margaret Price, Stock lending, proxy votes don't always mix, Pensions & Investments, Mar. 16, 1992, at 23 (paraphrasing a February 1992 statement of Ivan L. Strasfeld of the Labor Department).

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. Any one institution's decision to hold and vote shares is unlikely to affect the outcome, so lending will often be privately optimal. Yet collectively, institutional votes can often swing a voting outcome and benefit all shareholders. The inability of any one institution to capture the positive externality from voting will produce too much lending and too little voting. The SEC and DoL positions on share lending, discussed above, likely provide a quasi-safe harbor in terms of fiduciary challenges. If one's regulator is urging and perhaps requiring one to vote, it is hard to object to a decision to do so. Still, there could be value in a reliable safe harbor for all institutions which vote shares rather than lend them around a record date.

3. Reducing the Attractiveness of Lending Shares and Providing Equity Derivatives and Imposing Responsibilities on the Lenders and Providers

There are also a variety of tax and regulatory changes that could be deployed to make share lending less attractive to lenders, or to make equity swap transactions less attractive to derivatives dealers. In particular, stock lending income is ordinary income, that does not qualify for the reduced 15% income tax rate on dividends. If a mutual fund lends shares and receives a dividend-equivalent payment, the dividend would have qualified for a reduced tax rate; but the substitute payment does not.[116] A similar tax issue arises for lending by broker-dealers. If a broker lends customer shares and receives a dividend-equivalent payment in return, the customer will "payments in lieu of dividends," which are not entitled to the 15% rate.

[116] For discussion of how these tax considerations may cause stock lending to flow from mutual funds to (tax-exempt) pension funds, see Phyllis Feinberg, *[article title to come]***,** PENSIONS & INVESTMENTS, Sept. 1, 2003, at 6.

At the margin, these tax consequences should reduce the attractiveness of stock lending. For example, unless compensated for these tax consequences (which is not the current industry practice), investors could open cash accounts (from which shares cannot be lent) rather than margin accounts. The extent to which mutual fund investors and margin account holders are aware of these tax consequences of share lending is doubtful. Internal Revenue Service require broker-dealers to disclose annually to their customers the portion of investment income that qualifies for the dividend tax rate, but not the specific reasons why. One can imagine better disclosure, for example, a statement that "we earned $X last year by lending shares from your account; this increased your taxable income by an estimated $Y.") Broker-dealers could also be required to obtain customer consent to lend shares periodically, or even for each transaction.[117] We make no claim that particular tax or regulatory tweaks are desirable, only that they are possible.

Another possible approach is to put greater responsibility on share lenders or equity swap providers to know their clients, and how their clients will use the share borrowing or swap. In the Enron disaster, banks offered Enron a variety of financial products that helped Enron present a misleading financial picture to the public. One consequence has been multibillion dollar payments by major banks to settle class action lawsuits. Another is that regulators now expect financial institutions to do more to investigate their clients' use of financial products to game disclosure or tax rules.[118] The SEC, Federal Reserve Board, and the Office of the Comptroller of the Currency have issued a joint statement warning financial institutions against creating

[117] Rule 15c3-3(b)(3) adopted under the Securities Exchange Act specifies that the broker's borrowing of securities from its margin customer be pursuant to a written agreement that meets certain criteria; there is no requirement that the broker obtain the customer's approval prior to lending any particular securities. See Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069 (2002).

[118] See In the Matter of Citigroup, Inc. Exchange Act Release NO. 48230, 2003 SEC Lexis 1778 (July 28, 2003); In the Matter of J.P. Morgan Chase & Co., Litigation Rel. No. 18252 (July 28, 2003).

complex financial products that let their customers artificially alter their public financial statements or evade taxes.[119] It is not a large step to imagine that regulators could take a similar interest in investment banks' creation of instruments designed to facilitate empty voting or evade ownership disclosure rules.

In one respect, current rules already limit the purposes for which shares may be lent. Under Federal Reserve Regulation T, broker-dealers who have material dealings with the general public are exempt from the usual margin rules that limit borrowing to acquire securities. Other broker-dealers enjoy a more limited "permitted purpose" exemption. They may "borrow or lend securities in case of short sales, failure to receive securities required to be delivered, or similar situations."[120] Under the "permitted purposes" exemption, broker-dealers are required to make a good faith effort to determine the borrower's purpose and cannot lend shares for voting purposes.[121] All the Federal Reserve need do to greatly limit record date capture is to either extend the permitted purposes approach to all broker-dealers or make share lending for vote capture purposes an illicit purpose for otherwise exempt broker-dealers. Such a ban on share lending to permit record date capture is already the informal norm in the U.K.[122]

A similar "know your customer's purpose" approach could affect the market for some other forms of vote buying. Suppose that a hedge fund comes to a derivatives dealer, seeking

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[119] See Securities and Exchange Commission, Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, Rel. No. 34-49695, 2004 SEC LEXIS 1017 (May 13, 2004).

[120] See Regulation T, 17 C.F.R. § 220, especially § 220(2) ("exempted borrower" exemption for major broker-dealers); § 220.10(c) ("permitted purpose" exemption for other broker-dealers).

[121] With regard to record date capture to let borrowers take advantage of company dividend reinvestment plans, which typically allow use of dividends to buy new shares at a discount to market, the Federal Reserve staff ruled that stock lending was not a permitted purpose. Federal Reserve Board Rulings and Staff Opinions Interpreting Regulation T, 5-615.01, FRRS 5-615.01 (July 6, 1984).

[122] See Paul Myners, *Review of the impediments to voting UK shares – Report by Paul Myners to the Shareholder Voting Working Group: Progress – One Year On*, at 13 (March 2005) at 13; Bank of England, Securities Borrowing and Lending Code of Guidance xx (**year**) (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]").

simultaneously to buy shares and hedge its economic exposure, ending up with pure votes. One could establish a presumption that the hedge fund's goal is empty voting, and bar dealers from entering into these swaps

5. The Demand Side: Executive Hedging

The demand for vote buying and the products it depends on can be affected by techniques similar to some of those discussed above for the supply side. We offer here one example, involving executive hedging, which usually leaves executives with more voting power than economic interest. If this "lite voting" by executives is problematic, one could make it less attractive by increasing the adverse tax consequences of hedging. By hedging, the executive has effectively sold a portion of his shares. Internal Revenue Code Section 1259 taxes, as constructive sales, a limited set of hedges. For example, an equity swap that offsets "substantially all" economic exposure would trigger tax. Section 1259 is easy to avoid: standard zero-cost collars do not trigger it, nor would a swap that offset most, but not "substantially all" of an executives economic exposure.[123] While difficult to come up with an administrable rule that could not be easily gamed, one could try to move to a more easily triggered standard.

VI. Conclusion

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

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

Financial innovation now allows large scale, low cost decoupling between voting rights and economic ownership. The modern derivative, heretofore largely a risk management tool and an investment vehicle for investors and firms, now has the potential to affect voting outcomes. Strategies for trading risk turn out to be well adapted for trading votes. Hedge funds, taking advantage of modern equity derivatives and the now-massive stock lending market, have been the pioneers. Insiders have used decoupling strategies to retain votes while shedding economic exposure.

Not all vote buying is bad. Some could move votes from less informed to better informed investors, and strengthen shareholder oversight. Still, unless there are ways to separate good vote buying from bad, and allow only the former, the new vote buying, as we call it, threatens to leave the coupling between voting and ownership in tatters. We would face instead the unappetizing prospect of voting outcomes determined by hidden warfare among company insiders and major investors, each employing vote morphing and other financial innovations to acquire votes and thereby swing a voting contest.

While the potential threat posed by the new vote buying is serious, the current extent of new vote buying remains unknown, and the right regulatory response is not obvious. The first step is to better understand the new vote buying, through enhanced disclosure. Empty voting and hidden ownership should be exposed to public view. This article has therefore proposed disclosure requirements for both institutions and insiders. Our proposals would integrate and greatly simplify the four existing disclosure regimes for portfolio holdings. They are practical and indeed may 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 a sufficient response to hidden ownership. For empty voting, it will likely, in the end, be only a first step, but a sufficient step to give regulators, judges, companies, and investors a good view of the nature and scale of this new activity. Eventually -- perhaps soon -- substantive responses to empty voting may be needed. One family of substantive responses would involve focusing on voting rights themselves. Corporations can, for instance, amend their charters to condition voting rights of major shareholders on the presence of a coupled economic interest. Other responses would focus on voting architecture, and on participants in the markets on which empty voting relies.

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

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