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'Empty voting' ploy used by hedge funds is on SEC's radar

By **David Hoffman**
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PHILADELPHIA — The practice of borrowing company stock to manipulate the outcome of company votes has piqued the interest of the Securities and Exchange Commission and has rekindled a debate over stock lending.

In at least two speeches this year, SEC member Paul S. Atkins talked about the practice, which has been dubbed "empty voting."

"It carries the potential to create much mischief in shareholder voting," he told attendees at the Corporate Directors Forum in San Diego on Jan. 22.

More transparency

The practice, while legal, is so disturbing that federal regulators will likely find it necessary to respond in some way, SEC Chairman Christopher Cox told *The Wall Street Journal* late last month.

But what's the best way to address the issue?

Some industry experts suggested bringing more transparency to the murky, little-understood world of stock lending.

More transparency would "absolutely make it more difficult" for empty voting, said Jim Wiandt, president of Index Publications LLC in New York, which publishes the *Journal of Indexes*. It could make it easier to see where the demand for borrowed shares is coming from, he said.

There is no doubt that the issue of empty voting has created something of a headache for those involved in stock lending, said Charles Gradante, managing principal of Hennessee Hedge Fund Advisory Group LLC in New York.

For example, hedge funds, many of which rely on borrowing stocks to short, have had difficulty in recent years, because pension funds that loan out their shares have been reluctant to do so, as they fear that those stocks could be used to swing company votes, he said.

That has contributed to a shortage in supply that is limiting the ability of hedge funds to short, Mr. Gradante said. It is the Achilles' heel of hedge funds, because it limits their effectiveness, he said.

Making stock lending more transparent and efficient wouldn't be a cure-all, but it could be a step in the right direction, Mr. Gradante said.

An SEC spokesman didn't return calls seeking comment, but many industry experts said that a more transparent and efficient stock-lending market is on the horizon.

"The SEC is always so gung-ho for market efficiency and fairness," said William Uchimoto, a partner and co-chairman of the securities litigation practice group at Saul Ewing LLP in Philadelphia.

Stock lending is "a ripe area" for the SEC to get involved, he said.

But some industry experts have suggested that there is little will to bring about a more efficient stock-lending market, because creating such a market would be seen as giving tacit approval to those who engage in short selling, which is considered by many to be counter to the interests of long-term investors.

Traders typically short stocks by borrowing the security in the hope of selling it later when the price goes down and when it can be bought back at a lower price. The practice is controversial, because, critics say, it has been used to drive down the price of stocks and in the process allegedly destroy smaller companies.

Overstock.com Inc., an online retailer based in Salt Lake City, campaigned heavily for a rule adopted by the SEC in 2003 designed to rein in "naked short selling," the trading of stocks that an investor doesn't own or even plan to own.

Several industry participants, however, said that the negative perception of short selling is just that — a perception. The reality, they say, is that short selling helps create more-efficient markets by acting as a brake against overhyped stocks.

Given that, short sellers deserve an efficient market themselves, Mr. Uchimoto said.

Currently, if short sellers want to borrow a stock, they have to go to a broker or bank, he said. Because there is no centralized market, however, the lenders have pricing power they wouldn't otherwise have, Mr. Uchimoto said.

"The big stock lenders are going to have to be brought in [to a centralized market] kicking and screaming," he said.

But it isn't just the lenders, according to John Van, chief financial officer of Greenwich (Conn.) Alternative Investments, which operates an investible index and allocates client assets to hedge funds.

Hedge funds won't be thrilled about a centralized market, either, Mr. Van said.

"As little as they like to talk about their positions, they like to talk about their shorts even less," he said.

Nevertheless, it makes little sense for hedge fund managers not to put aside such concerns when the possibility exists that they may not be getting the best deal, Mr. Wiandt said.

And hedge funds aren't getting the best deals they otherwise would, Mr. Gradante said.

There is a supply-and-demand imbalance to which pension fund concerns over empty voting has contributed, he said. The result is that stock buying is becoming more difficult, Mr. Gradante said.

A more efficient market wouldn't necessarily correct that imbalance, but it could help, he said.

"There is no clearing house for [stock loans], and that maybe is the next step," Mr. Gradante said.