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Ownership in Public Companies*

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Abstract

Most U.S. public companies have a one share, one vote structure: voting power is proportional to economic ownership. Linking votes to shares gives shareholders an incentive to exercise voting power well, makes possible the market for corporate control, and legitimates managerial authority over property the managers do not own. Theory and evidence generally support linking votes to economic interest, although some models suggest that vote buying can sometimes be efficient.

However, new equity derivatives and other capital market developments now allow shareholders to readily decouple voting rights from economic ownership of shares. This decoupling (the "new vote buying") is largely undisclosed and unregulated. Hedge funds are prominent users of decoupling. Sometimes they hold more votes than economic ownership ("empty voting"). Sometimes they hold (undisclosed) economic ownership ("hidden ownership"), often with the *de facto* ability to acquire the votes if needed (with such morphable voting rights, "hidden voting ownership"). Insiders can also engage in empty voting. Over the past few years, new vote buying has affected shareholder votes and takeover battles on four continents.

This Article analyzes the new vote buying in the context of current finance theory as to corporate governance. We offer a framework for unpacking the functional elements of the new vote buying. We propose a disclosure-based regulatory response which would integrate and simplify five existing, inconsistent share ownership disclosure regimes. We also develop a menu of longer-term substantive responses. Two companion articles in legal journals (Hu and Black, 2006a, 2006b) discuss in greater detail the ownership disclosure rules and other legal rules that affect new vote buying.

1. Introduction

The shareholder vote has long played a central role in the corporate finance theory. Theory suggests that assigning voting rights to common shareholders places the power to

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oversee company managers in the hands of residual owners. The residual owners have an incentive to exercise that power to increase firm value. The more shares owned, the greater the incentive: some proportionality between ownership and voting power is called for. Linking shares to votes also facilitates the market for corporate control. For insiders, a disparity between voting power and economic interest predicts reduced firm value.

Yet the derivatives revolution in finance, especially the growth in equity swaps and other privately negotiated ("over the counter" or "OTC") equity derivatives, and related growth in the stock lending market, are making it ever easier and cheaper to decouple economic ownership from voting power. Hedge funds and company insiders are taking advantage of this opportunity. Sometimes, they hold more votes than shares -- a pattern we call "*empty voting*," because the votes have been emptied of economic interest. 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.

Investors or insiders can also have economic ownership that exceeds their (formal) voting rights. This ownership is often "hidden" because current ownership disclosure rules are normally triggered principally by voting power rather than by economic interest. Thus, even when economic ownership is significant, this ownership is not apparent to the outside world. Often, such "*hidden ownership*" is combined with *de facto* ability to acquire (legal) voting rights at any time. We use the term "*hidden voting ownership*" to refer to the possession of undisclosed economic ownership plus these informal—"morphable"—voting rights.

We refer to empty voting and hidden voting 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.¹

There are a number of ways to decouple votes from economic ownership. One method relies on the stock lending market, which lets one investor "borrow" shares from another. Under standard share loan agreements, the borrower acquires voting rights but no economic ownership, while the lender has economic ownership without voting rights. A second approach involves holding shares but hedging the economic risk on the shares by holding a short equity swap position. In a typical equity swap, the person with the long equity side (the "equity leg") acquires the economic return on shares (but not voting rights) from the short side (the "interest leg"). Gains or losses are cash settled at the swap maturity date. The combined position (long shares, short equity swaps) conveys voting rights without net economic ownership. Conversely, a long equity swap position conveys economic ownership without voting rights. One can also hedge a long share position -- thus ending up with voting rights but not economic ownership -- through such derivatives-based strategies as buying puts or writing calls.² Irrespective of such activities, the total votes held by all investors do not change. [Bernie: *the total economic*

¹ The "new vote buying" is a new example of the challenges that derivatives and financial innovation pose to corporate governance principles. For discussions of the overarching issue, see, e.g., Hu (1991, 1996).

² There are slight differences among these hedging strategies. The long side of an equity swap typically receives the full return on shares, including price changes as well as dividends or other distributions. In contrast, the returns on a single stock future, call option, or short put option position normally depends solely on share price changes.

exposure can change, such as when a derivatives dealer simply sells a call but doesn't hedge the exposure]

A recent public U.S. instance of empty voting illustrates the potential risks from empty voting. 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. When the deal was announced, King's shares soared, but Mylan's shares dropped sharply. To help Mylan receive shareholder approval for the merger, Perry bought 9.9% of Mylan – becoming Mylan's largest shareholder -- but hedged its market risk on the Mylan shares. Perry thus had **9.9% voting ownership** 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 would profit.³

Other uses of empty voting can perhaps be beneficial. For example a shareholder can borrow shares just before the record date for a shareholder vote, and return them afterwards ("record date capture"). Record date capture by insiders fosters entrenchment. Yet for outside investors, it can reduce collective action problems. A U.K. example illustrates.⁴ In 2002, Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a major U.K. property company. At British Land's shareholder meeting, Laxey emerged with over 9% of the votes, the better to support a proposal to dismember British Land. Just before the record date, Laxey had borrowed 8% of British Land's shares.

Empty voting by institutions is a close cousin to widely used techniques, including zero-cost collars, variable prepaid forwards, and the like,⁵ by which managers and controlling shareholders retain formal ownership of shares while reducing their economic ownership. In the U.S., these strategies have typically been driven by desire to shed risk while deferring taxes; their empty voting aspects are incidental. Abroad, controlling shareholders have equity swaps for less innocent purposes.

Conversely, investors can have hidden ownership -- economic ownership that is not disclosed because the investor has shed the formal voting rights that trigger disclosure but with the *de facto* ability to acquire votes quickly when needed. Perry's stake in a New Zealand company, Rubicon Ltd., which came to light in 2003, illustrates. New Zealand's large shareholder disclosure rules, like Section 13(d) under U.S. law, require disclosure by 5% shareholders. Perry used equity swaps to hold both an undisclosed 16% economic stake in Rubicon and *de facto* rights to 16% of the votes: Perry had a 16% hidden *voting* ownership. When an important election came along, Perry arranged for the *de facto* voting rights to morph into actual voting rights. The non-disclosure of Perry's 16% stake was upheld under New Zealand law.

³ We provide citations to news stories and other sources in one of our companion articles (Hu and Black, 2006a). The stories we report rely in some cases on news reports that refer to market rumors or other sources which may not be accurate.

⁴ We refer to this example merely to illustrate how record date capture can help outsiders overcome collective action problems. We are agnostic as to whether Laxey's actions were in the short- or long-term interests of British Land's shareholders.

⁵ The glossary at the end of this article defines zero-cost collars, variable prepaid forwards and a number of other terms used in this article.

The new vote buying is largely unregulated and often unseen. Corporate case law that governs "classic" vote buying does not reach it (see Section 3.3). Federal disclosure rules scarcely touch the new vote buying either (see Section 4). Lack of disclosure means that we cannot offer hard data on its extent. We did, however, search for and compile a list of over a dozen public anecdotes (see Table 1 below). It is no accident that these examples are all recent, nor that most involve hedge funds. The theoretical possibility of decoupling votes from economic ownership is not new. What is new are investor ability to do so on a large scale, declining transaction costs due to financial innovation, and a trillion dollar pool of sophisticated, lightly regulated, hedge funds free from the conflicts of interest that may deter other institutional investors from aggressive use of decoupling strategies.

The corporate governance risk posed by the new vote buying is 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. A second is that disclosure should be "good enough" to let regulators and investors assess how often vote buying occurs, but should not impose large new costs on investors. A third theme is to treat long and short positions symmetrically.

The fourth theme is "integrated" ownership disclosure. Currently, there are five distinct, idiosyncratic ownership disclosure regimes, applicable to active 5% shareholders (13D), passive 5% shareholders (13G), institutional investors (13F), insiders and 10% shareholders (16(b)), and mutual funds. We propose simpler, more consistent, rules. Integrated 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 logic behind the current rules. While the optimality of the current disclosure thresholds is contestable, we believe that they are at least reasonable. Moreover, societal norms dictate transparency as to the control of major companies and control contests. Mandated ownership disclosure is an immutable part of the financial landscape. Our aim is to make that disclosure coherent, simple, and therefore relatively cheap.

Disclosure alone may be sufficient as a regulatory response to hidden voting ownership. For empty voting, a substantive response may also be needed. Still, we consider it premature to propose substantive rules. One reason is that empty voting can sometimes be beneficial, depending on the circumstances. A second is the multiple forms that new vote buying can take, which we need to understand better before regulating. Simply delegating rule-writing power to companies is also problematic, because company managers have incentives to write rules that block vote-buying forms used by outside investors, while allowing forms attractive to insiders. Nonetheless, a number of substantive strategies could potentially prove useful in addressing empty voting. We sketch a number of possible strategies, and their strengths and weaknesses, at the end of this article.

This paper proceeds as follows. Part 2 proposes a taxonomy for empty voting and hidden ownership, and lists the public examples we were able to locate. Part 3 discusses the finance literature on the connection between voting and economic ownership of shares. Part 3 also compares new vote buying to other means of decoupling economic from voting ownership, such

as dual-class shares. Part 4 discusses current disclosure rules and our disclosure reform proposal. Part 5 sketches possible substantive responses to empty voting. Part 6 concludes. 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."

In two companion articles, one directed at an academic legal audience (Hu and Black, 2006a) and the other directed at regulators, judges, and legal practitioners (Hu and Black, 2006b), we provide additional details on vote buying examples, disclosure rules, our disclosure reform proposal, and substantive reforms.⁶ The former provides fuller citations and discusses reforms in other countries that address new vote buying. The latter focuses on matters more likely to be of interest to financial readers and is also more accessible. A glossary at the end of this Article provides brief definitions of some of the pertinent trade jargon.

2. The Technology of the New Vote Buying

2.1. *The Functional Elements of the New Vote Buying: A Taxonomy*

We begin by setting out what we believe to be the core functional elements of the new vote buying.⁷ Define "**formal voting rights**" as the *legal* right to vote shares under company law, regardless of who decides how to vote. Define "**voting rights**" or "**voting ownership**" as actual rights to vote shares or instruct someone else with formal voting rights on how to vote. Thus, if a broker holds shares in "street name" for a customer, the customer has voting ownership while the record owner has formal voting rights. The company at which voting takes place is the "**host company**." Define "**coupled assets**" as derivative securities (such as options, futures, and equity swaps) or other contractual rights (such as rights under a stock loan agreement), the return on which is directly related to the return on shares.

Define "**economic ownership**" as an entitlement to the economic return on shares, which can be achieved **directly** by holding shares or **indirectly** by holding a coupled asset. Economic ownership can be **positive** ("long") -- the same direction as the return on shares -- or **negative** ("short") -- the opposite direction as the return on shares. "**Full ownership**" of common shares is voting ownership plus economic ownership. "**Net economic ownership**" is a person's combined economic ownership of host company shares and coupled assets. Net economic ownership can be positive, zero, or negative (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 downside at \$45. The executive has

⁶ As far as we are aware, this Article and our two companion articles together constitute the first attempt to systematically address the corporate governance implications of the new vote buying. See, e.g., Marcus (2006). Other articles or working drafts that have at least touched on this issue include Martin and Partnoy (2005), Skeel (2005), and Kahan and Rock (2006).

⁷ 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 maximization as a corporate goal. We leave aside non-shareholder constituencies, the distinctions between the welfare of the corporation and the welfare of the shareholder, and between shareholder welfare and shareholder wealth. (Hu, 1995)

partial economic ownership, which will be higher for share prices within the \$45-\$60 range and lower 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, shares in Mylan's target, King Pharmaceuticals, were a related non-host asset. Define the combined return on host assets (i.e., host company shares and coupled assets) and related non-host assets as an "**overall economic interest**" in the host firm's shares, which can be positive, zero, or negative. In Mylan, Perry Corporation combined full ownership of Mylan shares with coupled assets that offset its direct economic ownership and left it with *voting ownership* and **zero net economic ownership**:

$$\begin{aligned} & [9.9\% \text{ full ownership}] + [-9.9\% \text{ indirect economic ownership}] \\ = & [9.9\% \text{ voting} + 9.9\% \text{ direct econ. ownership}] + [-9.9\% \text{ indirect econ. ownership}] \\ = & [9.9\% \text{ voting ownership}] \end{aligned}$$

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.

We consider a person to have "**hidden ownership**" when the person has indirect economic ownership that disclosure rules do not cover (or are interpreted by the person as not covering). In practice, hidden ownership will often include informal voting rights: such "**hidden voting ownership**" will generally not be verifiable by outside observers. Perry's hidden voting ownership of Rubicon offers an example.

Table 1 offers some illustrative examples of the forms that new vote buying can take, and how these relate to the terminology above. The remainder of this Section 2 provides details on the mechanics of decoupling strategies, and examples of their real-world use.

Table 1. Some Forms of New Vote Buying

Examples of some forms of new vote buying.

Example	Voting Ownership	Economic Ownership	Coupled Asset	Net Economic Ownership	Related Non-Host Asset	Overall Economic Interest
<i>Empty Voting</i>						
share ownership hedged with short equity swap (Perry-Mylan)	yes	direct	Yes	zero	yes (target shares)	negative
share ownership hedged with options (Coles Myer proxy fight)	yes	direct	short call + long put	zero	no	zero
share ownership hedged with related non-host asset (MONY-AXA)	yes	direct	possible	not known	yes (acquirer bonds)	negative
record-date capture via stock borrowing (Laxey-British Land)	yes (high)	direct (low)	share loan agreement	positive–(low)	no	low
insider hedging	yes	direct (lowered)	Yes	positive (lowered)	no	positive (lowered)
Deutsche Borse-LSE (hedge funds were long acquirer shares and short target shares)	Yes	direct	No	yes	yes (target shares)	could be higher or lower than direct interest, depending on stake in target
<i>Hidden Voting Ownership</i>						
voting rights exercised by acquiring shares (Perry-Rubicon)	informal right to acquire shares from derivatives dealers	indirect	equity swaps	yes	no	high
voting rights exercised by directing votes of others (Marks & Spencer)	informal right to direct voting by derivatives dealers which held shares to hedge swaps	indirect	equity swaps ⁸	yes	no	high

⁸ Technically, the coupled asset actually used was a “contract for differences” (CFD), essentially the United Kingdom version of the equity swap. In this Article, we refer to equity swaps and CFDs interchangeably.

2.2 Empty Voting Through Coupled Assets

2.2.1. Empty Voting By Hedge Funds and Other Outside Investors

One core strategy for empty voting is to hold shares but hedge the economic return on the shares. There are a variety of hedging strategies. The simpler ones include: (i) a short equity swap position; (ii) a short position in a single stock future; and (iii) a (short call, long put) position. Perry-Mylan, discussed in the introduction, offers a good case study. As of late 2004, Perry Corporation owned seven million shares of King Pharmaceuticals, a generic drug maker. Mylan Laboratories, a rival, agreed to acquire King Pharmaceuticals in a stock-for-stock merger, which promised a large profit for Perry. However, Mylan needed shareholder approval for the merger, and Mylan's shares dropped sharply when the deal was announced. Perry therefore bought a 9.9% stake in Mylan Labs, which it could vote in favor of the merger. Perry hedged its Mylan position through short equity swap positions with derivatives dealers and other unspecified transactions. The derivatives dealers who took the long side of these swaps likely hedged by selling Mylan shares short. A second hedge fund, Citadel, acquired 4.4% of Mylan's shares and was rumored to have followed a similar strategy. 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.

Carl Icahn, a major Mylan shareholder, opposed the acquisition. He sued Mylan and Perry under federal securities law, including Section 13(d) of the Securities Exchange Act of 1934. He claimed that Perry and other hedge funds following similar strategies held 19% of the Mylan votes. The lawsuit became moot when Mylan abandoned the acquisition because of accounting problems at King.

[let's consider deleting this paragraph: Perry and Citadel might have been able to acquire their Mylan positions with little impact on Mylan's share price. Here is why. Assume that they bought shares and (more or less simultaneously) entered into short equity swap positions. The derivatives dealers on the other side held long swap positions, which they might hedge by selling Mylan short. The market impact of the Perry and Citadel purchases and the dealers' sales would tend to offset each other. The foregoing presumes open market purchases and short sales. Instead one possibility is that the dealers simply borrowed shares (with no market impact) and sold them short privately to Perry (again with no market impact). Only once Perry's position was disclosed would there be an impact on Mylan's price (but by then, Perry was hedged and so would not care). Under current rules, smaller holders such as Citadel would never disclose anything. Meanwhile, someone else (the share lender in this scenario) was left with economic ownership of Mylan but no votes.]

Several other anecdotes can illustrate the contexts in which hedged share purchases have been used to influence voting outcomes.

- In 2004, French insurer AXA entered into a merger agreement to acquire MONY. To finance the bid, AXA issued convertible bonds, which were convertible into AXA shares at a discount to AXA's price *only if* AXA acquired MONY. Holders of AXA bonds apparently acquired MONY shares to vote for the merger, while short sellers of the AXA bonds (including the Highfields Capital hedge fund) acquired MONY shares to oppose

the merger, with neither group's vote turning on whether the merger was good for MONY. The bondholders may have hedged some or all of their MONY positions.

- During Hewlett Packard's 2002 acquisition of Compaq, some holders of Compaq shares, who would profit if the merger were completed, were rumored to have engaged in empty voting of H-P shares to support the merger. The merger announcement led to a sharp drop in H-P's price and to a proxy contest by Walter Hewlett opposing the merger. Empty voting might have affected the outcome of this very close vote.
- In a 2002 proxy contest at Australian firm Coles Myer, investor Solomon Lew held 3% of Coles Myer's shares. To support his proxy campaign, he acquired voting rights to another 4% by acquiring shares while hedging his economic ownership with (short call, long put) options positions.

These strategies are troubling. Many acquisitions turn out poorly for the acquirer (e.g., Bruner (2004); Moeller, Schlingemann and Stulz, 2005). 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 mergers. Empty voting on the acquirer's side by the target's shareholders could reduce the limited constraint the vote requirement now instills in the acquirer's managers. Moreover, these techniques can also be used in proxy fights for control. We note in Table 2 one 2002 Australian proxy contest in which they were so used. With control at stake, the temptation to quietly buy votes will be strong, especially if the other side may be doing so as well. Cleverness in vote buying – a characteristic not directly related to ability to run the company well – may become an important factor in proxy contest success.

2.2.2. Insider Hedging and Entrenchment

Controlling shareholders and corporate executives are typically ill-diversified, with much of their financial wealth tied to the success of a single firm. These insiders often want to reduce their economic risk, ideally without triggering a tax bill. Investment banks, for a suitable fee, have developed a number of strategies to accommodate insiders' desires. One is to combine share ownership with a short equity swap position. Another, known as a zero-cost collar, involves buying a put option (to limit downside loss) and simultaneously selling a call option (thus reducing potential gain).⁹ This sharply reduces economic ownership but preserves voting rights. Bettis, Bizjak and Lemmon (2001) report 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%.

Vote buying is only one possible reason for insider use of equity derivatives. For U.S. executives, it is probably a secondary reason. In Hong Kong, for example, equity swaps were apparently used often enough by controlling shareholders to hide changes in their economic ownership to prompt regulators to broaden disclosure requirements in 2003 (Westlake, 2002; Hong Kong Securities and Futures Commission, 2003; Hong Kong Securities and Futures Commission, 2005).

⁹ If the put and call options have the same exercise price and expiration date, this transaction is economically equivalent to selling shares. More commonly, the call option exercise price is somewhat above the put option exercise price, hence the term "collar" (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.

There are other ways for insiders to retain control while shedding economic ownership, including dual-class common stock and circular and pyramidal ownership structures. We discuss the differences between these techniques in Section 3.3.

2.3. Empty Voting Through Record Date Capture

An alternate empty voting 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) convey to the lender any dividends or other distributions on the shares during the borrowing period. The loan is callable at any time by the lender, and repayable at any time by the borrower. The borrowing contract leaves the economic risk of the shares with the lender. The borrower holds only votes, without economic ownership. The lender has economic ownership without votes. See International Securities Lending Association (2000). Record date capture involves borrowing shares shortly before the record date for a shareholder meeting (the date on which the shareholders eligible to vote are determined), and returning them soon afterward.

The traditional use of stock borrowing is to facilitate short selling. The borrower sells the borrowed shares in the market. The buyer receives full voting and economic ownership of shares (and has no reason to know it bought from a short seller). The short seller ends up with no votes and negative net economic ownership. The short-seller later closes out the short position by, for instance, buying shares in the market and delivering them to the stock lender. But, omit the short sale, and stock borrowing becomes an easy route to empty voting.

The Laxey Partners-British Land incident, discussed above, is a rare public instance of record date capture. A second apparent instance involved a 2002 takeover bid in the U.K. by Carnival for P&O Princess, in which some investors reportedly borrowed P&O shares in order to vote in favor of the bid. Christoffersen, Geczy, Musto and Reed (2006), discussed below, offer evidence of quiet use of record date capture.

2.4. Hidden Ownership

2.4.1. Hiding Voting Power Until Needed

Equity derivatives can also be used to conceal ownership. Disclosure rules that, as we discuss in Part IV, turn largely on voting rights rather than economic ownership. Equity derivatives can provide economic ownership and, in certain circumstances, a colorable deniability of voting rights.

Perry has used equity derivatives for this purpose as well. In early 2001, Perry was a major holder of Rubicon Ltd., a New Zealand company. New Zealand has large shareholder disclosure rules, similar to U.S. rules, which required Perry to disclose its ownership if over 5%.¹⁰ Perry reported in June 2001 that it was no longer a 5% holder. A year later, in July, 2002, Perry suddenly disclosed that it held 16% of Rubicon, having acquired 31 million shares from Deutsche Bank and UBS Warburg, just in time to vote at Rubicon's shareholder meeting.

¹⁰ See New Zealand Securities Amendment Act 1988, § xx.

What happened? In May 2001, Perry shed its voting rights but not its economic interest. It sold 31 million shares to Deutsche Bank and UBS Warburg and simultaneously acquired from them an equivalent long equity swap position, which it treated as falling outside New Zealand disclosure rules. When Perry needed voting rights, it terminated the swaps and reacquired the shares from those derivatives dealers. Another major shareholder challenged Perry's right to vote, based on its failure to disclose its ownership. Perry lost at trial but won on appeal.

How did Perry know it could reacquire Rubicon shares when it needed to vote them? The 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, the size of the swap and the transaction costs to hedge in another way. Perry could also expect the banks to happily sell the shares back to Perry when Perry chose to unwind the equity swaps. Even the New Zealand Court of Appeal, which ruled for Perry, 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.¹¹

Holding "matched shares" is not the only way for a derivatives dealer to hedge an equity swap, but if the swap involves a large number of thinly traded shares, alternative hedging strategies may be limited. If the dealer holds matched shares, the dealer might, if asked, either unwind the swap and sell the shares to its client (as in Perry-Rubicon) or vote the shares as its client wants. A 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 dealer would "ensure" that shares are available to be voted by its customer or sold to the customer on closing out the swap (Panel on Takeovers and Mergers, 2005a, ¶3.3). Dealers may hedge by holding matched shares, precisely because doing so lets the swap holder vote the shares if needed. As the Panel explained, if the dealer hedges in another way, the swap holder would "normally expect" the dealer to acquire the necessary shares, even if this resulted in cost to the dealer (Id. ¶ 3.4.). Examples of this practice include:

- In the 2004 bid by BAe Systems for U.K. company Alvis, BAe obtained commitments from hedge funds holding long equity swap positions in Alvis to either unwind the swaps, obtain shares, and vote in favor of the BAe offer, or ensure that the dealers from whom they acquired the swaps would vote the shares to support the offer.
- In the 2004 bid by Philip Green for U.K. company Marks and Spencer, Green announced that its bid was supported by investment banks who held 8.3% of Marks and Spencer's shares as "matched shares" to hedge equity swaps. This support was presumably at the direction of the hedge funds who held the long sides of these swaps.

¹¹ Ithaca (Custodians) Ltd. v. Perry Corporation, [2003] 1 New Zealand Law Reports p. 731, at ¶ 66 (Court of Appeal – Wellington).

In response, the Panel on Takeovers and Mergers adopted a new rule in late 2005 to require disclosure by persons with significant positive economic ownership, regardless of their voting rights. (Panel on Takeovers and Mergers, 2005b; Panel Executive, 2005)

2.4.2. Toeholds and Blocking Positions

Economic ownership without apparent voting ownership can be used in other contexts as well. In 2005, for example, Centennial made a takeover bid for Austral Coal. Rival Glencore acquired a "blocking position" (sufficient to prevent Centennial from reaching 90% ownership and then squeezing out remaining shareholders), through a combination of shares and equity swaps (which the derivatives dealers hedged with matched shares). Glencore took the view that the equity swap position did not need to be disclosed under Australia's large shareholder disclosure rules (which are triggered by 5% share ownership), and disclosed its combined position only after crossing 10%. The Australian Takeovers Panel held that Glencore should have disclosed its combined position as soon as its economic ownership crossed 5% and assessed damages based on its estimate of the savings to Glencore from purchasing its full stake prior to disclosure. In 2006, the Panel's decision was reversed on appeal by the Australian courts.

Also in Australia, BHP Billiton, before announcing a 2004 bid for WMC, acquired a 4.3% toehold through equity swaps. Its reasons for doing so are not known, perhaps it wanted to reserve the possibility to acquire more than 5% before disclosing its position.

In the earliest publicly known example of decoupling, Brierley Investments, in 1997, used equity swaps to increase its stake in John Fairfax Holdings from 19.98% to 25%. If Brierley had simply acquired more shares, it would have been required by Australian law to offer to buy all of the Fairfax shares. Brierley's position was disclosed to market participants; it sought to evade the mandatory bid rules, not the disclosure rules.

2.5. 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. One recurring situation is a proposed merger. We have seen how, in Perry-Mylan, Perry used an empty voting position in Mylan to profit, it hoped, from holding King shares. But there can also be situations in which economic ownership in both bidder and target can increase a shareholder's economic interest and thus reduce the collective action problems that can lead to shareholder passivity when an acquirer proposes an overpriced acquisition. Hedge fund efforts to oppose Deutsche Borse'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 Borse proposed to buy LSE. The following month, two hedge funds (Children's Investment Fund (CIF) and Atticus Capital), together holding 8% of Deutsche Borse, publicly opposed the bid, which was eventually dropped. The connection to vote buying is that certain hedge funds – perhaps including CIF and Atticus -- shorted LSE shares around the time the CIF/Atticus opposition was announced. Let us assume that CIF and Atticus went long Deutsche Borse and short LSE, thus betting that the acquisition would fail. This would enhance their net economic interest in the Deutsche Borse vote, which might make it feasible for them to undertake the cost of a public campaign against the deal.

However, other combined Deutsche Borse - LSE positions would have the opposite effect. An investor which held a short position in LSE that was large relative to its long Deutsche Borse position, would have an incentive to oppose the bid even if it would benefit Deutsche Borse, LSE, or both companies combined. It would have positive economic and voting ownership of Deutsche Borse, yet negative *net economic interest* in the success of the acquisition. Meanwhile, merger arbitrageurs who followed the "classic" strategy of betting on completion of a stock-for-stock acquisition by going long the target and short the acquirer (the opposite of the possible 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 Borse or the combined firms. Thus, the new vote buying could, at the same time, empower CIF and Atticus as they try to pressure Deutsche to make a "good" decision, and empower classic merger arbitrageurs to support deal completion regardless of the merits.

2.6. *The Extent of New Vote Buying*

Given that much of it is undisclosed, the extent of new vote buying is necessarily unknown. 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 the 18 publicly disclosed (or in some cases rumored) examples that we found, in inverse chronological order. Other sources also suggest that vote buying is reasonably common. These include:

- regulatory changes in Hong Kong (2003) and the U.K. (2005) to require disclosure of formerly hidden ownership, and self-regulatory efforts in the U.K. to limit record date capture (see Section 5.3)
- the market understandings on unwinding of swaps and voting of matched shares (see Section 2.4)
- statements by lawyers at major firms as to common understandings on whether hidden ownership positions must be disclosed. These include:
 - Freehills in Australia (Pathak and Popo, 2005)
 - Allen & Overy in the U.K. (primary outside counsel for the International Swaps and Derivatives Association) has stated that disclosure is not required for cash-settled derivatives in the U.S (Liew, 2000).
 - Cleary Gottlieb in the U.S., whose partners have written that "a long position under an equity swap would generally not be treated as beneficial ownership" under SEC rules (Greene et al., 2004, § 13.02).
- Lawsuits in the U.S. (involving Perry-Mylan); Australia (involving Glencore-Austral Coal), and New Zealand (involving Perry-Rubicon)

These responses to market activity would likely not exist unless the underlying practices were reasonably common. To these, we can add the quantitative evidence discussed above, that executive hedging (with vote buying effects, even if vote buying is not the principal goal) is common (Bettis, Bizjak & Lemmon, 2001), as well as the evidence, discussed below, on record date capture (Christoffersen, Geczy, Musto and Reed, 2006).

Table 2. Decoupling Examples

This table lists, roughly in reverse chronological order, the known (or publicly rumored) instances of decoupling of economic and voting ownership we were able to collect. The list is surely partial. If readers know of instances not on this list, we would be grateful to learn of them.

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden Ownership	Coupled or Related Asset	Description
2005	Austral Coal	Australia	Glencore		X	equity swaps	See Section 2.4
2005	Fuji TV	Japan	Nippon Broadcasting		X	stock lending	Nippon lent its shares in Fuji TV to others as a defense to a takeover bid by Livedoor, producing a variant of hidden ownership in which Nippon had economic ownership, but might recapture voting rights only if the Livedoor bid failed.
2005	Deutsche Borse	Germany	Hedge funds	X		target shares	See Section 2.5
2005	Portman Mining	Australia	Seneca (hedge fund)		X	equity swaps	Cleveland Cliffs had bid to acquire Portman. Seneca held a 9% economic interest in Portman through equity swaps provided by CSFB.
2004-2005	WMC Resources	Australia	BHP Billiton		X	equity swaps	See Section 2.4
2004-2005	Mylan Laboratories	U.S.	Perry Corp. (hedge fund)	X		equity swap	See Section 2.2
			Citadel (hedge fund)	X		unknown	
2004	DFS	U.K.	Polygon (hedge fund)		X	equity swap	Polygon sought to influence DFS despite owning only one share of stock (it had 3% economic ownership through equity swaps).
2004	Alvis	U.K.	Hedge funds (helping BAE Systems to acquire Alvis)		X	equity swap	See Section 2.4
2004	Marks and Spencer	U.K.	Hedge funds (helping Philip Green to acquire Marks and Spencer)		X	equity swap	See Section 2.4
2004	Canary Wharf	U.K.	"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 held by Songbird members
2004	MONY Group	U.S.	Highfields Capital (hedge fund)	X		acquirer's convertible bonds	See Section 2.2)

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden Ownership	Coupled or Related Asset	Description
2004	News Corp.	Australia & U.S.	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
2002	P&O Princess	U.K.	Investor (favor Carnival bid for P&O Princess)	X	maybe	share borrowing	See Section 2.3
2002	Hewlett-Packard	U.S.	holders of Compaq shares (target of H-P merger bid)	X		target shares	See Section 2.2
2002	Coles Myer	Australia	Solomon Lew (proxy contestant)	X	no	options	See Section 2.2
2002	British Land	U.K.	Laxey Partners	X		share borrowing	See Section 2.3
2001	Rubicon	New Zealand	Perry Corp.		X	equity swaps	See Section 2.4
1997	John Fairfax Holdings	Australia	Brierley Investments			equity swaps	See Section 2.4

3. Review of the Finance Literature and Implications for New Vote Buying

3.1. Theory

3.1.1. *One Share, One Vote*

Several strands of theoretical literature develop the basic contractarian theory of the firm, and the related argument favoring a one-share, one-vote capital structure. One strand develops the contractarian theory, in which common shareholders have voting rights proportional to economic ownership because this places voting power in the hands of residual owners, who have incentives to use it to increase firm value (e.g., Easterbrook and Fischel, 1983, 1991). A second derives from the hostile takeovers of the 1980s and focuses on the role of a one share, one vote regime in supporting the market for corporate control (e.g., Grossman and Hart, 1988; Harris and Raviv, 1988, Hart, 1995, ch. 8) and the power of large shareholders to influence management (Shleifer and Vishny, 1986).

A more recent strand derives from the cross-country law-and-finance literature, in which a major concern is the ability of controlling shareholder to tunnel away firm value. Higher economic ownership by insiders predict lower tunneling and higher firm value (e.g., Bebchuk, Kraakman and Triantis, 2001; Durnev and Kim, 2005). The intuition is simple. Assume tunneling is costly in that it reduces firm value. The higher the insiders' economic ownership, the greater the share of this cost they bear, and hence the less tunneling they engage in. A large gap between insiders' voting rights and economic ownership can also lead to distortion of the firm's investment decisions (Bebchuk, Kraakman and Triantis, 2001).

While disparity may encourage tunneling, it could serve other goals. If insiders are unwilling to relinquish control and cannot reduce their economic stake, they will be undiversified and hence averse to firm-specific risk. Greater ability to hedge economic ownership could make insiders more likely to approve risky positive net present value projects, and less likely to engage in value-reducing hedging within the firm (Hu, 1990, 1995). Vote buying by outside shareholders can also reduce free rider obstacles that limit the effectiveness of shareholder voting as a constraint on managers, as the British Land-Laxey Partners anecdote potentially illustrates. Thus, the cheaper decoupling promised by the new vote buying is not necessarily efficiency reducing.

A final strand of analysis focuses not on legal choices that encourage or limit disparity between insiders' economic and voting stakes. Morck, Wolfenzon, and Yeung (2005) argue that a legal regime that permits disparity between voting power and economic ownership can let a single investor of family control a larger empire, amass greater political influence, influence public policy, and in an extreme case, "capture" the state. This strand of analysis treats the disparity between insider economic ownership and control, and investor protection more generally, as endogenous to other country-level institutions (e.g., Pagano and Volpin, 2005; Milhaupt, 1998).

3.1.2. *The Value of Votes: Individual versus Collective Value*

A core concern with decoupling shares from votes derives from the related observations that: (i) for outside investors, votes have limited individual value, but can have substantial

collective value; and (ii) in most circumstances, the value of votes is a small fraction of the value of shares. Consider the votes held by a particular small shareholder. Someone is interested in acquiring votes, but only enough to obtain a majority. The vote buyer can, in effect, make a two-tier offer: price X until the buyer gets a majority, 0 thereafter. As in a two-tier tender offer for shares, there will be pressure on a shareholder to tender at any price greater than the back end price (here, zero). Moreover, at present, the vote buyer can conduct a rolling two-tier tender offer without rules. A small shareholder will face time pressure to sell fast, lest others sell first.

This concept can be formalized using "oceanic" Shapley values, which measure the likelihood that a voter will be pivotal. The Shapley value of a small "oceanic" shareholder depends on the holdings of significant shareholders (Milnor and Shapley, 1978; Shapiro and Shapley, 1978; see Zwiebel (1995) for an application to blockholdings in firms). If a firm has n outstanding shares, one significant shareholder holding a fraction x of the shares and many oceanic shareholders, the significant shareholder's Shapley value is $\{x/(1-x)$ for $x < 0.5$; 1 for $x \geq 0.5\}$. The oceanic shareholders have combined Shapley values of $\{1 - (\text{the significant shareholder's value})\}$, and thus Shapley value per share of $\{(1-2x)/n(1-x)^2$ for $x < 0.5$; 0 for $x \geq 0.5\}$. The per-share Shapley value of oceanic shareholders, and thus the value of their votes, drops sharply as the significant shareholder approaches absolute control ($x = 0.5$), and disappears once control is achieved.

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

3.1.3. Equilibrium versus Non-Equilibrium Models

Theoretical models exist in which explicit competition between incumbent and raider for votes, decoupled from shares, operates similarly to a market for coupled shares and votes (e.g., Blair, Golbe and Gerard, 1989; Neeman and Orosel, 2003). These models suggest that if insiders can be prevented from using a market for votes to lock up control before a raider appears, a control contest for votes operates similarly to a contest for shares, and could have (minor) efficiency advantages.

The models, however, are "extremely stylized" (Blair et al. at 423) and non-equilibrium, in ways that give them little relevance to the real-world contexts in which new vote buying is likely to arise. Most centrally, vote buying occurs only during a limited period, during which there is an explicit contest between incumbents and a raider. The incumbents and the raider compete through fully disclosed offers for votes, which expire at the same time. In other words, the models presume a voting tournament that is tightly constrained in time and fully transparent to all participants.

Still to be developed is an equilibrium model in which (i) the insiders can quietly move to acquire votes at any time, before a raider even emerges, (ii) once acquired, votes can be held indefinitely; and (iii) if insiders do not keep control, a raider can quietly acquire votes at any time. While such a model is beyond the scope of this project, we suspect that in equilibrium,

insiders will keep control, if only to ward off hidden raids by outsiders seeking to extract private benefits. Bebchuk's (1999) model, in which high private benefits of control make dispersed ownership unstable, offers an analogy. The lower the cost of acquiring control, the lower the level of private benefits needed to make dispersed ownership unstable.

3.2. Evidence

3.2.1. Divergence Between Insiders' Voting and Economic Ownership

The theoretical work on the potentially adverse value effects when insiders can separate economic ownership and voting rights (section 2.1.1) is supported by a significant body of empirical evidence. There are several strands of relevant research. One evaluates the stock price effects of dual-class recapitalizations in the U.S., a takeover defense popular in the 1980s, in which managers restructured companies to create a new class of high-voting stock and acquired the high-voting stock, while leaving other shareholders with low-voting stock. We discuss these transactions in section 3.3.2 below.

A second research strand concerns tunneling by insiders. In many countries, founding families maintain control by holding higher voting than economic ownership, through high voting shares or circular or pyramidal holding structures (Claessens, Djankov and Lang, 2000). Both in the U.S. (Gompers, Ishii and Metrick, 2004) and elsewhere (e.g., Claessens, Djankov, Fan and Lang, 2002; Lins, 2003), a disparity between insiders' voting and economic ownership predict lower values for minority shares. Tobin's q values are based on the trading prices of *noncontrolling* shares. Thus, the lower value of minority shares could be offset by higher value of *controlling* shares, whose value cannot be directly observed. Gompers, Ishii and Metrick (2004) and Joh (2003) offer some evidence that disparity predicts lower firm value.

3.2.2. Takeovers

Gompers, Ishii and Metrick (2003) report evidence that U.S. firms with strong takeover defenses have lower Tobin's q than firms with weak defenses. Cremers and Nair (2005) report abnormal returns to firms with weak takeover defenses, in the presence of outside blockholders. Both papers suggest that insider entrenchment through empty voting could reduce firm value. At the same time, Cremers and Nair's results suggest that outside investors' ability to amass large voting positions could enhance firm value.

A bidder's ability to amass a toehold stake can facilitate takeover bids (e.g., Bulow, Huang and Klemperer, 1999). A puzzle in finance is why few takeover bidders acquire toeholds, even though doing so appears to be profitable (e.g., Betton and Eckbo, 2000; Bris, 2001). Hidden ownership through an equity swap could offer a quiet toehold, that need not be disclosed. (Given the possibility that the holder of the short swap position will hedge by buying shares, the market impact of acquiring a swap position might be similar to the impact of acquiring shares directly.)

3.2.3. The Value of Voting Rights

The literature on the value of voting rights offers a sense for how much of a firm's value is at stake. Cross-country studies (Dyck and Zingales, 2004; Nenova, 2003) find a substantial value of control in many countries. In the U.S., the average value of control is 2-4% of firm

value (e.g., Barclay and Holderness, 1989; Nenova, 2003), but can be much higher in some control contests (DeAngelo and DeAngelo, 1985; Zingales, 1995). For firms with dual-class structures, high-vote shares typically trade at a 5-10% premium over low-vote shares (Lease, McConnell, and Smith, 1983; Zingales, 1995). Outside the U.S., the value of control can be much higher (e.g., Zingales, 1994, on Italy; Levy, 1982, on Israel).

3.2.4. Record Date Capture

Christoffersen, Geczy, Musto and Reed (2006), using proprietary data on stock loans of U.S. shares by a custodian bank in 1999 and a broker-dealer from 1996-2001, report evidence of record date capture. Share borrowing spikes on the record date, increasing on average from 0.21% to 0.26% of outstanding shares. The spike is higher for firms with poorer performance, if a vote is likely to be close, and with higher percentage support for shareholder proposals or opposition to management proposals. If limited to a short period around the record date (as this study), the cost of borrowing is trivial. The authors estimate the average cost at 0.6 basis points per year (insignificantly different from zero)! The point estimate of cost implies that a one-day loan for \$10 million of shares costs the borrower \$2.40. The authors argue that this pattern is consistent with votes moving from less- to better-informed shareholders.

The shares of most publicly traded stocks in the U.S. can be borrowed. D'Avolio (2001) studies shares available from just one large financial institution. Stocks which could not be borrowed accounted for less than 1% of market capitalization. Borrowing shares is generally cheap: 91% of the shares in this sample cost less than 1% per year to borrow. The number of borrowable shares is often large -- during some recent corporate battles, up to 20% of a company's shares were held by borrowers (Burgess and Drummond, 2005).

While borrowing costs are often low, they can be significant for a company with limited "free float" (shares not held by insiders) which has attracted substantial interest by short sellers. One would expect a similar price response if there was widespread share borrowing for vote buying purposes for a particular election, especially if there were competing buyers.

3.3. Analogies

We consider next the ways in which new vote buying is similar to, or different from, other forms of decoupling votes from economic ownership.

3.3.1. Dual Class Common Stock, Pyramids, and Circular Ownership

New vote buying is only one means for insiders to retain greater voting than economic ownership. Others include dual-class common stock (on which one class has high voting power and is held primarily by insiders, while a second class has low or no voting power and is sold to outside investors), pyramidal ownership structures (with insiders controlling the top company in the pyramid) (e.g., Almeida and Wolfenzon, 2005), and circular ownership, with insiders controlling a pivotal company. For insiders, then, new vote buying offers a new option, but not a fundamentally new opportunity.

There may be justifications for insiders to use dual-class stock, pyramids, or circular control to raise capital without relinquishing control. In particular, the buyers of noncontrolling shares know what they are getting, and will pay a market price. Thus, insiders pay a market

penalty when, say, companies issue lower-voting shares. In the new vote buying, however, buyers may not know the level of insider control. Moreover, insiders may be able to apparently cede control to the market, thus obtaining the market price benefits of doing so, while actually retaining control. Insiders may also be able to in fact cede control to the market for a time, but reacquire it later, perhaps when a threat to day-to-day control emerges.

3.3.2. Dual Class Recapitalizations

Dual-class recapitalizations offer a possibly better analogy to new vote buying. These were transactions, which became popular in the U.S. during the hostile takeover wave of the 1980s, after the New York Stock Exchange relaxed its one share, one vote rule. In a typical recapitalization, the company would propose to change to a dual-class voting structure, in which insiders would hold high-vote shares. The lower-vote shares would typically have slightly superior economic rights, such as a dividend 5 cents per share greater than the dividend on high-vote shares.

These recapitalizations let insiders acquire control without paying a market price for doing so. Outside shareholders voted to approve the recapitalizations because their votes were individually worth less than the promised higher dividend, which can be seen as a form of prisoner's dilemma (Gilson, 1987). Consistent with insiders acquiring control for a less-than-market price, the announcement of a dual-class recapitalization significantly reduced share price (e.g., Dann and DeAngelo, 1988; Gordon, 1988; Jarrell and Poulsen, 1988; but see Partsch, 1987). Most forms of midstream recapitalizations have been banned through joint action by the SEC and the stock exchanges (Bainbridge, 1991). In some respects, new vote buying is worse than a dual-class recapitalization -- a recapitalization required disclosure and a shareholder vote, new vote buying requires neither.

3.3.3. Voting by Record Owners

Another analogy involves the common practice in which investors hold shares in "street name" rather than their own name. The ultimate "record owner" is a securities depository (often Depository Trust Company (DTC)), which holds shares for the accounts of its members -- banks and broker-dealers -- which in turn hold shares for their clients. Under corporate law, DTC, through its nominee, Cede and Co., is a majority shareholder of almost every publicly traded U.S. company, yet has no economic ownership.

A web of market practices, SEC rules, and stock exchange rules have emerged to largely reunite voting rights with economic ownership. DTC and other depositories delegate voting authority to the banks and broker-dealers for which they hold shares. The banks and broker-dealers, in turn, must ask their clients for voting instructions and follow those instructions if provided. If a client does not return voting instructions, the bank or broker-dealer can vote on routine matters, but not on major matters, such as a contested election of directors or approval of an acquisition.

3.3.4. Classic "Vote Buying" Under Corporate Law

A final analogy is to classic "vote buying" under corporate law. Historically, corporate law, through common law in some states and statutory rules in others, barred a shareholder's sale

of his voting rights, shorn of economic interest, to a third party. The central concern was that vote buying would lead to unfair self dealing by those who gain control (Clark, 1979). Current Delaware law is somewhat more tolerant, and permits vote selling if the transaction is for a proper purpose and satisfies a test of intrinsic fairness, while disallowing vote selling that is intended “to defraud or in some way disenfranchise the other stockholders.” In the leading case of *Schreiber v. Carney* (1982), vote buying in connection with a restructuring, was approved by the minority, non-selling shareholders.¹²

Current vote buying doctrine, however, does not reach the new vote buying. The doctrine focuses on a vote *seller* and the payment the seller receives for the “naked” *transfer* of those rights to someone else. With the new vote buying, no vote seller or transfer of a shareholder’s voting rights can generally even be identified. The new vote buyer relies on ordinary market transactions, which are not individually suspect.

3.4. Testable Hypotheses

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

One set of hypotheses involves the markets on which new vote buying depends. Around the record date for a contested vote, we would expect (i) an increase in demand for stock borrowing; (ii) a possible decrease in the supply of lendable shares, because some lenders will prefer to vote their shares. This should increase the cost of borrowing shares or creating a short equity swap position (for which the dealer typically hedges by borrowing shares and selling them short). In an extreme case, the cost of borrowing shares or obtaining short equity swap positions might spike as the contestants vie to acquire enough votes to carry the election. Christoffersen et al. (2006) report higher borrowing with no apparent change in price, but this seems unlikely to be an equilibrium outcome for contested elections.

A second, potentially testable implication involves the wedge between insiders' voting and economic ownership. Cheaper decoupling should increase the overall level of decoupling. It might be feasible to exploit cross-country or cross-firm differences in the availability and cost of decoupling to test whether these differences predict differences in the extent of decoupling. A related hypothesis involves the minimum ownership that insiders need to maintain to ensure control. Ownership of 30-35% or so of a company's shares has generally been considered sufficient to create *de facto* control. If (i) insiders can more readily reduce economic ownership while maintaining voting ownership; and (ii) outsiders can acquire votes at modest cost, both factors should induce controlling families to maintain higher voting ownership.

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

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

4. Disclosure: Current Rules and Reform Proposal

We turn now to what one might do about the new vote buying. In this Section, we explain current disclosure rules and why much new vote buying can remain hidden (Section 4.1). We then propose enhanced disclosure of ownership (Section 4.2) and discuss the costs and benefits of this disclosure (Section 4.3).

4.1. Current Disclosure Rules

Currently there are five discrete disclosure systems for large shareholders:

- active 5% shareholders report current ownership on Schedule 13D
- passive 5% institutional investors report annually on Schedule 13G
- all institutional investors holding over \$100 million in U.S. equity securities report quarterly on Form 13F
- insiders (directors, officers, and 10% shareholders) report current positions under Exchange Act § 16(b)
- mutual funds report their portfolio holdings quarterly, through Forms N-1A, N-CSR, and N-Q.

These systems, taken together, are bewilderingly complex. Different rules often apply in determining which ownership positions can *trigger* the disclosure requirements and which positions must be disclosed once disclosure is required. 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 equity swaps and other "over the counter" (OTC) derivatives often escape disclosure, when an identical position using exchange-traded derivatives would be disclosed. Ownership of a call option is treated differently than a nearly equivalent sale of a put option. And so on. We briefly review here the disclosure rules, and summarize them in Table 3. Our companion articles provide details (Hu and Black, 2006a, 2006b). Our discussion should be understood as roughly but not wholly accurate.

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, *assuming that disclosure requirements are triggered*. Separate provisions govern which positions count toward triggering a disclosure obligation.

Reporting Scheme	Reporting Frequency	Long Positions		Short Positions			Share Loans	
		Equity Swaps; other OTC Derivatives	Shares and Exchange-traded Derivatives	Equity Swaps; other OTC Derivatives	Exchange-traded Derivatives	Short Sales of Shares	Lending	Borrowing (record date capture)
13D	current	partial	yes	Partial	yes	partial	unclear	Yes
13G	annual	no	yes	no	yes	no	no	generally no
13F	quarterly	no	partial	no	partial	no		No
§ 16 (director or officer)	Current	yes		Yes			illegal under § 16(b)	No
§ 16 (10% holder)								
Mutual Funds	Quarterly	yes		yes				No

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

Any person who acquires “beneficial ownership” (in the 13D sense) of 5% of a public company's shares must file Schedule 13D with the SEC within 10 days after crossing the 5% threshold. Institutional investors who invest “passively” (in the ordinary course of business and without intent to influence control) and own between 5% and 20% of a company's shares can file a more abbreviated Schedule 13G annually, with a 45 day lag -- year-end positions are reported on February 15. Beneficial ownership of shares includes “the right to acquire beneficial ownership within sixty days, including through exercise of an option or warrant.” 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 the shares, as well as filing of certain related written agreements.

Short positions do not trigger disclosure. If disclosure is triggered by a large long position, some disclosure is required for short positions. How Schedules 13D and 13G treat share lending and borrowing is unclear. Borrowing (which provides voting power) would likely be disclosable. However, Schedule 13G is unlikely to reach record date capture because few record dates will fall around the year-end reporting date. Share lending might be disclosable on Schedule 13D, but likely not on Schedule 13G.

Consider now whether the 13D or 13G rules would capture hidden voting through cash-settled equity swaps. Let Perry-Rubicon be an example. Perry held just under 5% of Rubicon's shares, plus cash-settled equity swaps conveying 11% economic ownership. Its *de facto* ability to acquire voting rights might be considered to be beneficial ownership, which includes indirect ownership “directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise.” (SEC Rule 13d-3). There is no clear SEC guidance. However, courts in New Zealand and Australia have ruled that similar rules in those countries do not require disclosure, and major law firms concur that disclosure is normally not required (see Section 2.6).

Consider next how Schedules 13D and 13G affect empty voting, using Perry-Mylan as an example. If Perry held less than 5% of Mylan, no disclosure would be required. Perry chose, however, to acquire 9.9% of Mylan's shares. If Schedule 13G was available, no disclosure of

Perry's hedges would be needed. Whether 13G was available turns on whether Perry was a passive investor, with no intent to influence control of Mylan. Perry initially took the position that Schedule 13G was available, and filed nothing (the Feb. 15 reporting date had not yet been reached). It filed a Schedule 13D only after Icahn filed his own 13D, indicating an intent to acquire Mylan, a step that Perry opposed.

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" 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. It did not attach its derivatives contracts as exhibits to Schedule 13D.

Consider next the HP-Compaq merger, in which investors with long positions in Compaq were rumored to have acquired empty voting positions in HP to vote for the transaction. Assume that a hedge fund owns over 5% of HP. Would Schedule 13D require disclosure of its position in Compaq? Here the answer is clear -- no disclosure is required, because Compaq is a separate company. In sum, Schedules 13D and 13G provide only limited disclosure of the existence and nature of the new vote buying.

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

The third ownership disclosure regime governs institutional money managers who hold at least \$100 million in U.S. equities. They must report their holdings at the end of each quarter on Form 13F, with a 45-day delay (the year-end report is due Feb. 15, and so on). Only publicly traded U.S. equity securities—such as common shares and *exchange-traded* options—are disclosed. Equity swaps and other OTC derivatives are not, nor are short sales. Thus, a manager who holds 1,000,000 shares and has separately sold 500,000 shares short will report owning 1,000,000 shares. Even for exchange-traded options, money managers report options they hold, but not options they have *written*, even if the written position is equivalent to a disclosable purchased position. If shares have been lent, the lender ignores the loan (that is, the lender reports owning the shares), while the borrower reports nothing.

Record date capture will not be disclosed. Hidden ownership through equity swaps will never be disclosed; if voting rights are needed at an upcoming shareholder meeting, the derivatives dealers on those equity swaps might be able to provide the needed shares. If an investor holds shares while hedging economic ownership, the direct ownership will be reported, the hedge will not.

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

The fourth source of ownership disclosure is Exchange Act § 16(b). Section 16(b) disclosure covers insiders, defined as officers, directors, and 10% beneficial owners of U.S. public companies (with beneficial ownership measured under the 13D rules). Outside shareholders usually avoid crossing the 10% threshold, because doing so triggers recapture of "short-swing profits" from buying and selling within a 6-month period. The same equity swap that lets an investor avoid 13D reporting also lets it avoid Section 16 disclosure. In addition to

the disclosure rules, short sales of shares are banned, as is holding a "net short" position, however achieved.

For covered persons, the required disclosure is based on "beneficial ownership" in the separate 16(b) sense, and is reasonably extensive. The 16(b) definition, unlike the 13D definition, focuses on economic ownership.¹³ Most economic interests, regardless of their form, must be disclosed, including both exchange-traded and OTC equity derivatives. The Section 16 rules for voting ownership unaccompanied by economic ownership, are less clear. Share lending and borrowing are likely not disclosable because they do not affect economic ownership, although borrowing would likely count toward the 10% threshold for triggering reporting by a 10% shareholder.

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

4.1.4. Mutual Fund Reporting

The final set of reporting obligations applies to mutual funds, which must report to the SEC quarterly on their portfolio holdings. Disclosure focuses on economic ownership and covers both long and short positions, and both exchange-traded and OTC derivative positions. There is no requirement to disclose stock lending or borrowing, as long as this activity affects only voting rights, not economic ownership. Thus, details aside, mutual fund reporting is similar to Section 16(b) reporting. Both systems thus cover hidden ownership reasonably well, and some flavors of empty voting. However, mutual fund disclosure captures only quarter-end positions.

4.2. A Proposal for Integrated Ownership Disclosure

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, 13D and 13G disclosure turn largely on voting ownership, while Section 16 and mutual fund disclosure focuses on economic ownership. Section 13F covers both voting and non-voting publicly-traded equity securities, but not OTC derivatives. None of the regimes effectively addresses share borrowing and lending. Only 13D and 16(b) disclosure is "real time"; the other disclosure regimes can be evaded by not holding a disclosable position at year- or quarter-end. 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.

We therefore propose "integrated ownership disclosure" reform that would largely replace five sets of rules with one set, and provide better disclosure of empty voting and hidden ownership. Our proposal builds on existing 16(b) rules and requires only information readily accessible to investors. For the most part, we would simply extend existing 16(b) and mutual fund disclosures to a broader class of reporting persons. Thus, additional compliance costs

¹³ 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).

should be limited, and will be offset for many investors 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 companies, judges, regulators, and legislators as they assess how to respond to new vote buying. But even if the rules had no other value, the simplification we propose would likely be worthwhile. To be sure, if one believes the current disclosure rules are overkill and that companies and investors would benefit from less disclosure, one might prefer the current loophole-ridden system to our proposal. Below, we first present our proposal, and then address this objection.

Our proposal would (i) move toward commonality between the standards for triggering disclosure and for what to report once disclosure is triggered; (ii) provide one set of ownership disclosure rules, instead of the current five sets; (iii) require disclosure of both voting and economic ownership; (iv) require symmetric disclosure of long and short positions; and (v) require symmetric disclosure of exchange-traded and OTC derivatives. These disclosures should capture most empty voting by 13D and 16(b) filers, who must report ownership changes promptly. Delayed filers would disclose empty voting above a threshold percentage (such as 0.5% of a company's shares) in their next periodic report. We would not change the current lag periods for delayed filers. Stock lenders would report their loans; stock borrowers would report their borrowings. We leave for another day disclosure of related non-host assets.

For OTC derivatives, current mutual fund practice can provide a guide as to what level of reporting detail is appropriate. We believe that reporting persons should disclose information sufficient to allow a derivatives dealer, with access to information on volatility and other pricing parameters, to estimate the derivative's value and its delta (how value depends on share price).

These proposals would expand disclosure, but would also integrate and substantially simplify the current multi-headed disclosure regime. 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 extended large shareholder disclosure to persons with both long and short equity derivatives positions. The principal difference between these approaches is that Hong Kong requires disclosure of a pure *short* economic position (as we would), while the U.K. does not.

Table 4 summarizes our integrated ownership disclosure proposal. For additional details on these proposals, see Hu and Black (2006a, 2006b).

Table 4. Proposed Integrated Ownership Disclosure

This table summarizes the disclosure changes we propose, in a format similar to Table 3 (which summarizes current rules).

	Reporting Frequency (same as current law)	Long Positions	Short Positions	Share Loans (lending or borrowing)	Empty Voting (over threshold level)
13D	current	yes	yes	yes	--
13G	annual	yes	yes	yes	yes
13F	quarterly	yes	yes	yes	yes
Section 16 (director, officer, 10% holder)	current	yes	yes	yes	--
Mutual Funds	quarterly	yes	yes	yes	yes

4.3. The Costs and Benefits of Enhanced Disclosure

In offering these proposals, we do not reassess the current disclosure thresholds, disclosure frequencies, delay periods, nor which investors must disclose their ownership positions. Implicitly, then, we assume that there is rough economic or political logic supporting the current rules. We defend this assumption below. We also believe that whatever the thresholds, delay periods, etc. are, the ownership disclosure rules should be internally coherent. Consider a tax analogy. One can believe that current tax rates are too high, and still prefer a system with few loopholes, which (unless rates are changed) ensures that people in fact pay these too-high taxes, over a loophole ridden system that produces lower overall taxes but favors the tax-clever and produces horizontal inequity.

The political history of ownership disclosure, in the U.S. and elsewhere also 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. We seek to make that disclosure coherent, simple, and therefore relatively low-cost.

4.3.1. Costs and Benefits of Ownership Disclosure

There can be value to investors in disclosure of large empty voting and hidden ownership positions. Consider empty voting by insiders. Theory suggests that a wedge between economic ownership and voting rights is problematic. The supporting empirical work involves a *disclosed* wedge. An undisclosed wedge is even more problematic than a disclosed wedge. If the controlling shareholder's wedge is disclosed, investors will pay a price for minority shares which reflects the controller's distorted incentives. Shares of firms with lower wedge will trade at higher prices (for supporting evidence, see Black, Jang and Kim, 2005).

In contrast, if decoupling is both hidden and easy to change over time, investors will not know which firms' insiders have a large wedge between economic and voting ownership, and which do not, nor confidence that the wedge will be stable over time. As in any adverse selection situation, they will discount the prices they pay for all shares. This discounted price, like other aspects of weak governance (Black, 2001) or asymmetric information (Myers and Majluf, 1984), will increase the firm's cost of equity capital.

Undisclosed decoupling could also contribute to a "lemons" equilibrium in which dispersed ownership is unstable even if it would maximize firm value, so that most firms retain concentrated ownership. Bebchuk (1999) develops a model in which, if private benefits of control are high, dispersed ownership is unstable because a new controller can pay a market price for shares and then profit by self-dealing. Atanasov, Black, Ciccotello and Gyoshev (2006) and Glaeser, Johnson and Shleifer (2001) report the collapse of initially dispersed ownership following mass privatization in Bulgaria and the Czech Republic, during a period when legal rules permitted extensive tunneling. The lower outsiders' cost to acquire control, the lower the level of private benefits at which dispersed ownership will be unstable. Disclosure offers a partial solution, by giving insiders comfort that if someone seeks control through vote buying, they will find out in time to respond -- they will not wake up one morning to discover that someone else controls more votes than they do.

More generally, ownership disclosure has both benefits and costs, in the takeover context and otherwise. On the benefit side, share pricing is likely more efficient if investors know what major investors are doing and possible changes in the control of the corporation. Requiring disclosure of this information can reduce costly private search for it. The social waste flowing from duplicative parallel private efforts at gathering information would be reduced. On the cost side, outside investors must be rewarded for searching for mispriced shares and mismanaged firms. Real-time disclosure would tend to reduce the return to search. Yet, a general feature of securities markets is that price-relevant information can often have greater private than social value. Gains to one investor from secondary trading of shares often come at the expense of other investors. Firms sometimes do benefit: the market for corporate control is animated in large part by the private rewards of search. The current system, with slightly delayed disclosure by insiders and large active shareholders (13D filers), and significantly delayed disclosure by other shareholders, could well strike a decent balance among these cross-cutting aspects of ownership disclosure.

4.3.3. Cost-Sensitive Compromises in our Disclosure Proposal

Our disclosure proposal incorporates a number of features that reflect sensitivity to the costs of disclosure. First, we would not change the current lagged disclosure for 13F, 13G, and mutual fund filers. This will reduce the value of this disclosure to directors, shareholders, and courts in addressing a voting 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 usually too late to alter those outcomes. Delayed reporting is a tradeoff of disclosure cost against timeliness.

Second, we would require disclosure of empty voting only if it exceeds a threshold percentage of the company's shares (such as 1.0%). The goal is to capture large-scale, intentional empty voting, without requiring additional disclosure from investors who engage in routine hedging. We expect that the vast majority of filers will not engage in empty voting of this magnitude and will report nothing. Third, the disclosures would be intentionally simple (for example, the number of shares and other principal terms of a derivative contract, but not its delta or actual value at the reporting date).

4.3.4. Analogies to Other Disclosure Systems

One cannot claim that because a particular form of regulation is widespread, it is efficient. But a weaker claim may be possible. If a particular type of disclosure regulation is widespread, it is probably not highly inefficient. Thus, it is at least relevant that many other countries require disclosure of the ownership positions of both inside and outside shareholders, that two countries have responded to new vote buying with disclosure rules that are similar to those we propose, and that private sector initiatives, now underway, look in the same direction.

United Kingdom. Our proposals are consistent with a 2005 revision to the U.K. Takeover Code, to extend large shareholder reporting to persons who have long economic ownership through derivative positions, without formal voting ownership (Panel on Takeovers and Mergers, 2005b; Panel Executive, 2005). In response to the Laxey Partners-British Land record date capture episode, U.K. self-regulation now informally restricts share borrowing solely for the purposes of voting at a shareholders' meeting (Myners, 2005; Bank of England, 2003).

Hong Kong. In 2003, Hong Kong extended large shareholder disclosure requirements to persons with long or short derivatives positions (Hong Kong Securities and Futures Commission, 2003).

Private Sector Responses. The need for additional information about new vote buying, and perhaps restrictions on share lending for voting purposes, is the subject of a private effort, 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 (ICGN, 2005; Lintstock, 2004).

5. Longer Run: A Menu of Substantive Approaches

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. We consider it premature to adopt substantive rules to address empty voting. In some contexts, empty voting has social benefits. Moreover, it is difficult to regulate an activity that can take many forms, about which little is yet known. Finally, market or self-regulatory responses may emerge that might be preferable to a government rule.

Still, a simple example can illustrate why some substantive regulation is likely to 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 requirement that offers be made to all shareholders on equal terms, minimum offer period, and a ban on two-tier offers. Similar problems would afflict bids for votes, decoupled from shares, or a proxy fight waged through efforts to buy votes decoupled from shares.

We therefore develop below a menu of regulatory options, and say a bit about their merits. For fuller discussions, see our companion articles (Hu and Black, 2006a and 2006b). There are three families of strategies. One focuses directly on voting rights. A second focuses on voting mechanics. A third involves interventions that affect the markets that support decoupling, especially the share lending market. We make no claim that the substantive rules we discuss are desirable, only that they are possible.

5.1. *Strategies Focused on Voting Rights*

5.1.1. *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. Martin and Partnoy (2005) 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.” One problem with this 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 and may be unaware of record date capture, equity swaps, and other alternatives.

In addition, new alternatives will emerge as the process of financial innovation continues. Especially when OTC derivatives are involved, the innovation process renders problematic traditional classification based regulatory approaches and require far more informationally-demanding and subtle forms of intervention. (Hu, 1993)

If the technology problem can be solved, there is some appeal to a rule that would disallow voting for the extreme case of negative economic ownership. But for the less extreme case of greater voting than economic ownership, the technical difficulties in measuring ownership become fearsome. For many derivative positions, economic ownership depends on share price and thus changes on a daily basis. In developing our disclosure proposal, we initially attempted to invent a workable scheme for disclosing economic ownership, measured in share-equivalents. The effort became absurdly complex, and we retreated to a simpler approach in which investors disclose only the *positions* that create economic ownership. 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 that an investment advisor runs both a “long-only” mutual fund that holds General Motors shares, and a hedge fund which is short GM. Should the mutual fund lose the power to vote its GM shares because the hedge fund, run by a different manager, has a short position?

In the end, a combination of factual uncertainty about when and how new vote buying occurs, how often 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 which would otherwise substantially exceed economic ownership, nor to argue that such a rule would be a serious error.

5.1.2. *Voting By Record Owners: Extension to Equity Swaps*

Currently, record owners pass voting rights to their clients (Section 3.3.3). These rules can provide precedent for connecting voting rights to economic ownership, when new vote buying technology has severed them. Consider, for example, a derivatives dealer who holds shares to hedge a short equity swap position. 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 (Section 2.4.1), thus reconnecting voting and economic ownership. In this situation, we should recognize that the market is placing voting rights where they ought to be, so that intervention, beyond disclosure, is not needed.

5.1.3. Corporation Opt-In

An alternative to mandatory limits on voting rights would be to let corporations decide whether to require a link between economic and voting ownership, through a charter amendment. Corporate opt-ins, such as only allowing shareholders with positive net economic ownership to vote, offer some flexibility benefits compared to a general rule, but raise other concerns. One again faces the problem that for shareholders, voting rights are collectively valuable but individually worth little. Thus shareholders can sometimes be persuaded, as in dual class recapitalizations, to part with these rights for little consideration.

More generally, midstream charter amendments by already-public companies should not receive the same presumption of likely efficiency as charter provisions adopted before a public offering (Bebchuk, 1989; Black, 1990). Insiders may propose rules that allow vote buying by insiders while blocking techniques used by outsiders. Thus, the "company choice" approach has risks. It seems premature to assess what scope there should be for charter amendments without knowing either the dimensions of empty voting or how companies might seek to respond.

5.1.4. State Corporate Law

How might judges respond to new vote buying by insiders? At one extreme, company insiders cannot use corporate funds or the promise of future business to directly procure votes. In the Hewlett-Packard proxy fight, for example, Walter Hewlett claimed that HP management had procured Deutsche Bank's votes through promises related to future business dealings. HP persuaded the court that it had sought Deutsche Bank's support for the merger on the merits.¹⁴ Yet it seems clear that procuring votes through such a promise would have violated management's fiduciary duty and constitute classic vote buying. Suppose, instead, that HP management had engaged in new vote buying to swing the outcome. 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. For example, if insiders hedge their economic ownership, state corporate law neither requires disclosure of the hedging nor questions the exercise of voting rights. Disclosure comes from federal rules. Judges will, however, face pressure to update current doctrine on vote buying, which is really about vote *selling*. They might disallow voting by an empty voter such as Perry with negative net economic interest. Another possible response is to reduce the importance accorded to shareholder votes as a guide to shareholder preferences. Gilson and Schwartz (2001) argue that elections are inferior to tendering decisions as a guide to shareholder preferences in a control battle. The potential for empty voting strengthens their case.

5.2. 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. Even institutional investors sometimes do not know when their shares have been lent and are sometimes unsuccessful in recalling lent shares for voting purposes (Lintstock, 2004). Many institutions lend shares

¹⁴ See *Hewlett v. Hewlett-Packard Co.*, 2002 WL 818091 (Del. Ch.), at 9 (finding that "no one from HP used any threats or inducements regarding future business relationships.")

through agents; often the agent can lend without the investor's knowledge. Most do not recall shares around record dates in order to vote them. Full information may change lender behavior. 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 effect on voting rights, is knowing to whom they have lent. This too is not 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 rules (2006) rules require lending agents to give their clients details on each loan. What stock lenders do with this information about 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 share lending has created an increasingly serious problem of "over-voting" by record owners. 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 on behalf of margin customers, lends 1 million, but receives voting instructions from holders of 1.5 million shares. There is at present no way to ensure that the broker will cast only 1 million votes, nor deciding whose voting instructions count. Instead, brokers follow ad hoc procedures.

Yet the solution to overvoting 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 *increase* the disparity between economic ownership and voting rights. A better solution might be a change in share lending practice in which lenders could elect whether to retain voting rights. Borrowers who need voting rights would have to borrow from lenders who were willing to part with them.

5.3. Strategies Focused on 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 or 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.

5.3.1. Encouraging Institutional Shareholders to Vote on Important Matters

Currently, an institution which can either lend shares and profit from doing so, or hold and vote the shares, faces a dilemma. The institution's vote 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. One response would be for regulators to encourage institutions to vote on important matters rather than lend their shares, create safe harbors against challenges on fiduciary grounds from beneficiaries for institutions that do so, and perhaps even require voting. Current SEC rules governing mutual funds, and Department of Labor rules governing company pension funds already encourage voting. This guidance could be strengthened, and extended to other classes of institutional investors.

5.3.2. Tweaking Supply and Demand for Share Loans and Equity Swaps

A variety of tax and regulatory changes 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 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 payment is thus taxed more heavily than the dividend would have been. Similarly, if a broker lends customer shares, its client will "payments in lieu of dividends," which are not entitled to the 15% rate.

At the margin, these tax consequences should reduce the attractiveness of stock lending. However, many mutual fund investors and margin account holders are likely not aware of the tax consequences of share lending. Broker-dealers must disclose annually to their customers the portion of investment income that qualifies for the dividend tax rate, but not the reasons why. A statement that "we earned \$X last year by lending shares from your account; this increased your taxable income by an estimated \$Y." could affect client willingness to hold shares in margin accounts unless compensated for doing so (current practice is no compensation) Broker-dealers could also be required to periodically obtain customer consent to lend shares.

One could also put greater responsibility on share lenders or equity swap providers to know how their clients will use the share borrowing or swap. Broker-dealers who do not deal with the general public already are subject to a "permitted purpose" limit on borrowing or lending securities under Federal Reserve Board Regulation T that bars lending to facilitate record date capture. This rule could be extended to all broker dealers. Indeed, a general ban on institutional share lending for record date capture is already the informal norm in the U.K. A similar "know your customer's purpose" approach could affect the market for equity swaps which form part of a client's empty voting or hidden ownership strategy.

The demand side for vote buying and the products it depends on can also be affected by regulatory tweaks. We offer here one example, involving executive hedging. One could make this "lite voting" by executives less attractive by increasing the tax consequences of hedging. Currently, a derivative position that offsets "substantially all" economic exposure triggers tax under Internal Revenue Code § 1259. This provision is easy to avoid: zero-cost collars do not trigger it, nor a hedge that offsets most, but not "substantially all" of an executive's economic exposure. One could potentially move to a more easily triggered standard, although we recognize the difficulties of developing an administrable rule that could not be easily gamed.

6. Conclusion

Financial theory and evidence have long suggested that the shareholder vote is a fundamental means by which corporate governance systems constrain managers' discretion over other people's money. The current paradigm assumes a connection between votes and economic interest. Financial innovation now allows large scale, low cost decoupling between voting rights and economic ownership. Derivatives, heretofore largely risk management tools and investment vehicles, can now affect voting outcomes. Strategies for trading risk can be used to trade votes. Among outside investors, hedge funds have been the pioneers. Insiders also use decoupling strategies to retain votes while shedding economic exposure.

Some vote buying 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 threatens to undermine the coupling between voting and ownership. The new vote buying also raises the troubling prospect of voting outcomes determined by hidden warfare among company insiders and major investors, each employing invisible financial weapons of unparalleled power. Success could come to turn increasingly on ingenuity and opacity in vote buying, rather than on substantive merits debated in open contests.

The right regulatory response is not obvious. The first step is to better understand and gauge the extent of the new vote buying, through enhanced disclosure of both empty voting and hidden ownership. This Article therefore proposes simplified, "integrated" disclosure requirements for both institutions and insiders, to replace the current bewildering patchwork quilt created by five separate ownership disclosure regimes. Disclosure may be a sufficient response to hidden ownership. For empty voting, it will likely be only a first step, but a sufficient step to give regulators, judges, companies, and investors a good view of the nature and scale of this activity. One family of substantive responses would focus on voting rights themselves. Other responses focus on voting architecture, and on the operation of the markets on which empty voting relies.

Which substantive alternatives should ultimately be adopted will depend on information as yet unknown, which our disclosure rules are designed to collect. We do know that the existing corporate governance paradigm assumes a link between voting rights and economic ownership. We suggest that this foundational assumption, essential to so many of the paradigm's essential prescriptions, may be nothing short of heroic.

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Glossary of Selected Terms

Trading jargon surrounds many new vote buying transactions, as well as various disclosure rules. This appendix accordingly defines selected terms, and discusses transaction mechanics, including how the transactions affect voting rights. Our definitions aim for general accuracy, not technical precision.

Term	Definition and Mechanics
Schedule 13D	SEC Schedule 13D, for reporting beneficial ownership (13D sense) of 5% or more by individuals and active institutional investors.
Form 13F	SEC Schedule 13F, for quarterly reporting of U.S. equity holdings by institutional investors.
Schedule 13G	SEC Schedule 13G, for annual reporting of beneficial ownership (13D sense) by passive institutional investors (investors whose actions do not affect control).
Section 16(b)	Securities Exchange Act § 16(b) and SEC Forms 4, 5, and 6, for reporting of beneficial share ownership (in the 16(b) sense) by directors, officers, and persons

Term	Definition and Mechanics
	with beneficial ownership (in the 13D sense) of 10% of a company's shares.
Forms N-1A, N-CSR, and N-Q	The basic forms for SEC mutual fund portfolio disclosures.
Beneficial owner (13D sense)	Sole or shared power to directly or indirectly vote or control the disposition of common shares.
Beneficial owner (16(b) sense)	Direct or indirect economic ownership of shares.
contract for differences (CFD)	The UK derivative that is similar to an equity swap.
dual-class common stock	two classes of common stock, one of which has higher voting rights and is held principally by insiders, while the other has lower or no voting rights and is held principally by outside shareholders
dual-class recapitalization	conversion from a one common share, one vote structure to a dual class structure, through exchange by outside investors of old, fully voting shares for new, low-voting shares, which typically pay a slightly higher dividend than the old shares
equity swap	A type of OTC derivative. In a standard cash-settled equity swap, the long (or "equity") side receives from the short (or "interest") side the economic return on shares (from dividends, other distributions, and price changes relative to a reference price), if this return is positive, and pays the economic return to the short side if it is negative. Most equity swaps are cash-settled.
forward contract (or "forward")	An agreement to deliver a security on a specified future date at a specified price.
future contract (or "future")	A standardized, exchange-traded, forward contract. Most financial futures are cash-settled (settled at expiration by payment of cash) rather than physically settled (settled at expiration by delivery of shares or other underlying financial instruments).
net short position (under 16(b))	Negative economic ownership of shares.
over-the-counter (OTC) derivatives	Derivative securities, including equity swaps, that are not traded on a public options or futures exchange.
overvoting	Situation in which a bank or broker-dealer has lent some of the shares it holds for customers, solicits voting instructions from all customers, receives voting instructions for more shares than it has voting rights for, and votes in accordance with all instructions received.
put-call equivalent to shares	A (long call, short put) position, where the call and put have the same exercise price and expiration date, conveys the same return as the return on shares.
record date	The date established by the company to determine which shareholders are eligible to vote at an upcoming shareholder meeting (voting record date) or which shareholders are eligible to receive a particular dividend (dividend record date).
record date capture	Borrowing shares for a short period around a record date, in order to vote at a shareholder meeting.
record owner	Person who holds formal legal rights to vote shares under corporate law. Often, shares are said to be held "of record" by a bank or broker-dealer. Technically, the bank or broker-dealer in turn relies on a securities depository to formally hold the shares. The depository is the true record owner, but passes on its voting rights to its bank and broker-dealer customers.

Term	Definition and Mechanics
share borrowing	Under standard share borrowing contracts, the borrower receives the full formal rights to the shares, including voting rights. The borrower agrees to pay to the lender the economic return on the shares for the period of the loan (from dividends and other distributions), and to return the shares at the end of the loan period. Thus, the borrower has voting rights but no economic rights (since the return on the shares is passed on to the lender). Conventionally, share loans are callable on demand by the lender; the borrower can also return the shares and close out the loan at any time. If the borrower has sold the borrowed shares, it closes out the loan by purchasing replacement shares in the market.
share lending	
short sales	The short seller must deliver shares to an anonymous buyer. To do so, he borrows shares from a share lender and delivers them to the buyer. To close out the short position and the share loan transaction, the short seller purchases replacement shares in the market and delivers them to the share lender. Leaving aside the impact of dividends, the short seller profits from a drop in the share price between the time he sells the shares and the time he closes out his short position.
variable prepaid forward	A forward sale combined with a put option: An executive agrees today to sell shares in X years at then market price, receives 75-90% of current price today, which is not refundable if share price drops.
zero-cost collar	Popular strategy for insider hedging, involving sale of a call option on shares with (exercise price > share price), and purchase of a put option with the same expiration date and (exercise price < share price), where the call and the put have equal prices, so the position involves zero net cost to the shareholder.

