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Business

How borrowed shares swing company votes

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By Kara Scannell, The Wall Street Journal

Private investment firms have found a simple way to profit from the workings of public companies: Borrow their shares, and then swing the outcomes of their votes.

In some cases, the strategy has allowed speculators to gamble that a company's stock will drop, and then vote for decisions that will ensure that it does -- without their ever having to own any stock themselves. Some outside interests have used the strategy to hide their voting power within a company until the last moment. Often, individual shareholders don't realize their own stocks, and their voting rights, have been borrowed from their brokerage accounts, until it's too late.

Fueling the practice -- dubbed "empty voting" in a study by two University of Texas professors -- is a booming business in lending shares. That business has nearly doubled in the past five years, according to one report, and now earns \$8 billion a year for big brokerages and banks plus an unknown amount for institutional investors. Voting rights are lent along with the shares, and increasingly, that is leading to unintended consequences.

Vote counters often fail to keep track accurately and let the borrowers and owners of the same shares both cast votes. Four big banks paid the New York Stock Exchange \$2.35 million last year to settle charges in this area. Meanwhile, other shareholders often are unaware that a big voting bloc has no real ownership stake in the company -- and that it may vote directly opposite the wishes of the stock's actual owners.

This phenomenon has gotten the attention of regulators, who fear it is escalating just as shareholder voting is gaining importance as a way to improve corporate governance and keep management excesses in check. If elections can be too easily gamed, critics fear, a basic foundation of public companies -- that shareholders vote in the company's best interest -- will be undermined.

The practice "is almost certainly going to force further regulatory response to ensure that investors' interests are protected," Securities and Exchange Commission Chairman Christopher Cox said in an interview. "This is already a serious issue and it is showing all signs of growing."

The SEC has no firm plans yet. Britain's securities regulator, the Financial Services Authority, has begun a study into whether to force greater disclosure of large investors' stakes in companies, regardless of whether they own stocks or are just borrowing them. One of the largest pension-fund managers there, Hermes, has called for regulators to outlaw voting altogether by borrowers of shares. In Hong Kong, the Securities and Futures Commission said it is studying "issues relating to borrowed shares and voting."

The concern arises just as more companies are moving toward requiring a majority of all

shares to elect directors, instead of simply a plurality of those casting votes. A recent U.S. federal appeals court decision opened the door to giving shareholders a greater say in the election and nomination of directors, and the SEC recently approved a rule to make it easier for investors to put up their own slates of directors. But the vulnerability of the voting system could set back such efforts.

"It seems in trying to perfect corporate governance, we were polishing an apple that had a lot of worms inside, and we didn't know it," says Carol Hayes, corporate secretary of Coca-Cola Co., and a member of the Society of Corporate Secretaries and Governance Professionals.

The opportunity for "empty voting" arises when brokerage firms or institutional fund managers lend the shares they manage to hedge funds or other firms, for a fee that can rise with how difficult the shares are to get. The value of securities borrowed on any given day has reached \$1.6 trillion after several years of double-digit growth, according to Astec Marketing Research Group Inc., a New York capital-markets research firm.

When it comes times for a shareholder vote, it's the borrowers that hold the voting rights. Under Delaware law, where most large companies are incorporated, voting rights belong to whoever holds the stock on a date the company chooses in advance of its stockholder meeting. It's as if in the U.S. electoral system, someone could borrow your voting rights and use them to vote in your place without your knowing it. Individual share owners often are unaware that contracts with brokerages normally allow the brokerages to make money by lending out stock if it's held in margin accounts, just as banks profit from lending their cash deposits.

The owners must ask for their stock to be recalled if they want to vote -- which means they would have to know the stock was lent and that the vote was coming. If their stocks are lent, the borrowers of the shares, not the owners, are supposed to receive invitations to vote. Stocks in cash accounts aren't affected.

No one knows how widespread "empty voting" is. Law professors Henry Hu and Bernard Black at the University of Texas at Austin have studied 22 instances world-wide from 2001 through 2006 in which either borrowed stock or hedging strategies, or both, were used. Consider one example:

Henderson Land Development Co., Hong Kong's third-largest property developer, owned 73 percent of a subsidiary called Henderson Investment. It offered a rich premium in November 2005 to buy the rest. It had failed in a similar effort three years earlier, but this time it came back with a better offer. Under Hong Kong law, the deal would go through unless 10 percent of all the shares opposed it. Since the parent owned such a large stake and large institutions backed the deal, passage was considered a foregone conclusion.

Yet the acquisition was voted down early last year by a slim margin. Several market participants were quoted in news reports saying there was a surge in borrowed shares by at least one hedge fund ahead of the vote, compared with little if any lending in Henderson shares over the previous seven months.

By borrowing the shares and simultaneously shorting the underlying stock, the hedge funds gained the voting rights to squash the deal and stood to profit when the stock dropped 18 percent the next day. After the Henderson vote, the Hong Kong regulator said it was examining voting practices.

"It appears that one or more hedge funds borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, thus profiting from its

private knowledge that the buyout would be defeated," the Texas professors wrote in the May 2006 Southern California Law Review. A Henderson spokeswoman declined to comment.

Altogether the professors analyzed 12 instances in which it appeared that hedge funds or other large shareholders voted to try to swing public-company contests in their favor without much ownership stake. In 10 others, they said investors just hid their stake in the company until a vote.

The shareholder vote is rooted firmly in corporate law, which is based on the notion that shareholders vote in the best interests of the company in which they own stock. The effects of short-selling and other sophisticated instruments that can separate a vote from economic interest were never considered. "You have this whole superstructure built on this notion that there is this coupling of economic interest and voting power," says Mr. Hu. "With these financial innovations, you're screwing around with the foundation."

Hedge funds say their actions are legitimate, lawful and many times in the best interest of their investors. Often they borrow stock or use a hedging strategy to minimize the risk of their stake without any intention to affect the votes of the companies. They also say that if institutions can make money by lending shares, there shouldn't be a judgment against those who borrow.

"You should be able to vote your shares irrationally if you want," says Mark Weingarten, a partner in New York with law firm Schulte Roth & Zable who advises hedge funds. He adds, "The rules and state law simply haven't caught up with the marketplace for sophisticated trading techniques. They never contemplated the slicing and dicing of ownership and voting power that's done in the marketplace."

It's routine for hedge funds and other investors to borrow shares to vote them. Many individual investors hold their shares in margin accounts with their brokers. Brokers lend those shares out, often when they are requested by short-sellers, who borrow shares in the expectation the price will fall, sell them and hope to profit by buying them back at a lower price.

The California Public Employees' Retirement System reported in October that it made \$129.4 million in net income from lending securities for the year ending March 31, 2006. Critics say investors like Calpers shouldn't lend their shares if borrowers will use them in ways to undermine corporate governance. Proponents of securities lending say Calpers and other institutional investors have a fiduciary duty to make the most money for their constituents.

Not everyone agrees where the fiduciary duty lies. Lord, Abbett & Co., a mutual-fund company, has scaled back its stock lending program recently, saying it sometimes didn't get securities back in time to vote and decided that the money it was earning from lending out stocks wasn't worth it. "It was impeding our corporate governance efforts in a troubling number of circumstances," says Robert Morris, chief investment officer at Lord Abbett.

Calpers says it prohibits lending its 30 largest equity investments to make sure they will be available for voting, and on a second list monitors 300 of its largest so that if Calpers wants to vote the shares, it can try to get them back. A Calpers spokesman called those measures "a sufficient safeguard for our interests, for the time being."

Brokerage firms keep records of which shares are lent out when, and which holders of stocks are supposed to have the votes. But shares can be lent and re-lent and the records don't always keep up. Sometimes proxies are sent to both owners and borrowers, leading to "overvoting."

The New York Stock Exchange, which says tracking of votes has become inadequate, found overvotes in almost all the shareholder votes it tested at Deutsche Bank in 2002 and 2003: 23 of 27 instances. "There shouldn't be overvoting," John Thain, chief executive of NYSE Group Inc., said in a speech last year. "The question is, 'How do we prevent that from happening?'"

Last February, Deutsche Bank agreed to pay \$1 million, without admitting or denying wrongdoing, to settle NYSE allegations that the brokerage firm didn't have proper systems in place. In June, UBS Securities, Goldman Sachs Group Inc. and Credit Suisse Securities agreed to pay a total of \$1.35 million, without admitting or denying wrongdoing, to settle similar NYSE charges.

James Morphy, the head of mergers and acquisitions at New York-based law firm Sullivan & Cromwell, says because the votes haven't yet affected many outcomes in general corporate elections, companies haven't spent the time or money to dig deeply into who actually owns and votes their stocks. "To the extent there are a lot more voting contests, these issues are going to come to the fore," he said. As shareholders are getting more power in the wake of management scandals, votes are narrowing, which forces companies to pay more attention to who their shareholders are -- as have the growth and increased combativeness of hedge funds.

One way "empty voting" occurs is by borrowing stock ahead of the date that companies use to determine which stockholders can vote at a particular meeting. Record dates are usually set 30 days before a vote, designed to give companies adequate time to print and mail information to its shareholders of record.

In 2002, activist British hedge fund Laxey Partners, which owned a 1 percent stake in British Land, a major British property owner, sought to break up the company and oust its chairman John Ritblat. With a key proxy vote approaching, Laxey boosted its voting stake in British Land to 9 percent by borrowing more than 40 million shares days before the record date. By being shareholders of record on the record date, Laxey was entitled to vote at the next meeting.

In the end, Laxey's proposals were defeated. But Mr. Ritblat criticized Laxey for borrowing the shares, saying it wasn't good corporate governance. The three institutions that lent out shares -- Hermes, Barclays Global Investors and Scottish Widows, a life insurance and investment arm of Lloyds TSB -- apologized to British Land. Hermes says it didn't lend shares to Laxey but apologized to British Land for not recalling its shares and voting its full strength in support of management.

Since then, several large pension funds have taken notice and established internal systems to allow them to recall shares ahead of a vote and better monitor which shares are lent.

Because corporate voting is mostly governed by state law, the SEC's main tool in voting issues is requiring more disclosure. "Empty voting" usually doesn't trigger current disclosure rules because they don't cover borrowed stock or derivative holdings unless an investor owns more than 5 percent. Many hedge funds own just shy of 5 percent, Mr. Hu says -- and then use empty-voting strategies to enlarge or hide their stake.

Paul Atkins, a Republican SEC commissioner, expressed concern in a speech this week that empty-voting and other techniques should be considered as the SEC looks to tackle other shareholder proposals. That could delay the SEC from moving forward in resolving whether shareholders are permitted to nominate their own directors on corporate ballots.

One potential solution is to give institutional investors better notice of important proxy votes so they can know to recall shares -- and the attached voting rights -- that they've lent. Some investors already write recall options into their lending contracts, but brokerage firms have advised it could make borrowing those shares less attractive.

Professors Hu and Black recommend regulators require disclosure of an investor's complete stake, however it is held. Disclosure now "is so patchwork, you almost never see it," says Mr. Hu. "We need to get a better grip on just how extensive these practices are."

Regulators, however, don't want to disrupt the stock-lending market, and also have to be careful that any fix doesn't have the reverse effect that they intend. For instance, weighing votes by how long the stock has been held could curtail empty voting but disenfranchise individual investors, too.

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Tom Lauricella contributed to this article.