Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership

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Abstract

Most U.S. public companies have a single class of voting common shares: voting power is proportional to economic ownership. Linking votes to shares is often thought to be desirable, because, as residual claimants, shareholders have an incentive to exercise voting power well. The linkage also facilitates the market for corporate control. On the other hand, decoupling is efficient in some situations. Equity derivatives and other capital market developments now allow shareholders to readily decouple voting rights from economic ownership of shares, often without public disclosure. Hedge funds are prominent users of decoupling. Sometimes they hold more votes than economic ownership (a situation we term "empty voting"). Sometimes they hold undisclosed economic ownership without votes, but often with the *de facto* ability to acquire votes if needed (a situation we term "hidden (morphable) ownership"). This Article analyzes empty voting and hidden (morphable) ownership, which we term the "new vote buying." We offer a framework for unpacking its functional elements and assess its potential benefits and costs. Two companion legal articles (Hu and Black, 2006a, 2006b) provide more details on current disclosure rules and offer a disclosure reform proposal.

Keywords: vote buying; equity swaps, record date capture, shareholder voting, stock lending

JEL classification: G32, G34, K22.

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1. Introduction

The shareholder vote plays a central role in the theory of corporate governance and capital structure. Most U.S. public firms employ a one common share, one vote structure, which links economic interest to voting rights. Assigning voting rights to common shareholders, in proportion to number of shares held, places the power to oversee company managers in the hands of residual owners, who have an incentive to increase firm value. Linking shares to votes also facilitates the market for corporate control. Yet there can sometimes be advantages to decoupling shares from votes. Decoupling has traditionally been used by insiders to retain voting control. A dual-class common share structure, with one class having voting control, is a familiar example. This structure can let firms pursue growth opportunities which they might forego if doing so required diluting insiders' control, and can make it easier for firms to make long-term, positive NPV investments with unobservable payoffs. Decoupling can also potentially reduce shareholder collective action problems and reduce transaction costs in a contest for corporate control.

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, offer new, low-cost, often low-transparency ways for both outside investors and insiders to decouple economic ownership from voting power in public companies. Over the last few years, these decoupling techniques, which we call the "new vote buying," have been employed worldwide in a variety of ways. This Article explores these new techniques and their potential benefits and costs.

Even if a firm has a one share, one vote capital structure, there are multiple ways to decouple votes from economic ownership. One method relies on share lending. 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 common approach involves holding shares but hedging economic risk by holding a short equity swap position. In a typical cash-settled equity swap, the long equity side acquires the economic return on shares (but not voting rights) from the short side. The combined position (long shares, short equity swaps) conveys voting rights without economic ownership. Conversely, a long equity swap position conveys economic ownership without formal voting rights.

Sometimes, investors use these techniques to hold more votes than shares. We develop the term "*empty voting*" to describe this pattern, because the votes have been emptied of economic interest. Alternatively, investors can have more economic ownership than formal voting rights. This ownership is often undisclosed because ownership disclosure rules for outside investors generally address voting power rather than economic interest. Often, this economic ownership is combined with *de facto* ability to acquire voting rights at any time. We develop the term "*hidden (morphable) ownership*" to refer to undisclosed economic ownership plus informal voting rights. We refer to empty voting and hidden (morphable) ownership together as "*the new vote buying*" or simply "decoupling."

The theoretical possibility of decoupling is not new. But supply and demand factors have changed in major ways. On the supply side, financial innovations (such as equity swaps and other OTC derivatives), coupled with massive growth in the share lending market, now permit large scale, low-cost decoupling. On the demand side, there is now a trillion dollar-plus pool of sophisticated, lightly regulated, hedge funds, which are largely free from the conflicts of interest

and concerns with adverse publicity that may deter other institutional investors from using decoupling strategies.

Current U.S. law leaves the new vote buying largely unregulated and often undisclosed. Lack of disclosure means that we cannot offer quantitative data on its extent. We did, however, search for and compile over 25 recent public examples (see Table 1 below). How many additional instances remain undisclosed, we cannot say.

This paper proceeds as follows. Part 2 develops a taxonomy for the functional elements of empty voting and hidden (morphable) ownership, and offers examples. Part 3 discusses the theoretical and empirical literature on the benefits and costs of decoupling. Part 4 summarizes current disclosure rules and sketches a disclosure reform proposal. Part 5 concludes. Two companion legal articles (Hu and Black, 2006a, 2006b) provide additional details on current disclosure rules, develop our disclosure reform proposal, and analyze possible reforms, some of which go beyond disclosure. An informal glossary at the end of this Article explains some commonly used terms. As far as we are aware, this Article and its companions are the first attempt to systematically address the new vote buying.[1]

2. The Technology of the New Vote Buying

2.1. The 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. We consider publicly traded companies and assume that a company has a one share, one vote capital structure.[2] Define **"formal voting rights"** as the *legal* right to vote shares under company law (supplemented by rules on voting shares held in street name), regardless of who decides how to vote. Define **"voting rights"** or **"voting ownership"** as formal or informal rights to vote shares, including the formal or informal power to instruct someone else how to vote. 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 returns on which are directly related to the return on host company shares.

Define **"economic ownership"** as 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** -- the same direction as the return on shares -- or **negative** -- the opposite direction as the return on shares. **"Net economic ownership"** is a person's combined economic ownership of host company shares and coupled assets, and can be positive, zero, or negative. An **"empty voter"** is a person whose voting rights substantially exceed his net economic ownership. Net economic ownership may depend on share price. Suppose, for example, that an executive enters into a zero-cost collar that caps upside on a company's shares at $60 and downside at $45. The

[1] Other articles or working papers that discuss or touch on new vote buying strategies include Martin and Partnoy (2005), Skeel (2005), Kahan and Rock (2007); Nathan (2007).

[2] Throughout this Article, we assume that a company has diversified shareholders with homogeneous preferences. We treat shareholder wealth 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, between shareholder welfare and shareholder wealth, and "short-termism" issues (Hu, 1991, 1995).

executive has partial economic ownership of the collared shares, 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 relates in some way to the value of the host company's shares. In Perry-Mylan (discussed in Section 2.2 below), for example, shares in Mylan's target, King Pharmaceuticals, were a related non-host asset. Define the combined return on host company shares, coupled assets, and related non-host assets as an **"overall economic interest"** in host shares, which can be positive, zero, or negative.

We consider a person to have **"hidden (morphable) ownership"** if the person has indirect economic ownership that disclosure rules do not cover (or are reasonably interpreted by the person as not covering), coupled with likely possession of informal voting rights**.** These informal voting rights will generally not be verifiable by outside observers and will depend on market customs and private incentives. Perry's ownership of Rubicon equity swaps (discussed in Section 2.3 below) offers an example.

2.2 Empty Voting

2.2.1. Empty Voting By Outside Investors

One core strategy for empty voting is to hold shares but hedge the economic return on the shares. The simpler hedging strategies include: (i) a short equity swap position; (ii) a short position in a single stock future; and (iii) a (short call, long put) position.[3] Partial hedges, producing partly empty voting, are also possible.

A U.S. example 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 rose but Mylan's shares dropped. To help Mylan receive shareholder approval for the merger, Perry bought 9.9% of Mylan but fully hedged its risk on the Mylan shares, ending up with **9.9%** *voting ownership* but **zero** *economic ownership*. 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's completion of the merger. The more Mylan (over)paid for King, the more they would profit.[4]

Perry and Citadel were probably able to acquire their Mylan positions with little impact on Mylan's share price. Assume that they bought shares and (more or less simultaneously) entered into short equity swap positions. The derivatives dealers who took the long side of the swaps would likely hedge, for example by selling Mylan short. The market impact of the share purchases and the dealers' hedges would tend to offset each other. The dealers could also borrow shares (with no direct market impact), sell them short privately to Perry and Citadel (with no

[3] 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 or an option position normally depends solely on share price changes.

[4] As it happens, no vote was taken; Mylan abandoned the acquisition because of accounting problems at King. We provide citations to news stories, regulatory filings, and other sources discussing Perry-Mylan and other new vote buying examples in Hu and Black (2006a). In some cases, the news stories refer to market rumors or other sources which may not be accurate.

market impact), and simultaneously take the long side of an equity swap with Perry (with no direct market impact). The dealers would end up hedged -- they would be short shares and long offsetting swaps.

As of early 2007, a situation similar to Perry-Mylan may be unfolding. In March 2006, Multi-Fineline Electronix (M-Flex), a Delaware company, made an offer to acquire a Singapore company, MFS Technologies (MFS). Another Singapore company, WBL, owns a majority stake in both M-Flex and MFS. In August, a special committee of M-Flex's board recommended that M-Flex's minority shareholders vote against the transaction. M-Flex then sued WBL, seeking to compel WBL to vote against the transaction based on WBL's fiduciary obligations as a controlling shareholder. M-Flex alleged that although M-Flex's charter requires that the offer be approved by a majority of M-Flex's minority shareholders, that provision does not offer the protection it ordinarily would because Stark, a hedge fund, holds at least 48% of the minority M-Flex shares and has an incentive to vote for the offer even if it is bad for M-Flex: Stark owns a large stake in the target, MFS, and has hedged most or all of its interest in M-Flex. M-Flex claimed that:

> Stark stands to make a significant profit through its holdings in MFS if the Offer is consummated and has obtained its voting interest in M-Flex only to attempt to protect such profits to the detriment of M-Flex and its other stockholders. M-Flex believes Stark, by its hedging activity, has effectively separated its voting power from its economic interest and, therefore, its incentives are directly opposed to the best interests of M-Flex and its true stockholders. In short, the more that M-Flex is forced to overpay for MFS, the more Stark stands to profit. [5]

Other anecdotes can further illustrate how hedged share purchases can be 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 share price *only if* AXA acquired MONY. Holders of long (short) positions in AXA bonds apparently acquired MONY shares to vote for (against) the merger, with neither group's vote turning on whether the merger was good for MONY. The bondholders may have hedged 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 this very close vote.

2.2.2. Insider Hedging

Empty voting by outside investors is a close cousin to widely used techniques by which company insiders (directors, officers, controlling shareholders) retain formal ownership of shares

[5] M-Flex complaint against WBL in Delaware (Oct. 17, 2006). Our discussion is based primarily on this complaint and a court order in California (Dec. 4, 2006) dismissing a separate M-Flex complaint against Stark. Stark countersued certain of M-Flex's directors for, among other things, misrepresentations and fiduciary breaches. On January 22, 2007, Stark and M-Flex voluntarily dismissed the suit by Stark against M-Flex; this did not affect that by M-Flex against WBL. We have made no effort to assess the accuracy of the M-Flex allegations.

while reducing their economic risk. One strategy 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).[6] Variable prepaid forwards are a somewhat different strategy for limiting risk while preserving formal ownership.[7] All of these strategies reduce economic ownership but preserve 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 by 25%. In Hong Kong, controlling shareholders' use of equity swaps to reduce economic ownership prompted regulators to broaden disclosure requirements in 2003 (Hong Kong Securities and Futures Commission, 2003, 2005).

2.2.3. 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 convey to the lender any dividends or other distributions on the shares during the loan period. The loan is typically callable at any time by the lender, and repayable at any time by the borrower (Bond Market Association, 2000; International Securities Lending Association, 2000). The lender retains economic ownership, without voting rights, while the borrower obtains voting rights, without economic ownership. 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.[8]

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 (with no reason to know it bought from a short seller). The short seller ends up with negative net economic ownership, without voting rights. Typically, the short-seller later closes out the short position by 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. (In the U.S., Federal Reserve Board Regulation T bars lending shares for voting purposes in many circumstances (Hu and Black, 2006a).)

Record date capture by insiders fosters entrenchment. Yet for outside investors, it can reduce collective action problems. A U.K. instance may illustrate. 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 and supported a

[6] 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. This limits ("collars") economic exposure to the range between the put and call exercise prices. In a "zero-cost" collar, the proceeds from selling the call equal the cost of the put.

[7] The glossary at the end of this article defines variable prepaid forwards and a number of other terms used in this article.

[8] A separate "dividend capture" strategy involves buying shares just before a dividend record date, and selling them just after this date. Many firms use the same record date for voting and for paying dividends. We use the term "record date capture" to refer to efforts to capture votes, not dividends.

proposal to break up British Land. Just before the record date, Laxey had borrowed 8% of British Land's shares.[9]

A more questionable use of record date capture appears to have occurred in Hong Kong in 2006. Henderson Land offered to buy the 25% minority interest in Henderson Investment at a premium. Henderson Investment's share price rose on anticipation that its shareholders would approve the buyout. Under Hong Kong law, however, the buyout could be blocked by a negative vote of 10% of the "free floating" shares -- about 2.5% of the outstanding shares. To everybody's surprise, 2.7% of the shares were voted against the buyout; Henderson Investments shares promptly fell 17%. Apparently, a hedge fund borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, profiting from private knowledge that the buyout would be defeated. One fund apparently held enough votes to defeat the buyout by itself.

2.3. Hidden (Morphable) Ownership

2.3.1. Hiding Voting Power Until Needed

Investors can also have greater economic than voting ownership. We term this pattern "hidden (morphable) ownership," because in many cases, the investor has shed the formal voting rights that trigger disclosure, while retaining the *de facto* ability to acquire votes quickly when needed. Perry's stake in a New Zealand company, Rubicon Ltd. illustrates. In early 2001, Perry was a major holder of Rubicon. New Zealand's ownership disclosure rules, similar to U.S. rules, required disclosure by 5% shareholders. 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, just before Rubicon's shareholder meeting. What happened? In May 2001, Perry shed its voting rights but not its economic interest. It sold 31 million shares to two derivatives dealers and simultaneously acquired from them an equivalent long equity swap position, which it treated as not requiring disclosure. When Perry needed voting rights, it terminated the swaps and reacquired the shares from the dealers. Another shareholder challenged Perry's right to vote, based on its failure to disclose its ownership, but the New Zealand courts upheld Perry's non-disclosure.

How did Perry know it could reacquire Rubicon shares when it wanted to vote them? The dealers needed to hedge their exposure on the swaps, and were likely to do so by holding the Rubicon shares they had bought from Perry. Perry could also expect the dealers to sell the shares back to Perry if Perry chose to unwind the equity swaps. The New Zealand Court of Appeal 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

[9] We use this example merely to illustrate how record date capture can respond to collective action problems. We take no view on whether Laxey's actions were in the interests of British Land's other shareholders.

> wanted to terminate the swaps and purchase the shares, it would have been commercially sound for the . . . counterparties to sell him those shares.[10]

Similarly, in the U.K., 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. If the dealer hedges in a way other than by holding matched shares, the swap holder would "normally expect" the dealer to acquire the necessary shares, even if this resulted in cost to the dealer (U.K. Panel on Takeovers and Mergers, 2005a, ¶3.3-3.4). Table 1 offers examples of this market practice. In response, in 2005, the Panel on Takeovers and Mergers adopted a new rule requiring disclosure of economic ownership, regardless of voting ownership. The rule applies if a takeover bid is made, but not otherwise (Panel on Takeovers and Mergers, 2005b).

Market expectation that a dealer will unwind a swap, however, is not a guarantee, as shown by a 2006 buyout offer by Sears Holdings (controlled by hedge fund manager Eddie Lampert) for the minority shares in Sears Canada. The offer required approval by a majority of the Sears Canada minority shareholders. The Pershing Square hedge fund had economic exposure to Sears Canada through equity swaps with SunTrust Capital Markets ("SunTrust"), which in turn, entered into equity swaps with a unit of the Bank of Nova Scotia (BNS); BNS then hedged in part by holding matched Sears Canada shares. BNS later became the dealer manager for the Sears Holdings offer. Pershing Square was unsuccessful in obtaining the matched shares so it could vote against the offer.

Why might BNS have been so unhelpful to Pershing Square? The Ontario Securities Commission (OSC) found that Sears Holdings induced BNS and another bank to vote for the offer by revising the offer to meet the banks' tax planning objectives, thus providing greater consideration to the banks than to other shareholders: implicitly, *old-style* vote-buying was attempted. The OSC blocked the banks from voting their Sears Canada shares: the Sears Canada minority shareholders then narrowly defeated the offer. The offer would have succeeded if BNS had been allowed to vote.

2.3.2. Other Uses of Hidden Ownership

Economic ownership without apparent voting ownership can be used in other contexts as well. Two examples:

- In 2005, 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), and did not disclose its swap position. The Australian Takeovers Panel held that Glencore should have disclosed its combined position under Australia's large shareholder disclosure rules; the decision was reversed on appeal by the Australian courts.
- *Avoiding mandatory bid rules*: In many countries, a shareholder who exceeds a threshold ownership percentage must offer to buy all remaining shares at a formula price. Having

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

economic but not voting ownership can let an acquirer avoid these rules. The Agnelli family's use of equity swaps for Fiat shares in 2005 offers a recent example.

2.4. Related Non-Host Assets

Additional complexities arise when related non-host assets form part of a shareholder's overall economic interest. One recurring situation is a proposed merger. Here, economic ownership in both bidder and target can reduce the collective action problems that deter shareholders from opposing an acquisition. Deutsche Borse's 2004 bid for the London Stock Exchange (LSE) offer a possible example. Soon after the bid was announced, two hedge funds (Children's Investment Fund (CIF) and Atticus Capital), together holding 8% of Deutsche Borse, publicly opposed the bid, which was later 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. If CIF and Atticus went long Deutsche Borse and short LSE, this would enhance their net economic interest in the Deutsche Borse vote, and might justify the cost of a campaign against the deal.

An economic interest in both sides to a prospective merger can, depending on one's relative positions in acquirer and target, create a variety of incentives that differ from those of other investors. For example, a merger arbitrageur who follows the classic arbitrage strategy of going long target - short acquirer would have an incentive to support a merger, even if it was bad for the acquirer or the combined firms. An investor who holds long positions in both companies but a larger position in the target (acquirer) will favor a merger on terms favorable to the target (acquirer).

2.5. The Extent of New Vote Buying

Much new vote buying is undisclosed. Its extent and how often it has affected voting outcomes are thus not unknown. But there is value in collecting the known instances in one place. Table 1 lists the publicly disclosed (or in some cases rumored) decoupling examples that we found, in inverse chronological order. Other sources also suggest that new vote buying is reasonably common. These include:

- regulatory changes in Hong Kong (2003) and the U.K. (2005) to require disclosure of economic ownership in certain circumstances;
- U.K. self-regulatory efforts to limit record date capture (see Section 5.3);
- as of early 2007, the Securities and Exchange Commission in the U.S. and the Financial Services Authority in the U.K. were considering changing disclosure rules to address new vote buying; [11]
- market understandings on dealer holding of matched shares and either unwinding swaps or voting matched shares as customers instruct (see Section 2.4)

[11] On these U.S. and U.K. developments and regulators' concerns, see, e.g., Atkins (2007); Grant and Guerrera (2007); Scannell (2007a, 2007b).

- statements by lawyers at major firms in Australia, the U.K., and the U.S. that hidden ownership positions generally need not be disclosed (Pathak and Popo, 2005 (Freehills); Liew, 2000 (Allen & Overy); Greene et al., 2004 (Cleary Gottlieb)
- Lawsuits in the U.S. (Perry-Mylan and M-Flex); Australia (Glencore-Austral Coal), Canada (Sears Canada), and New Zealand (Perry-Rubicon)

These responses to market activity suggest that the underlying practices are reasonably common. There is also limited quantitative evidence on executive hedging (Bettis, Bizjak & Lemmon, 2001) and on record date capture (Christoffersen, Geczy, Musto and Reed, 2006).

Table 1. 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, from a combination of public news stories, regulatory studies, and anecdotes provided by readers and workshop participants. The table is an expanded version of a similar table in Hu and Black, 2006a and is © 2007 Henry T. C. Hu.

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden (Morphable) Ownership	Coupled Asset	Description
2007	U.S. Global Investors	U.S.	Unspecified hedge funds	X			Company claims that share volatility "may be amplified" by hedge funds engaging in empty voting who opposecharter amendments.
2006	Multi-Fineline – Electronix	U.S./Singapore	Stark (hedge fund)	X		Unspecified hedges	See Section 2.2
2006	Telent PLC	U.K.	Polygon (hedge fund)	X		Share borrowing and/or equity swaps	Polygon blocks acquisition of Telent, exercising voting power beyond its economic interest.
2006	Sears Canada	Canada	Pershing Square (hedge fund)	X (attempted)	X (morphing failed)	Equity swaps	See Section 2.3
2006	Henderson Investment	Hong Kong	Hedge fund(s)	X	X (short position)	Share borrowing + short sale	See Section 2.2
2006	Time Warner	U.S.	Istithmar (private investment fund)		X	Equity-linked notes	Istithmar acquired equity-linked notes from UBS, which agreed to "consult" its client before voting or disposing of its matched shares
2005	Wendy's Int'l	U.S.	Trian and allied hedge funds		X	Matched call and put options	Trian mounts proxy campaign for spinoff of Wendy's subsidiary, has economic ownership primarily through options
2005	Fiat	Italy	Agnelli family		X	Equity swaps	See Section 2.3
2005	Austral Coal	Australia	Glencore		X	Equity swaps	See Section 2.3
2005	Exar	U.S.	GWA Investments (hedge fund)	X		Short sales	GWA sought board seats, its Exar position was 96% hedged.
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; Nippon had economic ownership, but hoped to *deny* voting rights to Livedoor.
2005	Deutsche Boerse	Germany	Hedge funds	X		Short sale of target shares	See Section 2.4

Date	Host Company	Country	Vote Buyer	Empty Voting	Hidden (Morphable) Ownership	Coupled Asset	Description
2005	Portman Mining	Australia	Seneca (hedge fund)		X	Equity swaps	Cleveland Cliffs bid to acquire Portman. Seneca held a 9% economic interest in Portman through equity swaps
2004-2005	WMC Resources	Australia	BHP Billiton		X	Equity swaps	BHP acquired 4.3% toehold through equity swaps.
2004-2005	Mylan Laboratories	U.S.	Perry Corp.	X		Equity swaps	See Section 2.2
			Citadel (hedge funds)	X		Unknown	
2004	DFS	U.K.	Polygon (hedge fund)		X	Equity swaps	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		X	Equity swaps	Hedge funds with equity swaps as to Alvis shares supported BAe Systems' bid For Alvis.
2004	Marks and Spencer	U.K.	Hedge funds		X	Equity swaps	Investment banks that held matched shares to hedge equity swaps supported PhilipGreen's bid for Marks and Spencer.
2004	Canary Wharf	U.K.	"Songbird" consortium (seeking to acquire Canary Wharf)		X	Equity swaps	Derivatives dealer UBS held 7.7% of Canary as matched shares to support equity swaps held by Songbird members
2004	MONY Group	U.S.	Holders and short sellers of AXA convertible bonds	X		Acquirer's convertible bonds	See section 2.2
2004	News Corp.	Australia & U.S.	Liberty Media	X	Hidden: yes Morphable: maybe	Forward contracts and equity swaps	Liberty Media held voting and nonvoting News Corp. shares and used derivatives to adjust its economic exposure
2002	P&O Princess	U.K.	Investor (favor Carnival bid for P&O Princess)	X	maybe	Share borrowing	P&O shareholders who favored Carnival's bid reportedly borrowed shares in order to vote for acceptance.
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	Lew bought additional shares, but hedged with options
2002	British Land	U.K.	Laxey Partners	X		Share borrowing	See Section 2.2
2001	Rubicon	New Zealand	Perry Corp.		X	Equity swaps	See Section 2.3
1997	John Fairfax Holdings	Australia	Brierley Investments			Equity swaps	Brierley held equity swaps instead of Fairfax shares to avoid Australia's mandatory bid rules

3. Literature Review and Implications for New Vote Buying

3.1. Theory

A number of theoretical strands in the literature address the efficiency of a one share, one vote capital structure, or of vote trading in connection with a takeover bid. As we will see, however, none maps directly onto the new vote buying. We offer here a selective review of this large literature.

3.1.1. One Share, One Vote: Decoupling By Insiders

Several strands develop the basic contractarian theory of the firm and the related argument for the efficiency of a one-share, one-vote capital structure (e.g., Easterbrook and Fischel, 1991). One strand derives from the hostile takeovers of the 1980s and focuses on the role of a one share, one vote rule in supporting the market for corporate control (e.g., Grossman and Hart, 1988; Harris and Raviv, 1988) and the power of large shareholders to influence management (Shleifer and Vishny, 1986).

Within the law-and-finance literature, models suggest that higher economic ownership by insiders should produce lower tunneling and higher firm value (e.g., Bebchuk, Kraakman and Triantis, 2001; Durnev and Kim, 2005). A large gap between insiders' voting rights and economic ownership can also distort their investment decisions (Bebchuk, Kraakman and Triantis, 2001). But decoupling could also provide a variety of efficiency gains. Insiders are often undiversified and hence averse to firm-specific risk. Greater ability to hedge economic ownership could make them 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). Dual-class share structures can also let controlling shareholders pursue growth opportunities which they might otherwise forego if forced to choose between the opportunity and potential loss of control (Gilson, 1987). These structures can also make it easier for firms to make long-term investments whose expected payoffs are hard for outside investors to assess (DeAngelo and DeAngelo, 1985).

A third strand of analysis focuses on legal rules that encourage or limit disparity between insiders' economic and voting stakes. Morck, Wolfenzon, and Yeung (2005) argue that disparity can let a single investor or family control a large business group, amass political influence, and in an extreme case, "capture" the state. This strand treats the disparity between insider economic ownership and control 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 observation that for outside investors, votes have limited individual value, but can have substantial collective value. The difference between individual and collective value makes it possible for market transactions in votes to produce inefficient outcomes.

Assume, for example, that someone is interested in acquiring a bare majority of votes. The vote buyer can, in effect, make a two-tier offer to small shareholders: price *X* until the buyer gets a majority, 0 thereafter, similar to a two-tier tender offer for shares. Shareholders will face

pressure to sell votes 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. Shareholders thus 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 (Milnor and Shapley, 1978; Shapiro and Shapley, 1978; see Zwiebel (1995) for an application of Shapley values to blockholdings in firms). The Shapley value of a small "oceanic" shareholder depends on the holdings of significant shareholders . 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 $x < 0.5$; and 1 for $x \geq 0.5\}$. The oceanic shareholders have combined Shapley values of {1 - (the significant shareholder's value)}, and thus Shapley value per share of $\{(1-2x)/n(1-x)^2$ for $x < 0.5$; and 0 for $x \geq 0.5\}$. The per-share Shapley value of oceanic shareholders, and thus the market value of their votes, approaches zero as the significant shareholder approaches absolute control ($x = 0.5$), and disappears once control is achieved.

Markets for shares potentially have a similar problem. The voting rights embedded in shares are valuable when control is up for grabs, but lose value as a large shareholder approaches absolute control. The impact of this collective value problem is muted, however, because in most situations, the value of votes is a small fraction of the total value of shares.

Moreover, the pool of tender offer bidders is constrained because the bidder must buy a majority of shares at a price that exceeds the current market price to attract takers. Buying votes without shares is much cheaper. If one excludes the possibility that an acquirer will extract private benefits, it could be desirable to reduce this entry cost by allowing direct trading of votes (Manne, 1964). However, if the bidder can extract significant private benefits, a reduced cost of control could facilitate bids by looters, as well as by managers who can run the firm more efficiently.

3.1.3. Takeover Bid Models: Explicit, Time-Limited Auctions

Formal models suggest that an explicit market for votes, in which an incumbent and raider compete for votes, is likely to operate similarly to a market for coupled shares and votes (e.g., Blair, Golbe and Gerard, 1989; Neeman and Orosel, 2007). These models suggest that a control contest for votes could have efficiency advantages, compared to a contest for shares. In particular, they could allow bids by managers who can't raise the funds to buy shares coupled with votes. The models, however, are "extremely stylized" (Blair et al. at 423) and non-equilibrium. Vote buying is permitted only during a limited period, during which there is an explicit contest between incumbent and raider. The incumbent and the raider make competing public offers for votes, which expire at the same time. The models thus presume a voting tournament that is constrained in time and transparent to all participants. That makes them of limited relevance in evaluating the new vote buying.

Still to be developed is an equilibrium model in which (i) insiders can acquire votes at any time, before a raider emerges, (ii) once acquired, votes can be held indefinitely; (iii) if insiders do not keep control, a raider can acquire votes at any time; and (iv) both sides can acquire votes quietly, without public disclosure. While such a model is beyond the scope of this project, we suspect that in equilibrium, if private benefits are potentially large, insiders will keep

control, if only to ward off raids by outsiders seeking 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. Contests for votes are more likely to be efficient in markets with low private benefits of control.

3.2. Evidence

3.2.1. Divergence Between Insiders' Voting and Economic Ownership

One strand of empirical work on the value effects of separating economic ownership and voting rights 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 which they would hold, leaving other shareholders with low-voting stock. We discuss these recapitalizations in section 3.3.2 below.

A second research strand concerns insider-controlled firms. 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, on average. However, it is difficult to draw firm conclusions from this research. First, the lower value of minority shares could be offset by a higher value of *controlling* shares, whose value cannot be directly observed, although Gompers, Ishii and Metrick (2004) and Joh (2003) offer some evidence that disparity predicts lower firm value. Second, family control could be efficient for some firms even if not on average. Third, causation is difficult to assess. Insider retention of control is likely to be endogenous to other firm characteristics (Lehn, Netter and Poulsen, 1990).

3.2.2. Takeover Defenses and Toeholds

Gompers, Ishii and Metrick (2003) report evidence that U.S. firms with strong takeover defenses have lower share prices than firms with weak defenses. Cremers and Nair (2005) report positive 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 obtain 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. This strategy could delay the need for disclosure until a formal bid is made, and thus facilitate acquiring toeholds. Depending on how the holder of the short swap position hedges, the market impact of acquiring a swap position could 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 with empty voting. Cross-country studies (Dyck and Zingales, 2004; Nenova, 2003)) find substantial value of control in many countries, sometimes as high as 50% of firm value. 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 U.S. 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 price difference between high- and low-vote shares can be much higher (e.g., Zingales, 1994, on Italy; Levy, 1982, on Israel). The price premium attached to high-vote shares, however, understates the value of control because controlling shares usually do not trade.

3.2.4. Record Date Capture

Christoffersen, Geczy, Musto and Reed (2006) 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 and for votes that turn out to be close. The cost of short-term borrowing is trivial. The authors estimate no significant average excess cost (over the usual, roughly 15 basis point annual cost of borrowing shares). The authors argue that this pattern is consistent with votes moving from less- to better-informed shareholders.[12]

The shares of most publicly traded stocks in the U.S. can be borrowed. D'Avolio (2001) reports that shares available from just one large financial institution cover firms which account for over 99% 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).

Borrowing costs can be significant for a company with limited "free float" (shares not held by insiders) or with substantial short selling interest. One would expect a similar price response if there was widespread record date capture for a particular election, especially if there were competing buyers. Yet at present, the share lending market operates oddly, with substantial excess supply at most times, and borrowing levels only rarely approaching the number of lendable shares (see Butler, 2006, for an example). Price responds to extreme demand shocks, but often not to smaller ones. As long as this pricing pattern remains, the cost to quietly borrow enough shares to swing a close election might be quite small.

3.3. Differences Between New Vote Buying and Other Forms of Decoupling

We consider next the ways in which new vote buying is different from other forms of decoupling votes from economic ownership. Decoupling can be classified along several dimensions: when it occurs (before shares are sold to investors or after); the period of time during which decoupling is permitted (at any time or, as in the takeover bid models, only for a limited period); whether and when it is disclosed (before it occurs, after it occurs, or never); and who does it (insiders, outside shareholders, or both).

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

Insiders have long had several means to retain greater voting than economic ownership. These include dual-class common stock (in which one class has high voting power and is held

[12] We discuss the inferences that we believe can and cannot be drawn from the Christoffersen et al. data in Hu and Black (2006a), at 857.

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, 2006), and circular ownership, with insiders controlling a pivotal company.

There can be justifications for insiders using one of these means to retain control. The ability to keep control may make the controllers more willing to issue equity to pursue growth opportunities. In terms of our classification scheme, these forms of decoupling are engaged in by insiders. They usually occur and are disclosed *ex ante*, so that investors pay an appropriate price for noncontrolling shares. Thus, if there is an efficiency benefit (cost) from decoupling, the insiders realize the associated gain or loss. These justifications, however, map imperfectly onto the new vote buying, which is often *ex post* and undisclosed. If decoupling occurs ex post, there is no longer reason to expect, in general, that the vote buyers will fully bear any effects on firm value.[13]

3.3.2. Dual Class Recapitalizations

Dual-class recapitalizations also offer a possible analogy to new vote buying. These transactions 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 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 slightly higher dividend.

In terms of our classification scheme, this form of decoupling is engaged in by insiders, is disclosed before it occurs, but occurs after shares are sold to investors. We lose the comfort that investors pay an appropriate price for noncontrolling shares and therefore that insiders bear the gains or losses from the recapitalization. Instead the insiders are likely to bear some but not all of any associated net cost. However, after the recapitalization, control is known, so after a one-time adjustment, investors should again pay an appropriate price for noncontrolling shares.

These recapitalizations might have been efficient (Lehn, Netter and Poulsen, 1990), but they may also have allowed insiders to 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 below-market price, announcements of these recapitalizations led to reduced share prices, on average (e.g., Dann and DeAngelo, 1988; Gordon, 1988; Jarrell and Poulsen, 1988; but see Partsch, 1987). Most midstream recapitalizations were banned through joint action by the SEC and the stock exchanges (Bainbridge, 1991).

3.3.3. Voting by Record Owners

A third analogy involves the practice in which most 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

[13] Circular ownership and pyramidal structures can also be established or strengthened ex post. We are aware of several Korean examples where ex post reinforcement of family control has occurred. In this case, the controlling shareholders will not fully bear the associated gains or losses in firm value.

and broker-dealers -- which in turn hold shares for their clients. DTC 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 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 must ask their clients for voting instructions. If a client does not return instructions, the bank or broker-dealer cannot vote on major matters, such as a contested election of directors or approval of an acquisition. A new NYSE rule will soon bar record owners from voting on uncontested director elections in many circumstances as well.

For this form of decoupling, these market practices and rules substantially -- and increasingly -- require recoupling of shares with votes. This recoupling reflects policy concerns that empty voting by record owners, if allowed, might produce poor voting outcomes. One worry is that banks and broker-dealers often have conflicts of interest that will cause them to vote in support of company managers (Heard and Sherman, 1987).

3.3.4. Classic "Vote Buying" Under Corporate Law

A final analogy is to classic "vote buying" under corporate law. Historically, corporate law barred a shareholder's sale of voting rights, without economic interest, to a third party. Current Delaware law is more tolerant, and permits vote selling if the transaction is for a proper purpose and satisfies a test of intrinsic fairness (Andre, 1990).[14] A principal rationale for the regulation of classic vote buying is that it creates a risk of self-dealing by those who gain control (Clark, 1979). New vote buying would presumably raise similar risks.

However, vote buying doctrine generally does not reach the new vote buying by outside shareholders, and only sometimes reaches insiders (see Hu and Black, 2006a, for details). The doctrine focuses on an *acquisition of voting rights* by a vote buyer from a **vote seller** and the purpose of the sale. With the new vote buying, empty voting often involves the new **vote buyer** formally owning shares while *shedding economic ownership*. No vote seller or transfer of naked voting rights can be identified. Record date capture is also not generally reached by existing case law.

3.4. Testable Hypotheses

Suppose that empty voting and hidden (morphable) ownership are or become reasonably widespread. What testable results might we expect?

Around the record date for a contested vote, we would expect (i) an increase in demand for share borrowing; and (ii) a possible decrease in the supply of lendable shares, because some lenders will prefer to either vote their shares or sell the shares to others who value the accompanying voting rights. 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 might spike as the contestants vie to acquire enough votes to carry the election.

[14] The leading modern case is *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982).

In theory, all ways of obtaining votes during a proxy contest should have similar costs. Compare Dodd and Warner (1983), who report that in proxy contests for control, share prices decline by 2-3% immediately following the record date. Christoffersen et al. (2006) report higher share borrowing on record dates with no apparent change in price, but this seems unlikely to be an equilibrium outcome for contested elections.

3.5 Summary of Policy Issues

The survey above suggests that new vote buying raises risks, compared to older forms of decoupling, due to four interacting factors. The first is that decoupling occurs after shares are sold to investors. The second is the disparity between the individual and collective value of votes, which makes it possible for someone to acquire control without paying an appropriate price for doing so. The third is lack of transparency in the markets in which votes are purchased. The fourth is the potential for controllers to extract private benefits, and thus to profit by buying control and then looting a company, rather than improving its operations (Cole, 2001).

The models of vote buying during a control contest, from Manne's (1964) original exploration to the present, address the first three concerns by assuming concurrent public offers for votes by competing bidders. Only Neeman and Orosel (2007) address private benefits. They show that with concurrent disclosed bids, homogeneous shareholder preferences, and a requirement that a bidder offer a uniform price for all votes, an efficient manager can outbid a looter. The real world of new vote buying is messier. The existing literature does not contemplate, for instance, the possibility of a vote buyer having a *negative* economic interest in the company, nor undisclosed bids for votes, achieved through complex transactions in which there may be no identifiable vote seller. At present, bids for votes which result in empty voting need not be either concurrent or disclosed; and need not be at uniform prices. Even if private benefits are low, it seems likely that disclosure of bids and transactions will be a necessary condition for vote buying to be efficient.

4. Disclosure: Current Rules and Reform Proposal

How best to balance the risks posed by the new vote buying against its potential benefits is not clear. However disclosure likely offers a place to start. Disclosure can provide information on the frequency of empty voting and hidden (morphable) ownership. Disclosure may also serve to deter some new vote buying. Not everyone will do in the sunshine what they will do in the dark. Moreover, some empty voting strategies may be less effective if disclosed. At the least, other shareholders will understand the empty voter's incentives (Briggs, 2007). Also, while disclosure is not a sufficient condition to ensure that an efficient manager can outbid a looter in the control contest models, it seems likely to be a necessary condition for us to have confidence in this outcome (compare Neeman and Orosel, 2007).

Conversely, if decoupling is undisclosed and can change over time, investors will, as in any adverse selection situation, 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, because it permits an outsider to acquire control and profit by self-dealing (Bebchuk, 1999). Atanasov, Black, Ciccotello and Gyoshev (2007) 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.

In this part, we explain current U.S. ownership disclosure rules. These rules are internally inconsistent, in that they treat economically similar positions differently, and allow much new vote buying to remain undisclosed. We then sketch a disclosure reform proposal which would address new vote buying, but refer readers to our companion law articles (Hu and Black, 2006a, 2006b) for details and discussion of the benefits and costs of the proposal.

4.1. Current Disclosure Rules

Currently there are five discrete sets of disclosure rules 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 the Securities Exchange Act of 1934 ("Exchange Act"), § 16(b)
- mutual funds report their portfolio holdings quarterly, through Forms N-1A, N-CSR, and N-Q

The overall ownership disclosure system is highly complex. Different rules often apply in determining which ownership positions *trigger* the disclosure requirements and which positions must be disclosed once disclosure is required. Positions involving equity swaps and other 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 2. Our companion articles provide details (Hu and Black, 2006a, 2006b). The discussion below is roughly but not wholly accurate. Additional disclosures may be required under the proxy rules and the tender offer rules for someone who launches a proxy contest or a tender offer.

Table 2. Ownership Disclosure Requirements Relating to New Vote Buying

This table summarizes current U.S. ownership disclosure rules, once 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, officer, 10% holder)	Current	Yes		Yes		Banned by § 16(c)	Probably no	
Mutual funds	Quarterly	Yes		Yes			Generally 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 instead file a more abbreviated Schedule 13G, with an initial filing if they cross 10% and annual reporting otherwise, with a 45-day lag -- year-end positions are reported on February 15 of the following year. Beneficial ownership of shares includes ownership "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise," as well as "the right to acquire beneficial ownership within sixty days, including through exercise of an option or warrant." (SEC Rule 13d-3) 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 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; lending likely would not

Because it focuses on voting rather than economic ownership, Schedule 13D provides some disclosure of empty voting (voting rights will be disclosed, but often without full details on their empty character. Schedule 13D generally does not reach hidden (morphable) ownership. Schedule 13G provides very limited coverage because it has a higher disclosure threshold, does not require disclosure of related positions, and captures only end-of-year positions.

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

The third set of ownership disclosure rules 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 of the following year, 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. For exchange-traded options, money managers report options they hold, but not options they have *written*. If shares have been lent, the lender ignores the loan (that is, the lender reports owning the shares), while the borrower reports nothing. Thus, the 13F rules provide very little disclosure of either empty voting or hidden (morphable) ownership.

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

Under Exchange Act § 16(b), insiders, defined as officers, directors, and 10% beneficial owners of U.S. public companies (with beneficial ownership measured under the 13D rules) must report their *economic* ownership. Outside shareholders can usually avoid crossing the 10% threshold, however. The same cash-settled equity swap that lets an investor avoid 13D reporting also lets it avoid Section 16 disclosure.

For covered persons, the required disclosure is reasonably extensive. Most economic interests, regardless of their form, most be disclosed, including both exchange-traded and OTC

equity derivatives. Share lending and borrowing are likely not disclosable because they do not affect economic ownership.

For hidden ownership, then, 16(b) disclosure does a good job. For empty voting, disclosure will vary. 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 their portfolio holdings quarterly. Disclosure focuses on economic ownership and covers both long and short positions, and both exchange-traded and OTC derivatives. Apart from the impact of rules relating to disclosure of how the fund voted, there is no requirement to disclose stock lending or borrowing which affects only voting rights, not economic ownership. Thus, mutual fund reporting is similar to Section 16(b) reporting. It captures hidden (morphable) ownership reasonably well, but will miss some empty voting. However, mutual fund disclosure captures only quarter-end positions.

4.2. A Proposal for Integrated Ownership Disclosure

The current disclosure rules are complex, treat substantively identical positions inconsistently, 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 rules effectively addresses share borrowing and lending. Only 13D and 16(b) disclosure is "real time"; other filers can avoid disclosure by not holding a disclosable position at year- or quarter-end.

If disclosure of new vote buying is desirable on balance, the current rules fall well short. We propose, in our companion law articles, "integrated ownership disclosure" rules, which would largely replace these five sets of rules with one consistent set, while providing better disclosure of empty voting and hidden (morphable) ownership. For the most part, we would extend existing 16(b) and mutual fund disclosures to cover current 13D, 13F, and 13G filers, cover both economic and voting ownership, require symmetric disclosure of long and short positions, and add reporting of share lending and borrowing positions. The required information should be readily accessible to filers, so compliance costs should be limited, and will be offset for many filers by adopting a single set of rules for what must be reported. We expect, but cannot prove, that overall disclosure costs would decline.

Our proposal would capture most empty voting by 13D and 16(b) filers, who must report ownership changes promptly. We would require delayed filers to 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. All filings would be public, as they are at present.

These proposals are consistent with recent regulatory changes made in the U.K. in 2005 (in the takeover context) and in Hong Kong in 2003 in response to aspects of new vote buying. Hong Kong requires disclosure of a pure *short* economic position (as we would), while the U.K. does not.

5. Conclusion and Policy Implications

Voting rights, coupled to economic ownership, have long been a central way in which corporate governance systems constrain managers' discretion. Yet innovation in equity derivatives and the growth of the share lending market now allow both insiders and outside investors to engage in large scale, low-cost decoupling of voting rights from economic ownership, often without public disclosure. Equity swaps, options, and other derivatives, heretofore largely risk management tools, can be used to hedge economic risk while retaining votes. They can also be used to hold both economic ownership and de facto voting ownership while avoiding the disclosure rules that address direct positions in shares. Share borrowing, which has been largely a means for selling shares short, also offers a means to acquire "naked" voting rights.

The corporate governance implications of the new ease of decoupling remain unclear, but are potentially large. On the positive side, decoupling can strengthen shareholder oversight or, under some circumstances, foster efficient investment decisions. On the other hand, the new forms of decoupling can also facilitate insider entrenchment, destabilize dispersed ownership, and, in the case of voteholders with a negative economic interest, sever the usual assumption that shareholders have a common interest in increasing firm value. Hidden (morphable) ownership offers an end run around our large shareholder ownership disclosure system.

The right regulatory response is not obvious. We believe that a sensible first step is to better understand the new vote buying, through enhanced disclosure. We therefore propose simplified, "integrated" disclosure requirements for both institutions and insiders, to replace the current, complex, inconsistent patchwork quilt created by five separate sets of ownership disclosure rules.

As a response to hidden (morphable) ownership, disclosure may well be sufficient. For empty voting, some additional regulation may eventually be needed. An analogy can illustrate. For takeover bids, an unregulated market for shares has well-known problems, driven by the high value of the marginal shares that just convey control, and the lower value of remaining shares. This has led to regulation of takeover bids, including a requirement that offers be made to all shareholders on equal terms, a minimum offer period, and a de facto ban on two-tier offers. Similar problems would afflict bids for votes, or a proxy fight waged by buying votes decoupled from shares. Our companion legal articles accordingly set forth three possible sets of strategies that go beyond disclosure: strategies focused on voting rights, voting architecture, and the supply and demand forces in the share lending and other markets on which the new vote buying relies.

Which further steps should be taken will depend on information as yet unknown, which better disclosure might help us collect. We do know that the existing corporate governance paradigm assumes a link between voting rights and economic ownership that can no longer be relied on.

Glossary of Selected Terms

Trading jargon surrounds many new vote buying transactions, as well as various disclosure rules. This appendix offers informal definitions of 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 (investors whose actions might affect control.
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), requiring reporting of beneficial ownership (16(b) sense) by directors, officers, and persons with beneficial ownership (in the 13D sense) of 10% of a company's shares.
Forms N-1A, N-CSR, And N-Q	The basic SEC forms for 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)	UK equity 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, often 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.
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, often cash-settled.
Over-The-Counter (OTC) Derivatives	Derivative securities, including equity swaps, that are not traded on a public options or futures exchange.
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, apart from any dividends on the 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 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 pays to the lender the economic return on the shares for the period of the loan (from dividends and other distributions), and returns the shares at the end of the loan period. Thus, the borrower has voting rights but no economic rights. 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	See *Share Borrowing.*
Short Sales	Sale of shares which the seller does not own. The short seller must deliver shares to an anonymous buyer. To do so, he borrows shares from a share lender. 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. Dividends aside, the short seller profits from a drop in the share price between the time he sells the shares short 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, and 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). The call and the put have equal prices, so the position involves zero net cost to the shareholder.

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