

# News flash

## Shareholder Emancipation – The Right to Vote

**A**ctivist shareholders in the United States have been intensely lobbying the Securities Exchange Commission (SEC) about the lack of investor rights in the US, when compared to the rights of European shareholders. The ‘European’ right to vote enables shareholders to influence change and take an active role in key decisions. Traditionally, the easiest way for US shareholders to make their voices heard has been via litigation and this US litigation culture together with the lesser shareholder rights, is what has contributed to the growing attractiveness of non-US markets for international capital<sup>1</sup>.

To reverse the trend - can the US learn from Europe? The SEC is looking to impose higher standards of proof in fraud cases, which it hopes will reduce US litigation culture, and import a more European-style system that allows for greater shareholder rights and democracy. In addressing the latter, the SEC has been alerted to ‘empty voting’ practices which can be manipulated by sophisticated investors to deprive shareholders of their basic right to vote. **Misha Nateghi** and **Kirsten Addison-Smith** report on ‘empty voting’, and how it threatens shareholder rights and undermines transparency and disclosure requirements.

### What is it?

**‘Empty voting’ is the practice of borrowing company shares to influence the outcome of company votes.** The practice has been on the European agenda for some time, but is growing in influence following research by University of Texas Professors Henry T. C. Hu and Bernard Black<sup>2</sup>, which appears to have uncovered over 20 instances in the last 3 years where alleged “empty voting” has impacted shareholder votes. **The opportunity for ‘empty voting’ arises when brokerage firms or fund managers lend the shares they manage for a fee. When it is time for a shareholder vote, the borrowers, rather than the owners, hold the voting rights.** Individual shareholders are usually unaware that brokers can make money by lending their shares, similar to how banks profit from lending cash held on deposit. It also makes it unlikely the shareholder will know about impending

company votes, because the borrower, not the owner, receives the invitation to vote. Even if the shareholder knows of the vote, the shares must be recalled to use the voting rights. Hedge funds, and other savvy investors, have developed strategies to take advantage of borrowed voting rights. Investors can borrow shares, in the expectation the share price will fall and they can buy back the shares at a lower price. In some cases, investors have gambled that a company’s share price will drop, and then voted for decisions to ensure that it does. **Investors are increasingly able to build up large voting positions while having little economic interest in a company. This practice undermines a fundamental assumption in corporate governance: share ownership, economic interest and voting rights all go together.**

The practice has also caused ‘over-voting’ where records have not been kept up to date, with regard to the shares that have been lent. This may result in both the shareholder and borrower being invited to vote. In a sample of 27 shareholder votes, the New York Stock Exchange found over-voting in 23 instances.<sup>3</sup>

The International Securities Lending Association has responded to the above criticisms in terms that, *“Securities are infrequently borrowed for the purpose of influencing shareholder votes and the cases in which borrowed shares... have influenced a shareholder vote are rarer still.”*<sup>4</sup>

<sup>1</sup> “Whatever next: the US eyes up European models”, The Financial Times, 26 February 2007.

<sup>2</sup> Hu, Henry T.C. and Black, Bernard S., “The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership”. Southern California Law Review, Vol. 79, pp. 811-908, 2006.

<sup>3</sup> “How Borrowed Shares Swing Company Votes”, The Wall Street Journal, 26 January 2007.

<sup>4</sup> “Spectre of empty voting is ‘far from reality’”, The Financial Times, 2 April 2007.

► **Regulatory response – US**

US regulators fear ‘empty voting’ is escalating just as shareholder rights are gaining momentum to improve corporate governance. In response, the SEC is “examining whether rules need to be changed” in order to ease the erosion of good corporate governance.<sup>5</sup>

So what is the best way forward? If the US follows a European model, it must consider increasing transparency of share lending practices, which will make it easier to see where the demand for borrowed shares is coming from. Presently ‘empty voting’ does not trigger disclosure because the rules do not cover borrowed shares unless an investor owns more than 5%.<sup>6</sup> Further research by Professors Hu and Black suggests that many hedge funds own just shy of that 5%, and then use empty-voting strategies to enlarge or hide their stake.<sup>7</sup>

To improve transparency, the SEC may also consider provisions that will give advance notice to investors of company votes, to allow an opportunity to recall the shares and the attached voting rights that have been borrowed.

**The European Example**

This has been an issue in Europe for some time, where holders of long positions in derivatives and other sophisticated options have used voting rights to influence the outcome of a number of high-profile takeovers, despite not having a large economic interest in the company.<sup>8</sup> On 7 November 2005, the UK Takeovers Panel introduced requirements for the disclosure of dealings in derivatives and options during offer periods, so that voting rights are transparent to the market. By making these disclosures mandatory, businesses can see who is seeking to control the outcome of important corporate decisions.

The Financial Services Authority (‘FSA’) is actively monitoring the progress of the Takeover Panel’s new rules to decide if greater disclosure of large investors’ stakes in companies is required, whether or not they own shares, or are just borrowing them. A committee made up of the FSA, the Bank of England and other UK market participants, have issued the ‘Securities Lending Code of Guidance’ to establish internal controls to prevent lenders from knowingly lending to clients who intend to use the voting rights to influence contentious corporate decisions.<sup>9</sup>

**The Transparency Directive**

The Transparency Directive (‘the Directive’) introduced in 2004 was intended to enhance transparency in EU member states, to protect investors and to promote

market efficiency, by establishing disclosure of major shareholdings and requiring a significant change in the way notifiable interests are identified. The Directive extends earlier notification requirements, so that a holder of more than 5% of shares in a company, including borrowed shares, must make a disclosure. Although these notification requirements were already in place in some member states (the UK’s Disclosure Rules), the Directive now establishes a benchmark for transparency across all member states. In an extreme example, Dutch authorities are currently considering lowering the disclosure threshold to 1%, the lowest level anywhere.<sup>10</sup>

**Conclusions**

It is interesting that the US is looking to Europe for guidance on improving shareholder rights, and how to tackle ‘empty voting’, which has already featured on the regulatory radar this side of the pond. What this emphasises is that corporate governance is not an isolated national issue. Regulators, Governments, businesses and industry leaders across the globe are collaborating and learning from each other – mutual recognition is increasing.

Corporate governance also continues to feature high on the agenda, even when claims activity is low and filed securities suits are down. It seems all too common that where companies are getting rid of the skeletons in the cupboard, some new practice is uncovered to renew the challenges to D&O Insurers, Brokers and Insureds – laddering, spinning, bundling, short selling, back dating, spring loading and, now, empty voting – is there no light at the end of the scandal tunnel...?

5. SEC Chairman, Christopher Cox, quoted in WSJ article above.  
6. Section 13 Securities Exchange Act 1934.  
7. Hu, Henry T.C. and Black, Bernard S., ‘Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership’. European Corporate Governance Institute Finance Working Paper No. 56/2006.  
8. FSA, Consultation Paper, Implementation of the Transparency Directive, March 2006.  
9. ‘Spectre of empty voting is far from reality’, The Financial Times, 2 April 2007  
10. ‘Dutch consider disclosure change’, The Financial Times, 12 April 2007

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