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One Share, One Vote? Not Necessarily

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One common assumption behind owning stock in a corporation is the concept of “one share, one vote.” Much like citizenship operates to confer the right to vote in the political world, it is assumed you must have “citizenship” in a corporation, by virtue of stock ownership, to vote in corporate elections. The reasoning behind this foundation is simple: If you own stock in a corporation, it is assumed that you have an interest in doing what is best for that company and thereby maximizing the value of your shares.

Unfortunately, innovations in the financial markets over the last 30 years have created the possibility, and, in fact, the reality, that the link can be severed between share ownership and one's economic interest, which leads to an incentive to maximize the value of a corporation and its shares. Indeed, capital markets today make it easy to divorce share ownership, and the associated voting rights, from any proportionate economic interest in the value of the corporation's shares. This separation can be caused by a multitude of transactions, in the form of equity swaps, forwards, futures, puts or calls, all of which call into question the fundamental assumption of “one share, one vote.”

When share ownership and the attendant rights to such ownership are separated from a proportional economic interest in the value of the corporation's shares, the possibility of “empty voting” arises. With that possibility comes the danger that those with objectives utterly opposed to maximizing the value of the corporation and its shares will enjoy the same voting rights and voting power as those of traditional shareholders. This article aims to explain the phenomenon of empty voting and its potential dangers and possible benefit, and considers the Securities and Exchange Commission's current investigation into the proxy process, including empty voting, and the proposals submitted to solve or at least reduce the problem.

What is empty voting and how does it occur?

Empty voting occurs when a shareholder's power to vote substantially exceeds such shareholder's economic interest in the corporation. This may occur in several factual situations.

First, where a shareholder sells its stake on or after the record date of a shareholder meeting but before the actual meeting date, the shareholder will be able to vote its shares even though it no longer owns them. Currently, there is no legal requirement that a record holder continue to hold its position after the record date through the date of the shareholder meeting. Thus, the shareholder can effectively maintain its right to vote, while removing any economic interest or threat of economic loss. For example, a shareholder with 2 percent of the corporation's voting power may sell its shares after the record date, establish a short position, and by the date of the shareholder vote it could promote its economic interests by favoring a position that could decrease the value of the corporation's shares.

Second, where a hedge fund uses a share lending arrangement (borrowing shares of stock on the record date), or an individual hedges economic exposure through the use of a derivative strategy, or engages in short-term trading, the result is a decoupling of voting rights from the economic ownership of shares — that is the classic description of empty voting. Today, investors, using very basic derivative contracts, can create portfolios that increase in value as a corporation's stock price declines, while maintaining the right to vote in shareholder elections. This opens the door to "empty voting." In addition, where a hedge fund borrows large numbers of shares to vote against the best interests of the corporation, and then profits from the ensuing drop in share prices by shorting the stock, the voting rights and economic rights of that shareholder are obviously dissociated.

These avenues to empty voting present significant challenges to existing shareholder and governance practices. The issue of empty voting raises several important questions, including: Should record shareholders be required to hold their shares to the election date? Should voting rights be granted to people who have acquired an economic interest in a company, through a derivative, without actually acquiring shares?

Potential dangers, possible benefit of empty voting

The potential dangers of empty voting may seem obvious; however, some commentators on the issue have suggested a potential upside to empty voting.

The hazards inherent in empty voting are based on opposing voting incentives for those without an economic interest in the corporation or with an economic interest that will benefit from the corporation's decline in value. This phenomenon may increase the risk of investors "gaming" the system, by voting contrary to traditional shareholder desires. In fact, hedge funds, proxy advisory firms and others have the opportunity to use empty voting to manipulate shareholder vote results and generate gains.

A related danger is that traditional shareholders may be deterred from exercising their voting rights based on the belief that these hedge funds and others control the vote. In short, empty voting gives those who have no "skin in the game" power to affect the corporation, its governance, and perhaps most importantly, the value of its stock.

However, some have observed that strategic traders and those savvy to the financial markets have access to unique information regarding a corporate decision or the impact of a decision on the corporation's value, and can more quickly and efficiently gather such information. Thus, some argue that allowing these well-informed traders and investors access to a corporation's vote, whether they have an economic interest or not, increases

efficiency and that these investors will make the “right” decision, positively influencing the corporation. In other words, informed shareholders should be permitted to acquire a large voting position from less informed shareholders, to improve efficiency in the voting process, increase accuracy in electoral outcomes and enhance shareholder value.

Despite this possible benefit, and what some argue may lead to an overall increase in the efficiency of the corporate voting process, most commentators believe there should be an alignment between the voter’s power to vote and such voter’s economic interest in the outcome.

The SEC and empty voting

The issue of empty voting has recently surfaced as a result of a concept release issued by the SEC last year seeking public comments on the current proxy system used in the United States. The concept release specifically sought public comments as to whether the proxy rules needed revisions to promote efficiency and transparency. Of particular concern is the fact that the SEC’s proxy rules have not been revamped in more than 30 years, yet there have been substantial and important innovations in the financial markets.

The SEC’s concept release appears to acknowledge that its laws have not kept pace with these financial innovations. The issues raised in the concept release related to the proxy system included the role of proxy advisory firms, the beneficial ownership system, proxy distribution fees, proxy voting totals, as well as the problem of empty voting and related decoupling issues.

Responses to the issue of empty voting were varied, some raising the alarm and arguing that empty voting must be eradicated, and others promoting the possible benefit discussed above. The suggestions received for addressing empty voting included increased transparency as to the existence and extent of hedging and derivative transactions that can affect the economic rights and voting motivation of shareholders. To this end, some commentators suggested increased disclosure by hedge funds, as well as the registration of and increased disclosure from proxy advisory firms, to bring all within the reach of the federal proxy rules.

Other suggestions included increased communications between boards and shareholders, through the use of technological improvements, to improve the methods by which boards gather information and gauge shareholder outlook. More extreme suggestions included substantive measures to address the rights of shareholders, including a requirement that the record shareholder continue to hold its position through the shareholder meeting, allowing corporations to amend their corporate charter to limit empty voting, or requiring large shareholders to certify prior to a vote that they are not empty voters.

Where do we go from here?

With the public comment period having closed, the SEC is now left to ponder these suggestions and the benefits and pitfalls of increased regulation to control or even eliminate empty voting. As the SEC has acknowledged, the current rules do not address innovations in the reality of the financial markets, and thus, those rules are often manipulated. Whether the SEC will completely overhaul the proxy system or simply modify the current rules is unknown; however, changes should be expected in the world of voting by shareholders in the future.