

Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union

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I. INTRODUCTION

The law responds to incidents of actual importance and attempts to solve real life problems. The field of corporate law is no exception. The groundbreaking choices of our modern company law are rooted in the needs of business life. For instance, consider the nineteenth-century ambition of encouraging investment in expensive projects, such as the construction of railways.¹ The decision to grant companies separate legal personalities and to introduce limited liability for their shareholders stems from this ambition. As a consequence of introducing the concepts of legal personality and limited liability, company law attempts to solve many problems, including the conflict between the shareholders and the creditors of a company.²

The law must remain adaptive and responsive to the constantly changing challenges of our society and our business life. One of the most pressing challenges of the past years is the emergence of alternative investment funds, in particular hedge funds, which masterfully exploit the traditional categories of corporate law, financial derivatives, and risk management.³ Traditionally, hedge funds tended to trade predominantly in financial instruments.⁴ This practice has changed in recent years, however. Benefitting from the development of information technology, futures markets, and the derivatives industry, some hedge funds discovered the potentials of equity markets. The ability to actively influence the strategy of target companies became an attractive business model for them.⁵ These hedge funds have chosen activism as part of their investment strategy: they invest in order to be active, and not the reverse. The traditional literature characterizes this new strategy as “offensive” activ-

1. On separate legal personality, see Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000). On limited liability, see Frank Easterbrook & Daniel Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976); see also Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

2. REINIER KRAAKMAN, JOHN ARMOUR, PAUL DAVIES, LUCA ENRIQUES, HENRY HANSMANN, GÉRARD HERTIG, KLAUS HOPT, HIDEKI KANDA & EDWARD ROCK, *THE ANATOMY OF CORPORATE LAW* 35–37 (2d ed. 2009).

3. On hedge funds generally, see DAVID STOWELL, *AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY: THE NEW PARADIGM* (2010); PETER ASTLEFORD & DICK FRASE, *HEDGE FUNDS AND THE LAW* (2010).

4. William Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1378 (2007); Financial Services Authority (FSA), *Private Equity: A Discussion of Risk and Regulatory Engagement* 26, 30 (FSA Discussion Paper 06/6, 2006).

5. See Brian Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51 (2011).

ism, where activism is part of the investment plan, as opposed to “defensive” activism, where shareholders with a preexisting stake in a company are dissatisfied with management and hence are lobbying for change.⁶

Internationally, lawmakers and regulators are looking for ways to respond to the new, unusual players in the corporate landscape, who have emerged by questioning some of the cornerstones of our corporate law. One of the strategies of hedge funds, which have become the focus of regulators in recent times, is their intentional exploitation of loopholes in the legal system to *break up the connection between risk and influence in shares of their portfolio companies*. That is, while a normal shareholder would always bear a certain economic risk that corresponds to the size of their stake in the company, hedge funds, by contrast, try to disconnect the relationship between equity and risk.

This intentional deconstruction of equity investment can take two forms. First, the hedge fund may want to reduce the risk that is usually associated with an equity investment. They do this for obvious reasons: a shareholder with reduced risk exposure retains its voting power and its influence in the company, but it does not bear the risk of negative returns. This strategy is what we may call “negative decoupling.” Second, activist investors can attempt to produce the opposite effect: they acquire an economic stake in a company without gaining voting power. This may be particularly interesting during takeover situations because, under the circumstances, current laws only require the disclosure of voting positions (but not economic exposure).⁷ Here the economic risk is higher than the voting power; we may term this “positive decoupling.”⁸

This Article is only concerned with the first of these two forms—negative decoupling.⁹ It looks at the various forms of negative risk-decoupling strategies and tries to shed light on their overall desirability. The main approach is functional-comparative in nature, focusing on law and economics as well as traditional corporate and financial law scholarship. The jurisdictional focus will be on U.K. and U.S. law, albeit with frequent discussions of various continental European jurisdictions. Particular emphasis will be placed on developing a legislative solution for

6. See IRIS CHIU, *THE FOUNDATIONS AND ANATOMY OF SHAREHOLDER ACTIVISM* (2010).

7. See 2004 O.J. (L 390/38).

8. The American scholars Henry Hu and Bernard Black have coined the notions of “empty voting” and “hidden ownership” for these two situations. These terms are highly illustrative but can be a little misleading and imprecise. See Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership* 79 S. CAL. L. REV. 811 (2006).

9. On the positive decoupling problem, see Maiju Kettunen & Wolf-Georg Ringe, *Disclosure Regulation of Cash-Settled Equity Derivatives – An Intentions-Based Approach*, LLOYD’S MAR. & COM. L. Q., 2012, at 227.

the EU context because the European institutions are currently proposing to adopt regulation at the EU level in response to the risk-decoupling phenomenon.¹⁰

Three distinct theoretical perspectives are used as an analytical framework to examine the vast challenges of risk-decoupling: (1) a classical agency costs approach; (2) an information costs perspective; and (3) a view from corporate finance. This Article argues that shareholders with hedged risk exposure do not correspond to the traditional market expectations of shareholders. Corporate law is still widely based on the nineteenth-century assumptions of optimal risk alignment and has not followed the pace of modern financial engineering opportunities. Risk-decoupling strategies create both agency and information costs for investors. Furthermore, they generate challenges for traditional categories of corporate finance, aiming to extract the “best of both worlds”—debt and equity.

Based on the insights developed from these policy perspectives, I develop regulatory reform proposals, particularly with regard to the EU context. Designing an adequate disclosure system is the appropriate and most effective remedy for the problems previously identified. Exceptionally, however, the regulator should be empowered to disenfranchise shareholders by imposing voting restrictions.

II. HEDGE FUND REGULATION AND RISK-DECOUPLING

The European Union first regulated Hedge Funds extensively with the Alternative Investment Funds Managers Directive (AIFM Directive), which was adopted in 2011.¹¹ This directive has harmonized the supervisory approach with hedge fund regulation across the EU member states. It introduces a comprehensive transparency and admission regime, detailing, *inter alia*, capital requirements, a maximum of leverage, and an independent asset valuation.¹²

10. *Commission Proposal for a Directive of the European Parliament and of the Council Amending Directive 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Commission Directive 2007/14/EC*, COM (2011) 683 final (Oct. 25, 2011), available at http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf.

11. See Council Directive 2011/61 of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No. 1095/2010, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>.

12. Eilis Ferran, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU*, 12 EUR. BUS. ORG. L. REV. 379, 399 (2011); Dan Awrey, *The Limits of EU Hedge Fund Regulation*, L. & FIN. MARKETS REV. 119 (2011).

Traditionally, hedge funds appeared as dealers only in financial instruments.¹³ However, this changed with the advent of computer technology, derivatives exchanges, and financial engineering. A growing number of hedge funds discovered the possibility of actively influencing the management of companies as a business endeavor.¹⁴ This is the activity that is largely known today as “shareholder activism.”¹⁵

One strategy has recently become the target of regulators and lawmakers worldwide—the artificial decoupling of risk and influence in shares of portfolio companies. Using a number of different techniques, hedge funds attempt to eliminate or to reduce the economic risk that is normally inherently attached to the shares that they buy.¹⁶ Some commentators have termed this strategy “empty voting,” referring to a share that is freed from its risk but still retains its regular voting entitlement.¹⁷ Hedge funds principally use financial derivatives or share lending strategies to effectuate this result. One newspaper article describes the phenomenon as follows:

[I]nnovations 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.’¹⁸

These strategies touch the core of corporate governance and the traditional assumptions of share ownership and voting rights. Under the corporate laws of all major jurisdictions, risk and voting rights are necessarily tied together in a bundle of which the share is composed as an invest-

13. Bratton, *supra* note 4, at 1378; FSA, *supra* note 4, at 26, 30.

14. Eveline Hellebuyck, *Activist Hedge Funds and Legal Strategy Devices*, in LEGAL STRATEGIES 277 (Antoine Masson & Mary J. Shariff eds., 2010); S. Geraghty & H. Smith, *Shareholder Activism as a Strategy for Hedge Funds*, in HEDGE FUNDS AND THE LAW ch. 8 (Peter Astleford & Dick Frase eds., 2010).

15. John H. Armour & Brian R. Cheffins, *Origins of “Offensive” Shareholder Activism in the United States*, in ORIGINS OF SHAREHOLDER ADVOCACY 253 (Jonathan GS Koppell ed., 2011).

16. Cf. Katayun I. Jaffari & Whitney W. Deeney, *One Share, One Vote? Not Necessarily: Manipulation of the SEC Proxy System to Effect Empty Voting*, LEGAL INTELLIGENCER, Feb. 25, 2011, at 7.

17. See Hu & Black, *supra* note 8.

18. See Jaffari & Deeney, *supra* note 16.

ment position. This “decomposition” of the legal elements of a share into its parts is accompanied by several resulting economic problems: if it is possible to separate the risk from the share—or put differently, if the share and its voting right remain an empty shell—the hedge fund pursuing such a strategy will no longer exercise the voting right in the way exercised by an optimal shareholder with perfect risk alignment. Quite the contrary, the hedge fund might ultimately be able to pursue goals that are quite opposed or even detrimental to the company’s interests. The hedge fund might misuse its control rights to further its own private benefits to the detriment of shareholders and potential investors.

This scenario exemplifies one of the implications of hedge fund activity for the functioning of traditional corporate governance mechanisms. It is clear that hedge funds’ sophistication in exploiting the traditional categories and tools of corporate governance poses significant challenges for regulators and lawmakers.

Indeed, this is a shortcoming of the AIFM Directive, as it is completely silent on this aspect of hedge fund activity. The AIFM Directive limits itself to rules on the supervision of hedge fund managers; it does not pursue an activities-based approach.¹⁹ In a similar context, the Treasury Committee of the British House of Commons came to the following conclusion: “A fundamental problem with the [AIFM Directive] is that it focuses on issues relating to macro-prudential risk, but does not address the risks to the real economy caused by the operation of private equity and hedge funds.”²⁰ The limitation is surprising for two reasons. First, it has traditionally been difficult to find a convincing definition of a “hedge fund,” such that every legal rule applicable to a hedge fund raises questions of legal scope and raises arbitrage opportunities.²¹

Second, and more importantly, in numerous situations regulatory intervention is not made pursuant to the existence of a given hedge fund but rather the concrete market or investment strategy it pursues. Like empty voting, any sophisticated market actor may pursue risk decoupling strategies, not only a hedge fund. One example concerns the conflict between carmakers Porsche and Volkswagen in 2008, where Porsche attempted to take over Volkswagen with an opaque strategy using deriva-

19. There are just a few such abstract provisions, in particular, on risk and liquidity management. See Alternative Investment Fund Managers (AIFM) Directive, *supra* note 11, art. 12.

20. HOUSE OF COMMONS TREASURY COMMITTEE, BANKING CRISIS: INTERNATIONAL DIMENSIONS, 2008-9, H.C. 615, at Ev 90, available at <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/615/615.pdf>.

21. See for instance the definition for an “alternative investment fund” in *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*, at 22, COM (2009) 207 final (Apr. 4, 2009).

tives and options. According to the press, Porsche acted “very much like a hedge fund.”²²

This Article adopts an approach that is distinguishable from the AIFM Directive. For the reasons described, it takes an activity-based perspective and analyzes the implications of risk decoupling on corporate governance. It proposes a regulatory approach that is not limited to hedge funds but rather generalizes all market-actors who engage in this strategy. It should be noted that risk-decoupling is only one of many different legal strategies that hedge funds pursue, which might warrant further study.²³ It nevertheless merits a detailed discussion because of its salient features and the particular challenges it poses to corporate scholarship.

The issue of risk decoupling and empty voting has already gained much attention by scholars in the United States.²⁴ This Article, however, attempts to analyze the problem in the particular governance context of the European Union. The objective is to develop concrete regulatory responses in an effort for a solution in the EU context.

III. RISK DECOUPLING: EXAMPLES AND PROBLEM ANALYSIS

Risk decoupling can be instrumentalized in many ways. Three main examples include the use of financial derivatives, share lending, and record date capture. These activities can all be used either to reduce or to eliminate the inherent shareholder risk. Each strategy will be considered in turn.

A. Financial Derivatives

The first example of a risk-decoupling strategy is the use of financial derivatives to reduce share risk.²⁵ The financial industry has developed a number of instruments that hedge shareholder exposure and shift the risk to another market participant. To illustrate, we may consider the

22. See Richard Chang, *Porsche: A 'Hedge Fund With a Carmaker Attached'*, N.Y. TIMES (Jan. 23, 2009), <http://wheels.blogs.nytimes.com/2009/01/23/porsche-a-hedge-fund-with-a-carmaker-attached>; Susanne Preuss, *Ein Hedge-Fonds namens Porsche*, FRANKFURTER ALLGEMEINE ZEITUNG (Oct. 29, 2008), <http://www.faz.net/aktuell/wirtschaft/unternehmen/vw-aktien-ein-hedge-fonds-namens-porsche-1711580.html>; Dietmar Von Hawranek, *Kafka und die Cash-Optionen*, DER SPIEGEL, Nov. 3, 2008, at 83, available at <http://www.spiegel.de/spiegel/print/d-61822082.html>.

23. See, e.g., Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

24. E.g., Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775 (2005); Hu & Black, *supra* note 8; Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008).

25. See Avner Kalay & Shagun Pant, *Time Varying Voting Rights and the Private Benefits of Control 2*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1556688.

example of a simple trader who holds 100 shares of company X plc, trading at £50 per share. The simplest way to transfer the risk of this long position to another market participant would be for the trader to sell the shares, using a “future” derivative. These instruments are standardized contracts between two parties to exchange a specified number of shares for a price agreed today to be delivered at a specified future date. This contract would free the trader from the risk in price drop of X plc shares since he has already sold them. Nevertheless, he remains shareholder, the “owner” of the shares, until he has delivered them to the purchaser.

On a more sophisticated level, equity swap derivatives can transfer the entire risk of share price movements to a transaction counterparty.²⁶ Imagine two parties to a transaction, A and B, who agree to distribute the risk of the share price of X plc as follows. A has to reimburse B for any losses that the share price of X incurs over an agreed time period; conversely, B has to pay A the equivalent of any gains the X shares make during the same time. Under this type of equity swap contract, A is called the “long side,” while B is called the “short side”; A bears the same risk as if he held the agreed number of X shares, while B’s interest is exactly opposite. For our purpose, the most interesting consequences emanate where B (the short side) is simultaneously a regular shareowner in X with the same amount of shares that are referenced under the swap agreement. If this is the case, B will be equally short as long; B’s risk in the shares will be entirely eliminated. If the shares increase in value, B will have to reimburse the gains to A under the swap agreement, and if their value drops, B will be compensated by A for any losses. In other words, where a shareholder holds a corresponding short position pursuant to a derivative agreement, he may entirely lose his economic exposure to the shares and become indifferent as to the share price.²⁷

Theoretically, most derivatives that shift risk onto another party can achieve a similar result. For instance, a shareholder may use a short call—the sale of a right to purchase—or a long put—the purchase of right to sell—to effectuate a similar result. Also, the shareholder could simply sell short an amount of shares corresponding to the long side in shares they hold. Short selling also creates a short position in shares.²⁸

26. Hu & Black, *supra* note 24, at 640.

27. It should be noted that the long side of the swap agreement will usually also be interested in hedging its position. It can, for instance, short sell a corresponding share position to eliminate its risk from the derivative. *Id.* at 642.

28. Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 348 (2007); Roberta Karmel, *Voting Power Without Responsibility or Risk: How Should Proxy Reform Address the Decoupling of Economic and Voting Rights?*, 55 VILL. L. REV. 93, 103 (2010).

Finally, it must be noted that the ratio between long and short position can even be negative; namely, the holder of a block of shares holds derivatives conferring a negative interest that exceeds the positive exposure.

Table 1: Overview of Derivatives and Their Use for Risk Decoupling

Derivative	Short Description	A	B
Forward, Future	Sale with performance in the future	Single Stock Future	
Call	Right to purchase	Short call (Sale of a right to purchase)	Long Call (Purchase of a right to purchase)
Put	Right to sell	Long put (Purchase of a right to sell)	Short put (Sale of a right to sell)
Swap	Exchange of cash flows	Writer (short side)	Equity (long side)

(A = shareholder, B = bank)

The famous *Mylan-Perry* case illustrates this concept.²⁹ The case relates to an American takeover battle in 2004, in which Mylan Laboratories, Inc. sought to acquire King Pharmaceuticals, Inc. An American hedge fund, Perry Corp., had a significant ownership stake in King (the target) and stood to benefit from the takeover, which offered King shareholders a 61% premium.³⁰ However, it was unclear whether the takeover would benefit Mylan shareholders; in fact, some of the shareholders, in-

This situation became relevant in *Deephaven Risk Arb. Trading Ltd. v. UnitedGlobalCom, Inc.*, No. Civ.A. 379-N, 2005 WL 1713067 (Del. Ch. July 13, 2005). Regarding this case, see Michael Lee, *Empty Voting: Private Solutions to a Private Problem*, 2007 COLUM. BUS. L. REV. 883, 886 (2007).

29. JUAN RAMIREZ, HANDBOOK OF CORPORATE EQUITY DERIVATIVES AND EQUITY CAPITAL MARKETS 242 (2011); see also Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, 1024 (2006); Hu & Black, *supra* note 8, at 816.

30. Hu & Black, *supra* note 8, at 828.

cluding iconic hedge fund manager Carl Icahn, voiced strong concerns.³¹ Since the takeover depended on an approving vote by the Mylan shareholders, Perry began its unusual strategy. It bought 10% of Mylan's outstanding shares while intending to vote them in favor of the transaction. Perry proceeded to enter swap transactions that hedged risk from any potential drop in Mylan's share price. Technically speaking, Perry took the short side of a total return equity swap with third parties, essentially banks. These have been described above.³² As Perry referenced as many Mylan shares as it had previously bought on the stock market, it was indifferent as to the development of the share price. As a result, Perry could vote the Mylan shares in favor of the takeover, without fearing any potential economic downside (as other Mylan shareholders) in order to realize the value from the takeover as a King shareholder.³³

The transaction was never consummated for unrelated reasons.³⁴ In 2009, the Securities and Exchange Commission announced a settlement agreement with Perry over the question of whether the hedge fund correctly disclosed its accumulation of nearly 10% in Mylan shares.³⁵ This settlement, however, only concerned the question of disclosure of the long position, and it did not address the wider question of risk decoupling. Pursuant to the settlement, Perry paid a \$150,000 fine without admitting any wrongdoing.³⁶ Another well-known case is the transaction between Stark and M-Flex, which will, however, not be reiterated here.³⁷

Furthermore, it should be noted that a total elimination of the risk, as in the *Mylan-Perry* case, is certainly an exceptional situation. But it does not seem implausible that derivatives are more often used by hedge funds to produce, at the very least, a *partial* reduction of the risk. The SEC's investigation into the *Mylan-Perry* case discussed "merger arbitrage," a common behavior of hedge funds during the advancement of corporate takeovers.³⁸ It should be noted that the decoupling effect of

31. *Id.*

32. *See supra* text accompanying note 26.

33. Hu & Black, *supra* note 8, at 828.

34. *Id.* at 829.

35. *See* In the Matter of Perry Corp. Respondent, Exchange Act Release Nos. 2907 & 60351, 2009 WL 2163550 (July 21, 2009).

36. Press Release, Sec. & Exch. Comm'n, SEC Charges Perry Corp. with Disclosure Violations in Vote Buying Scheme (July 21, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-165.htm>.

37. Hu & Black, *supra* note 28 at 349; Hu & Black, *supra* note 24, at 634.

38. In the Matter of Perry Corp. Respondent, Exchange Act Release Nos. 2907 & 60351, 2009 WL 2163550, at *3 (July 21, 2009).

derivatives may also be purely temporary in character.³⁹ Unlike traditional deviations from the “one share one vote” standard, such as multiple voting shares, derivative contracts allow hedge funds to construct economically similar results selectively in certain well-timed situations.⁴⁰

A more typical activity for risk-eliminating or risk-reducing transactions is hedging transactions of management or other senior employees of the company. Using so-called “collar transactions” or “executive equity swaps,” an investor can, for example, sell a call option at a certain strike price and purchase a put option at a lower exercise price.⁴¹ For a relatively low price, an investor can in this way limit the potential appreciation or depreciation of their long shares, within a range (of a *collar*) between the two prices. Empirical studies have shown that management and senior personnel use these structures often to avoid or to reduce the risk exposure of an equity stake they hold.⁴² Thus, economically speaking, it amounts to a countermeasure against the efforts in recent years to introduce variable components into executive remuneration: stock option plans, employee share-based programs, and other schemes have become popular to better align the interests of management and shareholders and to incentivize management to take on more risk.⁴³ This type of hedging transaction is particularly problematic when managers engage in the practice because the managers may possess insider information. They can use the transaction, in addition to a hedge in their equity stake, to the detriment of shareholders.

B. Share Lending

Share lending can be used to create risk-decoupled long positions. The notion of “share lending” is slightly misleading, however, because it describes a transaction where securities are not simply “lent” and then retransferred. Rather, one party transfers the ownership of numerous securities to another and, at a later time, receives a corresponding number

39. This is emphasized by Avner Kalay and Shagun Pant, *Time varying voting rights and the private benefits of control* (Working Paper, November 2009).

40. *See id.*

41. *See* Paul Bolster, Don Chance & Don Rich, *Executive Equity Swaps and Corporate Insider Holdings*, 25 FIN. MGMT., No. 2, 1996, at 14.

42. *See* J. Carr Bettis et al., *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders*, 36 J.L. FIN. & QUANTITATIVE ANALYSIS 345 (2001); Lucian Bebchuk & Jesse Fried, *Executive Compensation as an Agency*, 17 J. ECON. PERSP. 71 (2003); *see also* Concept Release on the U.S. Proxy System, Securities Act Release No. 3052, 2010 WL 2779423 (July 14, 2010).

43. *See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).

of shares in return (though not necessarily the identical shares).⁴⁴ The transaction can also be structured as a “repurchase agreement,” where shares are sold and later repurchased. Both structures can be used for a variety of purposes, including hedging and speculation. Most commonly, borrowers use them for short selling: borrowers are betting on falling share prices and sell shares that they do not own, hoping to obtain them later at a cheaper price. The International Corporate Governance Network (ICGN) emphasizes the beneficial role of share lending in its Code of Best Practice.⁴⁵ According to the guidelines, securities lending increases market liquidity, reduces the risk of failed transactions, and significantly increases the returns of investors.⁴⁶

Securities lending can, however, also be used to effectuate risk-decoupling strategies. It is crucial to understand that the legal structure necessarily implies a *transfer of ownership* between the lender and the borrower. This transfer of ownership indeed corresponds to the interests of the parties, as a securities lending transaction is intended to temporarily transfer the securities to the borrower while allowing him to use them commercially. It follows that the borrower also acquires the voting right, which is attached to the share.⁴⁷ This stands in stark contrast to the exposure felt from the consequences of the voting decision, which will affect the lender once the shares have been retransferred to him. The lender remains the “beneficial” owner, that is, the person bearing the consequences of the share price development and the actor economically interested in the share. Thus, the borrower acquires temporary ownership in the shares but does not feel the economic consequences of this ownership. Strategic investors have discovered and exploited this fact in the

44. See INT’L SEC. LENDING ASS’N, GLOBAL MASTER SECURITIES LENDING AGREEMENT ¶ 1.1 (2010).

45. See INT’L CORP. GOVERNANCE NETWORK, SECURITIES LENDING CODE OF BEST PRACTICE (2007), available at https://www.icgn.org/files/icgn_main/pdfs/best_practice/sec_lending/2007_securities_lending_code_of_best_practice.pdf.

46. *Id.* at 3.

47. See Paolo Santella et al., A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in the EU and in the US 27 (2009) (working paper), available at <http://ssrn.com/abstract=1137491>; MAZARS & MARCCUS PARTNERS, TRANSPARENCY DIRECTIVE ASSESSMENT REPORT – PREPARED FOR THE EUROPEAN COMMISSION INTERNAL MARKET AND SERVICES DG, FINAL REPORT 124 (2009), available at http://ec.europa.eu/internal_market/securities/docs/transparency/report-application_en.pdf; MARK C. FAULKNER, SECURITIES LENDING & CORPORATE GOVERNANCE 5 (2005), available at <http://www.bankofengland.co.uk/markets/Documents/gilts/slegjun05.pdf>; EUROPEAN SEC. MKTS. EXPERT GRP. (ESME), FIRST REPORT OF ESME ON THE TRANSPARENCY DIRECTIVE (TD) 6 (2007), available at http://ec.europa.eu/internal_market/securities/docs/esme/05122007_td_report_en.pdf; THOMAS KEISER, FINANCIAL COLLATERAL ARRANGEMENTS: THE EUROPEAN COLLATERAL DIRECTIVE CONSIDERED FROM A PROPERTY AND INSOLVENCY LAW PERSPECTIVE: AN ACADEMIC ESSAY IN LAW 148 (2006).

way some have used share borrowing to acquire temporary voting influence in a company or to temporarily cross a certain share threshold and quota. In particular, there is a danger that a borrower might vote the borrowed shares at a general meeting, where the lender will bear the economic consequences. Consequently, the ICGN Code also mentions the risks attached to a misuse of the voting right by the borrower.⁴⁸ According to the ICGN, this situation can lead to cases of shares being voted by parties who have no equity capital at risk in the issuing company and thus no long-term interest in the company's welfare. ICGN therefore calls for a clear lending policy at institutional investors.⁴⁹

The problem may be illustrated by the following quote:

The insurers' and pension funds' trade bodies have underlined that next month's annual meeting of Mitchells & Butlers will be a cliff-hanger, by urging members to call back lent stock and to refuse to lend it out. They fear borrowers may not vote the shares, or vote them in a way that the shareowners later regret.⁵⁰

In view of the potential abuse or misuse of voting rights following share lending, the ICGN states:

[I]t is bad practice to borrow shares for the purpose of voting. Lenders and their agents, therefore, should make best endeavours to discourage such practice. Borrowers have every right to sell the shares they have acquired. Equally the subsequent purchaser has every right to exercise the vote. However, the exercise of a vote by a borrower who has, by private contract, only a temporary interest in the shares, can distort the result of general meetings, bring the governance process into disrepute and ultimately undermine confidence in the market.⁵¹

In the United Kingdom, the former City Minister Lord Paul Myners pointed out the problem in his various reports of share voting from 2004–2007.⁵² These documents highlight the need to demonstrate to lenders the consequences of share-lending transactions on the voting right. It becomes clear in this appeal that not all lenders are apparently aware of the

48. INT'L CORP. GOVERNANCE NETWORK, *supra* note 45, at 3.

49. *Id.*, at 5.

50. Andrew Hill, *Neither a Borrower . . .*, FIN. TIMES, Dec. 18 2009, at 18.

51. INT'L CORP. GOVERNANCE NETWORK, *supra* note 45, at 3.

52. See PAUL MYNERS, REVIEW OF THE IMPEDIMENTS TO VOTING UK SHARES (2004) [hereinafter MYNERS, REVIEW]; PAUL MYNERS, REVIEW OF THE IMPEDIMENTS TO VOTING UK SHARES: AN UPDATE ON PROGRESS (2005) [hereinafter MYNERS, UPDATE ON PROGRESS]; PAUL MYNERS, REVIEW OF THE IMPEDIMENTS TO VOTING UK SHARES: AN UPDATE ON PROGRESS THREE YEARS ON (2007) [hereinafter MYNERS, UPDATE THREE YEARS ON].

fact that they are not just lending the share but also the voting right. Overall, Lord Myners advocated a necessary balance between the significant position of the voting right and the economically useful exchange of securities via lending transactions.⁵³

In recent years, several strategies in securities lending—for the purpose of risk reduction and managerial influence—have been recognized. To illustrate, a few real world cases will be discussed as follows.

In the *Lindner* case, “borrowed” shares were used for the purpose of a “squeeze-out” in a German partnership. Both the founder and general partner of a limited partnership, along with another shareholder, transferred, by way of a loan, their limited shares totaling 33.5% to a shareholder who already held 62.59% of the limited partnership. The loan agreements provided that an annual fee was to be paid and, during the term of the loan, the equivalent of all dividends would be reimbursed to the lenders. The borrower, whose stake had thus grown to 95%, then demanded the implementation of a squeeze-out procedure in accordance with §§ 327a-327f of the German Aktiengesetz.⁵⁴ Minority shareholders challenged the transaction on legal grounds.⁵⁵ They were ultimately not successful; the German Supreme Court held that the accumulation of a 95% stake as required for the squeeze-out by way of a securities borrowing structure does not amount to an abusive or otherwise illegal procedure.⁵⁶ Therefore, the activity did not trigger legal nullity or voidability of the resolution.⁵⁷ This judgment is based on a formal approach that focuses only on the legal ownership of the principal shareholder of the shares in question (and not deviating shareholder agreements).⁵⁸

Another example can be found in the *British Land* case.⁵⁹ Shortly before a British real estate and investment company held its general meeting, the hedge fund Laxey Partners disclosed that it had more than

53. MYNERS, UPDATE THREE YEARS ON, *supra* note 52, at 9.

54. This requires 95% of the shares.

55. Bundesgerichtshof [BGH] [Federal Court of Justice], Mar. 16, 2009, ENTSCHIEDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN [BGHZ] 180, 154 (Ger.).

56. *Id.*

57. *Id.* The lower instance courts, by contrast, had held that the squeeze out resolution was void.

58. For comments on the decision, see Mark S. Rieder, *Kein Rechtsmissbrauch beim Squeeze-out*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 981 (2009) (Ger.); Sebastian Goslar & Klaus von der Linden, *Grenzen des Rechtsmissbrauchseinwands gegen Gestaltungen beim Aktienrechtlichen Squeeze out* BETRIEBS-BERATER [BB] 1986 (2009) (Ger.). On the decision by the Munich court of appeal, see Christoph Kumpan & Martin Mittermeier, *Risikoentleerte Stimmrechte – Auswirkungen von Wertpapierdarlehen im Gesellschaftsrecht* ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 404 (2009) (Ger.).

59. RAMIREZ, *supra* note 29, at 240; Norma Cohen, *Laxey Partners Increases British Land Stake to 9%*, FIN. TIMES, July, 16, 2002 at 23.

tripled its equity stake from 2.9% to 9.0% within a few days. The general meeting was to, *inter alia*, decide on a proposed change in management and a share buyback program.⁶⁰ As a consequence, the general meeting ended in disagreement. While most other participants considered the strategy of Laxey a violation of good corporate governance, Laxey's position was that it would act as an advocate for all shareholders and effectively control the company's management.⁶¹ Ultimately, Laxey's position did not succeed, but the case nevertheless caused a stir and demonstrated the possible extent of voting manipulation by borrowed shares. Furthermore, the shift in Laxey's shares allowed the latter to significantly strengthen its position within the circle of shareholders, for instance, by being given the option to convene an extraordinary general meeting.⁶² The particular irony of the case was that prominent institutional investors, such as Hermes, were among the lenders; Hermes knew nothing of its role in facilitating the rebellious action of Laxey. Hermes, who is a leader and supporter of corporate governance standards, later apologized to British Land.⁶³

The merger between the British cruise line *P&O Princess Cruises plc* and the American travel company *Carnival Corporation* later confirmed these fears. Discussions during the extraordinary general meeting of P&O Princess, which had to decide on whether to accept the restructuring, revealed that many shares were borrowed by activist shareholders and that the borrowers might have voted against the wishes of the long-term investors.⁶⁴ There were also fears that some borrowers would tender the shares to Carnival as part of its partial takeover offer, again displacing the long-term investors.⁶⁵ This case has led to considerable legal and political debate. Various reform proposals were considered, including a change in the content of standard borrowing agreements, or the introduction of a prohibition on the borrowing shares for the purpose of exercising the voting rights.⁶⁶ There was a fear, however, that these extensive changes would lead to market disruptions. Finally, the only successful change was a modification of the voluntary *Stock Borrowing and Lend-*

60. RAMIREZ, *supra* note 29; Cohen, *supra* note 59.

61. Hu & Black, *supra* note 8, at 834.

62. Cohen, *supra* note 59.

63. John Waples, *Ritblat Hits at CSFB and Laxey for Vote 'Conspiracy,'* SUNDAY TIMES, July 21, 2002, at 1; *see also* Hu & Black, *supra* note 60, at 834.

64. Stock Lending & Repo Comm., Summary of Meeting Held at the Bank of England ¶ 3 (Dec. 11, 2002).

65. *See* Susan Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2901 (2007).

66. Stock Lending & Repo Comm., *supra* note 64, at ¶ 4.

ing Code of Guidance, a best practice code for securities lending. This code now states:

C.7.4 A person could borrow shares in order to be able to exercise the voting rights and influence the voting decision at a particular meeting of the company concerned. There is a consensus, however, in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for example, an AGM or EGM. Lenders should also consider their corporate governance responsibilities before lending stock over a period in which an AGM or an EGM is expected to be held. Beneficial owners need to ensure that any agents they have made responsible for voting and for securities lending act in co-ordinated way.⁶⁷

The Code is not binding law, but the reform is intended to send a strong signal to market participants that these practices will not be tolerated.

The discussion raises a variety of follow-up questions. In particular, it begs the question of how often the strategy of securities lending in practice actually occurs or may likely occur. Second, and closely related, is the questionable role of the securities *lender* in this type of transaction. Intuitively, one might think that a lender who knows the intentions of the borrower, or guesses them, will simply refrain from entering into the transaction or take precautions accordingly. In short, questions relate to the significance of this approach at a practical level and the concrete interests of the parties involved.

1. Restrictions

The seemingly effortless use of securities lending transactions, as in the examples described above, is subject to significant practical limitations when these transactions occur. In attempting to pursue such a strategy, a borrower faces the most obvious difficulty of a recall clause, which often appears in security lending agreements. Most of the popular framework agreements for lending securities include a standard clause for any type of early termination of the individual lending. Most international securities lending transactions are made on the basis of the *Global Master Securities Lending Agreement (GMSLA)*.⁶⁸ This is published by the industry group *International Securities Lending Association (ISLA)*,

67. BANK OF ENG., SECURITIES BORROWING & LENDING CODE OF GUIDANCE 18 (2009), available at <http://www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf>; see also Stock Lending & Repo Comm., *supra* note 64, at ¶ 4.

68. Kingsley T.W. Ong & Eugene Y.C. Yeung, *Repos & Securities Lending: The Accounting Arbitrage and Their Role in the Global Financial Crisis*, 6 CAPITAL MKTS. L.J. 92, 93 (2011).

and the current version dates from 2010.⁶⁹ Paragraph 8.1 of this document sets out the lender's right to terminate a loan of securities. Subject to any terms of the relevant loan, for example, where a fixed period has been agreed, the lender may terminate the agreement by giving notice equal to the standard settlement time for the securities concerned, and the borrower must redeliver the shares by the end of this period. As other master agreements contain similar clauses, in practice, most borrowing contracts include a right of termination or a call-back option. Whether such a right of revocation or termination is also realized, however, is another question. Practitioners point out that most borrowers are looking to avoid a recall of loaned securities. A frequent exercise of the recall option could accordingly render the lending business much less attractive for borrowers.⁷⁰ Meanwhile, market observers report that most securities are recalled only in exceptional circumstances, such as before a takeover or in the event of serious cost concerns.⁷¹

Practitioners familiar with the market point out a second issue. It is often not easy to pile up a large block of shares simply through borrowing shares.⁷² This is especially true at a general meeting when an important decision is on the agenda, in particular, the decision of reorganization or other transactions because these plans often wake up other activist shareholders and arbitrageurs, which reduces the availability of borrowable shares in the market.

A third consideration is the cost side. The borrowing of shares may indeed often be possible at relatively low cost,⁷³ but in practice, high security payments are to be made to the lender, who is naturally unwilling to bear the default risk of the borrower.⁷⁴ In the case of *Laxey* and *British Land*, the security provided amounted to about 105% of the market value of the shares and was therefore even above the actual purchase price.⁷⁵ The requirement to provide security at this level can pose major obstacles for many potential borrowers.

69. See INT'L SEC. LENDING ASS'N, *supra* note 44.

70. MARK FAULKNER, AN INTRODUCTION TO SECURITIES LENDING 49 (4th ed. 2007) ("Recalls are part and parcel of the securities lending business. However, borrowers seek to avoid recalls wherever possible and frequent recalls may discourage borrowers from accessing portfolios. In practice the lenders, or their agent, communicate the lender's position with regards to voting to the borrowers so as to avoid any surprises.").

71. Santella et al., *supra* note 47, at 29. In addition, a more frequent exercise of the right to recall lent shares would not even be desirable, as this could significantly reduce market liquidity. See ESME, *supra* note 47, at 7.

72. RAMIREZ, *supra* note 29, at 241.

73. See Christoffersen et al., *supra* note 65.

74. RAMIREZ, *supra* note 29, at 242.

75. *Id.* at 240.

Finally, both strategic marketing issues and the reputation of the borrower are to be considered. If the borrowing strategy becomes known in the market, the seriousness of the investor is jeopardized. Equally, his reputation and commitment to the welfare of the investment may be in doubt.⁷⁶ In a similar vein, sophisticated models of game theory or simply common sense suggest that lenders will not enter into similar lending transactions with the borrower a second time if they suffered from an abusive exercise of the voting right; alternatively, lenders will, at the very least, price-in the risk and seek to negotiate a compensation for the possible losses of value in his investment.

2. The Lender's Interests

All of the discussed considerations are largely invalidated, however, when taking into account the motivations and incentives of the *lender*. Three factors seem to be particularly salient.

First, the lender will almost never make the decision about a specific rental transaction separately; the preparation and execution of the contract is carried out in most cases by central depositors who bring together supply and demand on a case by case basis, but also automatically in accordance to standard contracts.

This aspect is not resolved by the fact that the lender is usually a sophisticated institutional investor.⁷⁷ Even in these circumstances, we expect that they themselves benefit from the rental fee, and as long as the other shareholders do not lend out their shares, the possible abuse of their voting rights by the borrower is unlikely.⁷⁸ This mirrors the basic problem of collective action that we know from share voting—when it comes to lending out shares, the same issue of free-riding can be noticed. A more charitable account would argue that institutional investors will always balance the fees they obtain from lending, on the one hand, with the cost of a recall and an informed exercise of their voting rights on the other.⁷⁹ However, an early recall of the shares will usually carry an over-

76. *Id.* at 242.

77. Hu & Black, *supra* note 8, at 897.

78. *Id.* at 896. *But see* Reena Aggarwal, Pedro Saffi & Jason Sturgess, *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market* (Geo. McDonough Sch. Bus., Research Paper No. 2012-07, 2011).

79. FLA. STATE BD. OF ADMIN., CORPORATE GOVERNANCE – ANNUAL REPORT 2006, at 29 (2007), available at <http://www.complianceweek.com/s/documents/Compliance%20Week%202007/Resource%20Materials/McCauley,%20Michael%20-%20SBA%20of%20Florida/2006%20SBA%20Corporate%20Governance%20Annual%20Report%20FINAL.pdf>. (“In consideration of recall, the SBA attempts to balance the cost of reduced securities lending income against the discernible benefits of recalling shares to exercise voting rights. In this context, the proportional SBA share owner-

all additional cost in such a calculation. The risk of abuse seems to be so remote and abstract that it typically is not incorporated as a relevant factor in the cost consideration. One fund manager has described the conflict as follows: “The problem is that the corporate governance implications cannot be easily costed, but lending can.”⁸⁰ Therefore, it is not surprising that, in practice, an overall recall of lent shares occurs very rarely.⁸¹

Second, a significant problem exists during the voting of important projects because investors are not timely informed.⁸² Particularly under U.S. law, in the context of convening a general meeting, documentation and notice requirements appear in moments of unfavorable timing. Often, the lender does not have sufficient time to recall the shares. But even when timing is not an issue, it is uncertain whether the lender will actually call back the shares. The lender may only do so if: (1) the “right” decision makers—those within the internal structure of the investment fund—become aware of the important weight attached to the vote; and (2) these decision makers convince other decision makers involved in the same internal structure that a decision to recall the shares is necessary.⁸³ Moreover, those existing incentives in the internal fund structure of the lending institutions may turn out to be problematic. For example, some funds pay their fund managers exclusively out of the fees that stem from securities lending transactions and provide no additional salary.⁸⁴ For these fund managers, their personal income depends on the fund’s lending volume—the consequences of this arrangement do not require further explanation.

The circumstances change when the lender is a small investor or individual. Here, the investors often already lack the knowledge of their shares being lent out (it is often carried out by a custodian or intermedi-

ship will be evaluated to determine an optimal amount, if any, of a company’s loaned securities that need to be recalled.”); *cf.* MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, YALE SCH. OF MGMT., VOTING INTEGRITY: PRACTICES FOR INVESTORS AND THE GLOBAL PROXY ADVISORY INDUSTRY 11 (2009), available at <http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/Voting%20Integrity%20Policy%20Briefing%2002%2027%2009.pdf>.

80. Chris Taylor, *Concern Grows Over Borrowed Votes*, FIN. NEWS (May 9, 2005), <http://www.efinancialnews.com/story/2005-05-09/concern-grows-over-borrowed-votes>.

81. FLA. STATE BD. OF ADMIN., *supra* note 79 (“Although the SBA shall reserve the right to recall the shares on a timely basis prior to the record date for the purpose of exercising voting rights for domestic, as well as international securities, the recall of loaned securities is likely to be infrequent.”); *see also* MYNERS, UPDATE THREE YEARS ON, *supra* note 52, at 9 (discussing a study by the Investment Management Association); Simon Targett, *Top Pension Funds Plan Securities Lending Code*, FIN. TIMES, June 14, 2004, at 1 (discussing a study by Linstock).

82. MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, *supra* note 79, at 12.

83. *Id.*

84. Simon Wong, *Barriers to Effective Investor Engagement*, FIN. TIMES, Jan. 16, 2012, at 6.

ary). Even if the investor is aware of the transaction, however, the problem of rational apathy of dispersed investors aggravates the conflict. As we know from the broad exercise of voting rights, the relationship between vote and benefit is often so unfavorable for retail investors that the rational investor will not seriously engage in calculating the value of his voting right and other rental options.⁸⁵

Given these various incentives, it is not surprising that only a tiny fraction of all shares on loan are being recalled. Empirical studies estimate the proportion of recalled shares to be no more than 2% of all lent shares.⁸⁶

3. Particular Incentives Within Index Funds

In addition to these basic problems, index funds exacerbate the incentives in favor of lending. Index funds are simple mutual funds that mimic a specific, representative index (such as FTSE 100 or Dow Jones) as accurately as possible. These funds are popular with investors because fees are usually quite low in comparison to actively managed funds, which charge extra management fees. To achieve their aim, index funds invest in the securities underlying the index in the same proportion as the index. Other funds use derivatives (swaps) to bind the fund's performance to the index.⁸⁷ In 2012, about \$3 trillion was invested in index funds.⁸⁸

The indexing of investment transposes findings from the efficient market hypothesis⁸⁹ and modern portfolio theory⁹⁰ into a simple investment strategy. In its moderate form, the efficient market hypothesis holds that financial markets are efficient in the sense that, at the very least, all information publically available is already priced in the securities.⁹¹ With

85. See Hu & Black, *supra* note 29.

86. Gene D'Avolio, *The Market for Borrowing Stock*, 66 J. FIN. ECON. 271, 273 (2002); see also MYNERS, UPDATE THREE YEARS ON, *supra* note 52, at 9 (discussing a study by the Investment Management Association); Simon Targett, *Top Pension Funds Plan Securities Lending Code*, FIN. TIMES, June 14, 2004, at 1 (discussing a study by Linstock).

87. The so-called tracking error indicates how exact this replication is. The lower the tracking error, the closer the development of the fund is in comparison to the reference index.

88. James Mackintosh, *It's Easy to Only Just Beat a Poor Index*, FIN. TIMES, July 16, 2012, at 24.

89. See Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); see also HENDRIK HOUTHAKKER & PETER WILLIAMSON, THE ECONOMICS OF FINANCIAL MARKETS 130 (1996).

90. See William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425 (1964); James Tobin, *Liquidity Preference as Behavior Towards Risk*, 25 REV. ECON. STUD. 65 (1958); see also Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

91. See the seminal work by Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) [hereinafter Gilson & Kraakman, *Mechanisms*]. More

new information immediately and fully priced in, no one, except insiders, is able to achieve lasting above-market profits. Following this logic, investors should not try to systematically outperform the market; they should instead rely on a predefined index. On this basis, modern portfolio theory recommends that investors solve just a single optimization problem—to choose the market portfolio, which corresponds best to their own maximization of preferences.⁹² In practice, this is best represented by a predefined index, such as the Dow Jones.

In today's financial markets, the success of the indexing strategy is best illustrated by the advent of exchange-traded funds (ETFs).⁹³ These funds are similarly traded like securities on the stock market. Indeed, they imitate a particular index such as the FTSE 100 or the Dow Jones, and in more recent times, they also use bond or commodity indices. For investors, the low costs are of a particular advantage because the management fee of index funds is usually less than 0.3%. For actively managed funds, the costs are almost always between 1.5% and 3%, sometimes even more. These higher fees may be understandable given the fund manager's quality of work. For actively managed funds, the fund managers observe the markets and decide which securities are bought or sold. An index fund such as the ETF is passively managed, however. It only has to reflect the performance of the corresponding index. Changes must be made only if the index is adjusted or its contents are modified.⁹⁴

The administrative costs of index funds can be further reduced where the fund lends out its portfolio securities to other market partici-

recently, for a perspective on the Global Financial Crisis of 2008, see Luigi Zingales, *Learning to Live With Not-So-Efficient Markets*, 139 DAEDALUS, no. 4, 2010, at 31; Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs* (Apr. 2012) (working paper) [hereinafter Gilson & Kraakman, *Market Efficiency*], available at <http://www.law.umn.edu/uploads/12/d7/12d77c902205da28b32a345e4497654e/CLEAN-EMCH-4-1-12-2-2-Kraakman.pdf>.

92. See Tobin, *supra* note 90.

93. The ETF industry has grown over the past years by about 40% per year and administers a capital of almost \$1.5 trillion. More recently, experts have emphasized the systemic risks that may be created by ETFs. See Richard Milne, Michael Mackenzie & Nicole Bullock, "Push-button Perils" *Investment: Exchange Traded Funds*, FIN. TIMES, June 6, 2011, at 7; see also FIN. STABILITY BD., POTENTIAL FINANCIAL STABILITY ISSUES ARISING FROM RECENT TRENDS IN EXCHANGE-TRADED FUNDS (ETFs) (2011), available at http://www.financialstabilityboard.org/publications/r_110412b.pdf. This critique has, however, in no way included the funds' popularity. See David Ricketts, *Traditional Index Funds Lose to ETFs*, FIN. TIMES, Feb. 6, 2012, at 9.

94. See William M. Humphries, *Leveraged ETFs: The Trojan Horse Has Passed the Margin-Rule Gates*, 34 SEATTLE U. L. REV. 299, 301 (2010) (discussing in detail the various characteristics of ETFs).

pants temporarily. This strategy is widely popular in practice.⁹⁵ Some funds allegedly make more profits with the fees they obtain for the loans than with their traditional fund fees.⁹⁶ As explained, many titles will be held for long periods of time in the portfolio passively and not traded. For these titles, funds are tempted to improve the return of their portfolio by lending them out instead of keeping them useless in their portfolio. Fund managers use the generated fees to further reduce the overall costs of the fund and thus improve their competitive standing.⁹⁷

The temporary transfer of these portfolio securities to other market players happens regularly without the option of retransferring for the general meeting.⁹⁸ Even if such an option existed, there is no incentive for fund managers to make use of it; the strategic objective of the index fund is to reflect the underlying index as closely as possible—not to outperform nor influence it. The fund therefore has no interest in exercising its voting rights, which in turn increases its willingness to temporarily let go of the securities over and including the record date and the annual general meeting. Where an investor borrows shares of a portfolio company against a fee, in order to actively influence the strategy of the company, it will only be advantageous for the index fund. In this way, the index fund achieves a double advantage: it receives the rental fee, and it benefits from the actions of an activist (borrowed) shareholder, which, in the optimal case, has a positive influence on the strategy of the management. This situation has important implications for the ability of third parties to borrow securities for the sole purpose of voting.

In other words, for a manager of an index fund, the performance of the target company is ultimately irrelevant, and all that counts is the exact mapping of the index. Given the choice of exercising voting rights in a particular company or passing them to other hands against a fee, the manager will always choose the latter option.

Studies have shown that predominantly large, passive institutional investors, whose investment targets are well-known publicly held com-

95. Many funds lend out up to 25% of their portfolio shares. See Niels Nauhauser, *Index-ETFs bergen stets ein Kontrahentenrisiko*, BÖRSE ONLINE (Jan. 12, 2010), <http://www.boerse-online.de/versicherung/meinung/nauhauser/:Niels-Nauhauser—Index-ETFs-bergen-stets-ein-Kontrahentenrisiko/619195.html>. In one study, researchers even found loan quotas of up to 100%. *SCM Private Research Reveals UK Retail Fund Managers Controlling over £241 Billion, Can Lend Out up to 100% of Funds Yet Investors Are Kept in the Dark*, SCM PRIVATE 1 (Sept. 1, 2011), <http://www.scmprivate.com/content/file/pressreleases/press-release-scm-private-stock-lending-release-01-september-2011.pdf>.

96. FIN. STABILITY BD., *supra* note 93, at 4–5.

97. On possible conflicts of interests, see Paula Niall & Pauline Skypala, *Regulatory Spotlight Turns on Lending Business*, FIN. TIMES, Jan. 23, 2012, at 8.

98. INT'L CORP. GOVERNANCE NETWORK, SHARE LENDING VIS-A-VIS VOTING 14 (2004).

panies, are the ones who lend out shares.⁹⁹ Given the reduced probability of a recall, borrowers prefer these types of investors as business partners.¹⁰⁰ Also, tax incentives increase the likelihood of passive funds in the lending business.¹⁰¹

Overall, the current market situation seems to virtually invite parties to borrow shares “for free” and to use them for their own independent purposes. In any case, the lender usually has little or no motivation to control the exercise of its voting shares or the timing of recalling them back.

C. Record Date Capture

A third phenomenon of negative risk decoupling is the strategy of “record date capture.” It is somehow connected to securities lending, but it can be considered as a separate category that includes distinct problems and implications. Most jurisdictions worldwide have introduced a system where there is a cut-off date to register for the general meeting. The date is some time before the meeting actually takes place. Hedge funds may exploit the divergence between the record date and the date of the general meeting in order to produce a situation resembling a risk-decoupled shareholder.

The strategy is simple. The decisive day determines which shareholders are entitled to vote at the general meeting. Because there is necessarily a certain divergence between the record date and the date of the general meeting, the strategy allows for the situation that the actual voters at the meeting are not necessarily at the same time current shareholders. This creates the possibility for nonunified shareholder decision-making and risk exposure. While smaller, unintentional deviations are to be accepted as inherent features of the system, larger deviations can be deliberately exploited and manipulated by knowledgeable market actors for their own purposes.

1. The Record Date System

A “record date” refers to the date that designates the shareholders entitled to vote at the general meeting.¹⁰² Most jurisdictions set such a

99. See D’Avolio, *supra* note 86.

100. See *id.*

101. See *id.*

102. Commission Proposal for a Directive of the European Parliament and of The Council on the Exercise of Voting Rights by Shareholders of Companies Having Their Registered Office in a Member State and Whose Shares are Admitted to Trading on a Regulated Market and Amending Directive 2004/109/EC, at 6, COM (2005) 685 final (May 1, 2006).

specific date in advance of each shareholders' meeting. The system is usually justified in doing so because it allows shareholders to make adequate preparations to attend the meeting. While the notion of a record date is fundamentally similar in most countries, the time span between the record date and the general meeting varies significantly from country to country.

In the United Kingdom, the period between the record date and meeting is relatively short. As a starting point, the exact period is left to the articles of the company itself: it can choose the period freely, but the date shall be not more than forty-eight hours before the meeting.¹⁰³ In practice, the vast majority of issuers choose the date as late as eighteen hours the day before the general meeting.¹⁰⁴

At the other end of the spectrum, the laws of the United States (or rather, Delaware), pursuant to § 213 of Delaware General Corporate Law, require a record date to be fixed prior to each meeting, which must occur within sixty days of the meeting and no less than ten days prior to meeting.¹⁰⁵ A recent study found that the median value the companies set is a period of about fifty-four days.¹⁰⁶ Those who are registered as shareholders on the record date are entitled to be informed of the meeting, to attend, and to vote on it.¹⁰⁷ Investors can indirectly find out the time period any individual company has set. While the company has no direct obligation to communicate this time period to individual investors, it is obliged to inform brokers, dealers and other intermediaries at least twenty trading days before the record date about the details.¹⁰⁸ This information will therefore be widely known.

German law, in turn, provides a general statutory record date for all listed companies. The registration date for any voting entitlement is re-

103. See Uncertificated Securities Regulations, 2001 No. 3755, art. 5, ¶ 41 (U.K.). "For the purposes of determining which persons are entitled to attend or vote at a meeting, and how many votes such persons may cast, the participating issuer may specify in the notice of the meeting a time, not more than 48 hours before the time fixed for the meeting, by which a person must be entered on the relevant register of securities in order to have the right to attend or vote at the meeting." Cf. Companies Act 2006, c. 46, art. 7, ¶ 360B(2) (U.K.).

104. Institute of Chartered Secretaries and Administrators, ICSA Response to the Consultation on Modernisation of the Directive 2004/109/EC (Transparency Requirements for Listed Companies) (Aug. 20, 2010), available at http://ec.europa.eu/internal_market/securities/transparency/index_en.htm.

105. Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1233 (2008).

106. See Christoffersen et al., *supra* note 65, at 2900; see also Aggarwal, Saffi & Sturgess, *supra* note 78, at 17–18.

107. DEL. GEN. CORP. LAW § 219.

108. 17 C.F.R. § 240.14c-7(a)(3).

quired twenty-one days before the general meeting.¹⁰⁹ This rule only applies to bearer shares.¹¹⁰ It is a mandatory rule and cannot be changed by the articles of association. The government justifies the length of the period because foreign shareholders need appropriate time to prepare for their participation.¹¹¹

Throughout the European Union, the record date system is a relatively recent concept supported by European Union legislation. The EU Shareholder Rights Directive of 2007¹¹² makes a record date system mandatory for all EU member states and sets thirty days as the maximum period before which a general meeting could be held.¹¹³ As we have seen, this large window of time has produced very different results in practice. Member States have chosen a range of time periods, from the above-mentioned two days in the United Kingdom (and Ireland or Cyprus) to thirty days in Malta.¹¹⁴ In the recent past, U.K. policy makers considered extending the period, which was considered too short.¹¹⁵ These proposals have been withdrawn, however.¹¹⁶ The Directive does not give further details of how the record date operates.

Despite these differences in the set record date, all systems experience similar legal effects. The entitlement to vote necessarily follows the ownership of shares on the record date. Put differently, shareholders who own the shares on the record date (or “record moment,” more precisely) do not lose their voting right if they sell their shares before the meeting. Conversely, those who acquire shares after the record date are not entitled to attend or vote at the meeting. The shareholding status quo on the record is “frozen” for purposes of the general meeting. The usual justification for the system is that it enables shareholders (and the company) to adequately prepare for the meeting; arguably it takes a substantial time period for information and documents to be shipped in time for the gen-

109. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6 1965, BGBL. I S. 2479 § 123(3) (Ger.).

110. For registered shares, only those shareholders who have been entered into the official registry may invoke shareholder rights, § 67(2) AktG. Only those registered may attend and vote at the general meeting. Many companies have also used the statutory option to determine a separate registration requirement for the general meeting. *See* AktG § 123(2).

111. This is according to the official explanations of the Act. *See* Rechtsausschuss des Bundestages, *Beschlussempfehlung und Bericht zum Regierungsentwurf des UMAG*, BT-Drs 15/5693, at 17.

112. Council Directive 2007/36/EC, art. 7, no. 3 [2007] O.J. L184/17 (EC).

113. *See generally* Hilde Laga & Floris Parrein, *Corporate Governance in a European Perspective*, in *THE EUROPEAN COMPANY LAW ACTION PLAN REVISITED* 79, 97 (Koen Geens & Klaus J. Hopt eds., 2010).

114. Council Directive 2007/36/EC, art. 15 [2010] O.J. C285/1 (EC) (providing a list of days).

115. MYNERS, *REVIEW*, *supra* note 52.

116. MYNERS, *UPDATE THREE YEARS ON*, *supra* note 52.

eral meeting.¹¹⁷ Moreover, the record date system is believed to alleviate concerns over conflict in the voting process and to help determine the entitlement of voters.¹¹⁸

2. Risk Decoupling and Record Date Capture

Although the rules for setting a record date prior to the general meeting are configured in detail, one universal and critical feature is the inherent shift in risk and voting between the record date and the day of the meeting.¹¹⁹ The record date system favors legal certainty over commercial reality. Thus, the record date determines in advance which shareholders are entitled to vote and simultaneously accepts those entitled to vote who are allowed to sell their shares between the record date and the meeting. This implies that those voting are possibly no longer the economically interested shareholders and may no longer be affected by the economic consequences of the shareholders' decisions. Conversely, investors who purchase shares between the shareholders' meeting and the record date are not entitled to vote—their interests are therefore not considered at the general meeting. There is a serious increase in the shift of risk as the period between record date and meeting gets larger. For this reason, the European Commission sought to limit the permissible time period when drafting the Shareholder Rights Directive.¹²⁰ This attempt to limit the period emerged at the end of the legislative process, however, and it was not possible to fully implement the ambitious goal.¹²¹ Consequently, the longer period of thirty days was stipulated in the final Directive text.¹²²

117. For the official explanations on the German law introducing the record date system, see Bundesregierung, *Entwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG) vom 7.1.2005*, BR-Drs 3/05, 25.

118. CLEARING & SETTLEMENT ADVISORY & MONITORING EXPERTS' GRP., SOLVING THE INDUSTRY GIOVANNINI BARRIERS TO POST-TRADING WITHIN THE EU 94 (2008), available at http://ec.europa.eu/internal_market/financial-markets/docs/cesame/cesame_report_en.pdf.

119. MYNERS, REVIEW, *supra* note 52, at 7.

120. EUROPEAN COMM'N, FOSTERING AN APPROPRIATE REGIME FOR SHAREHOLDERS' RIGHTS—SECOND CONSULTATION BY THE SERVICES OF THE INTERNAL MARKET DIRECTORATE GENERAL 12 (2005).

121. See *Proposal for a Directive of the European Parliament and of The Council on the Exercise of Voting Rights by Shareholders of Companies Having Their Registered Office in a Member State and Whose Shares are Admitted to Trading on a Regulated Market and Amending Directive 2004/109/EC*, art. 7, COM (2005) 685 (EC).

122. Overall, however, the EU-wide introduction of a record date has been a large step toward a more efficient European capital market. In fact, the legal systems of many member states had previously subscribed to a system of "share blocking." This meant that for example trading of voting shares between registration date and general meeting was simply prohibited, or even that shares had to be deposited during this time. This practice reduced the liquidity of securities markets in the days

How can certain investors strategically abuse this system? In a simple way, the record date system can be combined with the strategy of securities lending, as described above. A hedge fund may therefore borrow shares precisely over the record date, subsequently return them, and therefore acquire the right to vote at the general meeting. As an example, consider the aforementioned case of the hedge fund Laxey Partners, which briefly increased its stake in British Land to 9% over the record period.¹²³ In a similar context, consider the general meeting of the restaurant chain *Mitchells & Butlers*.¹²⁴ In both cases, a securities lending strategy was used to produce a short-term voting entitlement, and thus, securities lending was effectuated for its risk-decoupling function.

The strategy of record date capture can also be used without the borrowing of shares, however. Ultimately, any transaction of shares between the record date and general meeting is potentially capable of bringing about a risk-decoupling situation. Every regular shareholder who sells any of his shares after the record date—but before the general meeting—may vote as a risk-freed or risk-reduced shareholder at the general meeting. To be sure, buying will be more expensive than borrowing shares, and therefore probably less common. Also, the parties close to this type of transaction will usually agree over the exercise of the voting rights contractually. Nevertheless, this consideration is another matter, and it is merely important here to determine the existing possibilities for risk decoupling.

An additional constellation deserves mention, which has been notably pointed out by Jaap Winter. Companies whose shares are traded on various stock markets can take advantage of different record date arrangements for the manipulation purposes of two different markets.¹²⁵ For example, if a European company is listed on both a European and an American stock exchange, it is conceivable that an investor votes twice. First, he may obtain a voting entitlement according to the American record date, which is usually about sixty days before the annual general meeting.¹²⁶ If he then switches his American shares into European shares, he may possibly be entitled to vote according to their national system a

before the general meeting considerably. Faced with the choice to either not being able to sell the shares or not to vote at the meeting, in particular institutional investors often opted for the second alternative in such a framework. The share blocking system was thus also politically controversial, as policy makers intended to increase the presence of all shareholders at general meetings.

123. See *supra* text accompanying note 59.

124. Hill, *supra* note 50.

125. Jaap Winter, *The European Union's Involvement in Company Law and Corporate Governance*, in *THE EUROPEAN COMPANY LAW ACTION PLAN REVISITED*, *supra* note 113, at 140.

126. See *supra* text accompanying note 105.

second time at the same meeting. Winter does not provide empirical evidence in support of this constellation, but he asserts that it does happen in practice.¹²⁷ The American Clearing House DTC has recognized this risk but, so far has not taken remedial action, especially because there has never been an instance of “over voting,” where more votes are cast than actually exist.¹²⁸

D. Empirical Evidence

The different constellations described above (derivatives, securities lending, and record date capture) beg the question: To what extent are these strategies actually used in practice? What is, in other words, the empirical reality?

To date, there is no conclusive empirical analysis demonstrating the pervasiveness these strategies have in real life. We know of a number of cases that have become known to the broader public via the media or through court procedures.¹²⁹ Beyond these high-profile cases, however, it is difficult to assess whether we have exposed only the tip of the iceberg. This is mostly due to the hidden nature of the strategies employed. Given that there is no obligation of transparency, there is no requirement to disclose negative interests in shares. No notice of borrowed shares is required, nor is the wider public required to be informed of record date strategies. Usually, the hedge fund pursues this business strategy for the very reason that there is no existing obligation of disclosure. Indeed, hedge funds pursue many activist strategies behind the scenes—that is, with little or no publicity.¹³⁰ It is this uncertainty over the frequency of risk-decoupling strategies that caused the European market supervisor ESMA¹³¹ to launch a “call for evidence” in September 2011 in order to assess whether regulatory intervention is necessary.¹³² Much of the evidence did not involve concrete figures or statistics, which, as confirmed by their sources, stems from the hidden nature of the activities in question.¹³³

127. Winter, *supra* note 125.

128. See Author's private correspondence with Jaap Winter (on file with author).

129. For example, see the cases discussed *supra* Part III.A–C.

130. Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 708 (2007).

131. ESMA is the acronym for the European Securities and Markets Authority.

132. See EUROPEAN SEC. MKTS. AUTH. (ESMA), ESMA/2012/415, CALL FOR EVIDENCE ON EMPTY VOTING (2012), available at <http://www.esma.europa.eu/system/files/2012-415.pdf>

133. The responses are published at *Call for Evidence on Empty Voting*, EUROPEAN SEC. MKTS. AUTH., <http://www.esma.europa.eu/consultation/Call-evidence-Empty-voting#responses> (last visited Nov. 10, 2012, 12:51 PM); see also ESMA, *supra* note 132.

Some literature attempts to delineate how risk-decoupling strategies play out in practice. For example, Henry Hu and Bernard Black released the first of major works studying this area. Indeed, Hu and Black compiled and documented a number of worldwide incidences of risk decoupling. Their most recent paper counts eighty-two cases.¹³⁴ This compilation allows for a prima facie understanding of the problem; we have to bear in mind, however, that these two academics draw their information from publicly available sources only.¹³⁵ With this understanding, the study must be considered as a first impressionistic overview.

In an ambitious and innovative study, Christoffersen and others examined the market for securities lending.¹³⁶ First, they found that the borrowing of securities significantly increases around the record date.¹³⁷ This finding supports the conclusion that there is an active market for voting rights. The authors show that the volume of borrowed shares spikes on the record date in a way that, on average, 0.1% more shares are borrowed on these days than on regular days.¹³⁸ At first blush, this does not seem like a dramatic increase, but an average increase of this magnitude can mean a big increase in a singular case.¹³⁹ Second, the study found that borrowing costs are extremely low.¹⁴⁰ This finding may, however, be questionable—the low price may be due to the fact that the authors' data include all types of meetings, including votes on issues of relatively low importance. However, the price is known to increase significantly for important measures such as restructuring.¹⁴¹ Also, this finding may simply confirm the claim that lenders of securities often have no information, or at least no timely information, on when an important vote is scheduled.¹⁴²

In any case, the study emphasizes the potential importance of borrowing transactions for the voting process.¹⁴³ Participants of a practitioners' roundtable workshop at Yale School of Management echoed this

134. Hu & Black, *supra* note 24, at 661.

135. *Id.*

136. See Christoffersen et al., *supra* note 65.

137. *Id.* at 2910.

138. *Id.*

139. But compare this with the study by Aggarwal, Saffi & Sturgess, *supra* note 78, who find a relatively small increase in demand around the record date.

140. Christoffersen et al., *supra* note 65, at 2912.

141. David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANN. REV. FIN. ECON. 103, 113 (2010).

142. FLA. STATE BD. OF ADMIN., *supra* note 79, at 31; see also COUNCIL OF INSTITUTIONAL INVESTORS, EVERYTHING YOU ALWAYS WANTED TO KNOW ABOUT SECURITIES LENDING, BUT WERE AFRAID TO ASK 4 (2006).

143. Christoffersen et al., *supra* note 65, at 2904.

theory.¹⁴⁴ Other market participants have confirmed this assessment. For instance, the Florida State Board of Administration (SBA), one of the largest pension funds in the United States, recently examined its lending volume for general meetings with important voting issues.¹⁴⁵ The SBA found that there was indeed an unusually high volume of borrowed shares in the context of controversial or important general meetings.¹⁴⁶

The informative value of these studies reporting on the tendencies of the market for *borrowed securities* will depend on whether similar movements (before and after the record date) can be equally observed on the *regular stock market*. Hypothetically, each and every investor could, of course, buy regular shares in order to gain additional voting power with respect to a particular voting date. This is why Christoffersen and co-authors compared the activities around the record date of borrowing and purchase markets.¹⁴⁷ The study did not find any comparable increase of regular trading around the record date that could correspond to the borrowing volume.¹⁴⁸ The authors concluded that the regular and legal process of “vote buying through share buying” occurs only on a rare basis, and the temporary borrowing of shares is advantageous for activist investors.¹⁴⁹

There is an absence of meaningful data on the use of derivatives to effectuate risk decoupling. This lack of data is particularly due to the fact that, at least until now, trading of over-the-counter (OTC) derivatives is possible without registration or supervision.¹⁵⁰ This means that data is difficult or impossible to obtain. Nevertheless, the British Investment Management Association estimates that negative risk-decoupling strategies in the variant of the use of derivatives occur more frequently in practice than share borrowing or record date capture.¹⁵¹

144. MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, *supra* note 79, at 11.

145. Letter from Ashbel C. Williams, Exec. Dir., State Bd. of Admin. of Florida, to Elizabeth M. Murphy, Sec’y, Sec. & Exch. Comm’n (Oct. 20, 2010), *available at* <http://www.sec.gov/comments/s7-14-10/s71410-180.pdf>.

146. *Id.* at 5.

147. Christoffersen et al., *supra* note 65, at 2908–09.

148. *Id.* at 2908.

149. *Id.*

150. There are proposals to fix this lack of data in the wake of the financial crisis. A proposed EU instrument, widely known as European Market Infrastructure Regulation, proposes to introduce reporting requirements for OTC derivatives. *See Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories*, COM (2010) 484/5 (EC).

151. Ellen Kelleher, *Enquiry Starting into Empty Voting*, FIN. TIMES, Sept. 25, 2011, at 3.

In this context, the only reliable figures are from the specific context of “collar transactions,” which were discussed above.¹⁵² In particular, management uses these transactions in an attempt to reduce dependence on the stock price.¹⁵³ In other words, management seeks to counteract the results intended by stock option programs and share-based remuneration agreements, which attempt to bind remuneration to stock performance. Empirical studies have shown that management and executive staff use these instruments frequently and expressly to avoid the risk exposure of their shares.¹⁵⁴

Finally, a general study on the stock price development of listed companies by Yair Listokin deserves mention. Listokin examined the contrary valuations of shares by both shareholders and the market to show that both groups reach different conclusions at narrow and contentious general meetings.¹⁵⁵ For example, when shareholders vote in favor of a management proposal by a close majority, the market evaluates this negatively, and vice versa. From this result, Listokin believes that conclusions can be drawn on the existence of risk-decoupling strategies in the company.¹⁵⁶ This concerns at least the special constellation, where the management profits itself from a risk-decoupling situation. If this situation is the case, the empirical results of Listokin’s study are consistent with the theoretical expectations. In both constellations, the voting process is distorted, which leads to a divergence between voting result and market valuation.

IV. PROBLEM PERSPECTIVES

The analysis so far has shown that risk-decoupling strategies are legally possible, and that activist hedge funds are indeed ready to use them to pursue their goals. While a certain uneasiness from these strategies is immediately conceivable, a thorough analysis is required to justify any legislative intervention. If no case is made for market problems, the phenomenon could equally be endorsed as a market-efficient choice by specific actors.¹⁵⁷ In order to examine the implications of risk-decoupling

152. See *supra* text accompanying note 42.

153. *Id.*

154. See Bettis et al., *supra* note 42; Bebchuk & Fried, *supra* note 42, at 71; see also Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42981, 43018 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275).

155. See Yair Listokin, *Corporate Voting versus Market Price Setting*, 11 AM. L. & ECON. REV. 608 (2009).

156. *Id.* at 632.

157. For instance, this could be underpinned by contract-based corporate theories and by elements of the efficient market hypothesis. See FRANK EASTERBROOK & DANIEL FISCHEL, THE

strategies, three different perspectives may be selected to illuminate the economic problems underpinned: a classical principal–agent relationship, a perspective from information costs, and a corporate finance view. Each of the three perspectives will be considered in turn.

A. Principal–Agent Perspective

The first view is a classical perspective stemming from the well-known principal–agent theory, which is well established in corporate law and governance.¹⁵⁸ Here, the claim is that a risk-decoupled shareholder creates new agency costs. In short, a new actor enters the stage, and the presence of this new type of shareholder confronts other shareholders and investors with additional costs.¹⁵⁹

1. Risk Decoupling and Agency Costs

A risk-decoupled shareholder has a different risk profile than a regular shareholder and will therefore exercise voting power, depending on the situation, either in a more or a less risk-averse way than the average shareholder. Economic theory and empirical studies have shown that some shareholders who have voting power that exceeds their relative economic exposure tend to show nonjustifiable risk-averse behavior.¹⁶⁰ This finding has important implications for the community of shareholders as they share a joint enterprise and a common interest. Institutions such as shareholder voting and majority rule derive their authority implicitly from the assumed fact that shareholders will vote in an optimal relationship to the capital invested. From this assumption, the proportionality principle applicable to risk and influence has been developed, which leads, in its strictest form, to the principle of “one share, one

ECONOMIC STRUCTURE OF CORPORATE LAW (1991); *see also* BRIAN CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE, AND OPERATION* (1996); HOUTHAKKER & WILLIAMSON, *supra* note 89, 130; Fama, *supra* note 89; Gilson & Kraakman, *Mechanisms*, *supra* note 91. More recently, with regard to the financial crisis of 2008, *see* Gilson & Kraakman, *Market Efficiency*, *supra* note 91; Zingales, *supra* note 91, at 31.

158. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For an overview, *see* John Armour et al., *Agency Problems and Legal Strategies*, in *THE ANATOMY OF CORPORATE LAW*, *supra* note 2.

159. *See generally* Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877 (2010); Andrew Lumsden & Saul Fridman, *Proxy Voting and Vote Selling*, 61 KEEPING GOOD COS. 332, 333, 337 (2009).

160. RONALD J. GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 249 (2d ed. 1995).

vote.”¹⁶¹ This normative principle of legal policy holds that one should ensure a proportionate allocation of share ownership and control in a company. “Ownership” in this context can be equated with “cash flow rights.” The principle implies that any shareholder should own the same fraction of cash flow rights and voting rights, thus attributing an amount of control to a shareholder that is proportionate to his shareholding. Inherent in the principle is the proscription of deviations from a proportionate allocation of ownership and control via so-called “control-enhancing mechanisms” (CEMs).¹⁶² While academically debated, many perceive proportionality as being rationally compelling based first on the observation that shareholders—as the company’s residual claimants—have the strongest interest in maximizing firm value and, second, on the belief that voting power should match economic incentives alone. Additionally, recent public debates about proportionality have assumed an emotional dimension; the idea that each share entitles the owners to equal influence has intuitive appeal. It has led to slogans such as “shareholder democracy,” based on assumed parallels between societal and corporate governance.¹⁶³ The ultimate objective of establishing a “one share one vote” (OSOV) principle in the European Union has been pursued on two levels, with diverging methods and aims. Based on the recommendations of an academic expert group, the European Commission has pondered whether to introduce mandatory legislation, whereas the Court of Justice of the European Union has indirectly been working on a case-law based approach over the past years.

Easterbrook and Fischel authored the quintessential OSOV supporting paper in 1983. The article emphasizes that deviations from an equal voting right in the company will create agency costs for management.¹⁶⁴ This essential assertion is based on two instances: first, and fundamental-

161. On this subject, see Jonathan Rickford, *Invisible Hand or Dead Hand? – Reflections on the EU “One Share One Vote,”* in ONE SHARE ONE VOTE? TOMORROW’S COMPANIES: ONE UNIVERSAL MODEL OR TAILORED EQUITY STRUCTURES? 67 (2006); Mike Burkart & Samuel Lee, *One Share – One Vote: the Theory*, 12 REV. FIN. 1 (2008); Renée Adams & Daniel Ferreira, *One Share – One Vote: The Empirical Evidence*, 12 REV. FIN. 51 (2008); Wolf-Görg Ringe, *Deviations from Ownership-Control Proportionality—Economic Protectionism Revisited*, in COMPANY LAW AND ECONOMIC PROTECTIONISM 209 (Ulf Bernitz & Wolf-Georg Ringe, eds., 2010); Koen Geens & Carl Clottens, *One Share One Vote: Fairness, Efficiency and EU Harmonisation Revisited*, in THE EUROPEAN COMPANY LAW ACTION PLAN REVISITED, *supra* note 113, at 145.

162. Possible CEMs are, for instance, multiple voting rights, voting ceilings, nonvoting (preference) shares, etc.

163. The term “shareholder democracy” is imprecise, as modern democracy would imply proportionality between influence and the number, rather than investments, of shareholders.

164. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 409 (1983).

ly, the two scholars argue that shareholders in possession of disproportionate voting rights will not make optimal decisions for the company.¹⁶⁵ Where a shareholder bears a higher economic risk than is reflected in his voting right,¹⁶⁶ his incentives to vote may be distorted. This is because he might be more willing to accept a risk when his financial interest is lower than his actual influence in the company. Conversely, if his financial exposure is greater than his equity share, he might not be in a position where his voice is heard in the same way as it corresponds to his interests.

Second, the paper claims that disproportionate ownership structures impede corporate takeovers or changes of control, thereby strengthening the position of managers over shareholders.¹⁶⁷ Disproportionate voting rights can thus lead to an insulated management position, especially when the management is supported by, or connected with, the shareholder who enjoys special voting rights.¹⁶⁸ This is relevant at three levels: first, differentiated voting rights facilitate control by an economic minority stake and make a takeover extremely difficult without a breakthrough rule, which sets them aside during the period of a takeover bid. Second, means of circumventing OSOV, such as voting agreements, may increase managerial discretion and discourage potentially value-increasing takeovers.¹⁶⁹ Third, voting restrictions such as voting caps can represent important antitakeover devices that discourage potential bidders from making an offer.¹⁷⁰ Moreover, many recognize that deviations from OSOV permit an over-representation of minority interests in the company's governance, leading to the possibility that there will be diverging preferences among the members of the board. In this way, schemes such as these expose the firm to an uncompensated risk of making inconsistent or illogical decisions.¹⁷¹

165. *Id.*; cf. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783 (1972); Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 135 (1987).

166. Or vice versa—his voting rights are greater than his economic risk.

167. See Easterbrook & Fischel, *supra* note 164. This point is emphasized by a dissenting opinion in the Jenkins Report. See BD. OF TRADE, REPORT OF THE COMPANY LAW COMMITTEE, 1962, Cmnd. 1749, at 207–10 (U.K.), available at http://www.takeovers.gov.au/content/Resources/other_resources/downloads/jenkins_committee.pdf.

168. Marc Goergen et al., *Corporate Governance Convergence: Evidence From Takeover Regulation Reforms in Europe*, 21 OXFORD REV. ECON. POL'Y 243, 253 (2005).

169. See Rafel Crespi & Luc Renneboog, *Coalition Formation and Shareholder Monitoring in the UK* (Ctr. for Econ. Res., Discussion Paper No. 2000-18, 2000), available at <http://arno.uvt.nl/show.cgi?fid=4037>.

170. See Goergen et al. *supra* note 168.

171. See Easterbrook & Fischel, *supra* note 164.

The above-mentioned arguments certainly cannot aggregate to support the problem of risk decoupling. The strongest claim—that there are distorted incentives for the exercise of voting rights—remains an essential feature of risk-decoupled shareholders. A shareholder who eliminates his exposure will vote for other reasons than someone who has responsibility for his financial position. Even if it is only a gradual reduction in risk, the decisions and votes are already to some extent distorted.

Aside from the mere distortion of incentives, the second point to be mentioned is the so-called private benefits of control that a risk-decoupled shareholder may pursue. The concept of special benefits (private benefits of control) stems from finance scholarship and is a relatively new discovery. The traditional literature has assumed that all shares are homogeneous, they exist equally, and that shareholders therefore generate returns on the same scale. Over the last thirty years, however, a different view has slowly gained support. According to this view, a controlling shareholder can reach a number of advantages, which other shareholders cannot obtain. Starting from a simple model in 1980,¹⁷² the concept of “private benefits” has become central to understanding the relationships between different groups of shareholders. Empirical studies have shown that the level of private benefits gained by controlling shareholders diverges significantly, and depends on the legal system in question.¹⁷³ These levels of private benefits are also used as a universal indicator of the principal–agent conflict—the degree of severity between majority and minority shareholders in a jurisdiction.¹⁷⁴

These private benefits can arise in many different shapes and constellations.¹⁷⁵ How then do they accompany risk-decoupled shareholders? A shareholder whose risk falls short of his voting influence can profit from disproportionate benefits in comparison with the other shareholders. The *Mylan-Perry* case described above¹⁷⁶ serves as an extreme ex-

172. See Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of Corporation*, 11 BELL J. ECON. 42 (1980).

173. Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 336 (2003); see Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 551 (2004); see also Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371 (1989); Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957 (1994).

174. Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, in THE ANATOMY OF CORPORATE LAW, *supra* note 2, at 89, 107.

175. See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006).

176. See RAMIREZ, *supra* note 29; Hu & Black, *supra* note 29.

ample: the hedge fund Perry became involved with Mylan without risk. It could thereby enjoy the additional benefit in the form of its involvement with the competitor King. More precisely, in such an extreme situation, the shareholder resolution in favor of the takeover benefits one shareholder in particular (Perry), but it does not bring the same benefits for all other shareholders. On a less dramatic level, the same result can be observed. The fact that the risk profile of one shareholder is distinct from that of other shareholders means that in transactions with the company, an investment decision or a specific management strategy for the company as a whole (including the (minority) shareholders) may be both detrimental and beneficial for the risk-decoupled shareholder.

In addition to the distorted voting incentives, these special benefits represent an additional and distinct cost factor. The distortion of voting interests means that the risk-decoupled investor enters into either “too much” or “too little” risk, in comparison with a regular shareholder who enters with proper risk alignment. The pursuit of private benefits is distinguishable; it allows the voting shareholders to pursue separate advantages due to increased voting power. For instance, if a hedge fund, H, holds 5% of the shares of company X, but temporarily acquires an additional 5% by means of securities borrowing transactions over the record date, certain aspects have to be distinguished. On the one hand, there is the danger that H will vote in a more risk-friendly way than it would as a regular shareholder because H bears a reduced risk exposure compared with other shareholders. The co-shareholders are thus affected by H’s increased appetite for risk because, unlike regular shareholders, H does not fully feel the consequences of its decisions. An additional and separate danger comes from a variety of private benefits; H may use its voting power of 10% of the votes in a way that the company enters into transactions that are advantageous only for H, either directly or via a third party. In extreme cases, as with *Mylan-Perry*, H can cause X to enter into inherently harmful measures of which H itself, however, will benefit because of an interest in a competitor or takeover target.

2. Reduction of Agency Costs?

In contrast to the discussion thus far, some argue in the literature that risk-decoupling structures do not exacerbate agency costs, but could rather reduce them.¹⁷⁷ This claim is based on the following reasoning: one of the main problems of shareholder voting rests on the fact that

177. Christoffersen et al., *supra* note 65, at 2904; cf. Mike Burkart & Samuel Lee, *Signaling in Tender Offer Games* 23 (Fin. Mkts. Grp., Discussion Paper No. 655, 2010).

small shareholders generally do not exercise their voting rights. This finding is the well-known phenomenon of “rational apathy” of (small) shareholders.¹⁷⁸ The argument then deduces that these apathetic shareholders could transfer their voting rights to other shareholders. The collective action problem could be overcome in this way—shareholders who take an active interest in the strategic direction of the company could accumulate a stronger voting position in order to effectively control the management and thus reduce managerial agency costs. Especially in an environment characterized by a high dispersion of shares, medium-sized shareholders could be awakened to become an effective and important controller of management.¹⁷⁹ This process would alleviate the above-described collective action problem.

This claim is an old argument in disguise. Already in the literature on isolated vote trading, investigating whether it could produce value-enhancing situations, proponents argue that such an approach could help the problem of investors’ passivity which could thus be overcome.¹⁸⁰ This argument was primarily made in the context of takeovers and acquisitions, to enable the bidder to acquire additional voting rights and thus replace the management of the target company.¹⁸¹ Opponents have pointed out that this theory is based on two conditions that are not always met: first, the proposed acquisition was actually in the interests of the shareholders, and second, the purchaser used the right to vote in a way that is actually in the interests of all shareholders.¹⁸²

178. See KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974); cf. Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Eddy Wymeersch, *Shareholders(s) Matters(s)*, in *UNTERNEHMEN, MARKT UND VERANTWORTUNG – FESTSCHRIFT FÜR KLAUS J. HOPT ZUM 70. GEBURTSTAG AM 24. AUGUST 2010*, 1565, 1571 (Stefan Grundmann et al. eds. 2010).

179. See Hu & Black, *supra* note 8, at 820, 852; see also Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42981, 43017 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275); COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA, *DISCLOSURE OF CASH-SETTLED DERIVATIVES* 13 (2009). For a more differentiated view, see Alon Brav & Richmond Mathews, *Empty Voting and the Efficiency of Corporate Governance*, 99 J. FIN. ECON. 289 (2011).

180. See, e.g., Bruce Kobayashi & Larry Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 39 (2006); Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427, 1436 (1964); Burkart & Lee, *supra* note 177, at 19.

181. Thomas J. André, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 587 (1990).

182. Robert Thompson & Paul Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 162 (2009) (referring on both points to André, *supra* note 181, at 587; Richard Hasen, *Vote Buying*, 88 CAL. L. REV. 1323, 1354 (2000); Saul Levmore, *Voting with Intensity*, 53 STAN. L. REV. 111, 137 (2000)).

These objections also prove viable in the context at issue here. In particular, the second argument is the key point: all structures of risk decoupling demonstrate vividly that the voter usually pursues objectives that are precisely not in the interest of the wider community of shareholders, but rather uses its risk-decoupled position deliberately for the purpose of achieving her own benefits, and for disadvantaging other investors. There are two conflict situations that are fundamentally different. First, in corporate takeovers, the management of the target company often acts out of self-interest (usually the risk of losing their position); and second, in contrast, the vote buyer threatens in risk-decoupling situations to consciously undermine or manipulate the voting process for lack of his own risk, or because of reduced risk. This is often to the detriment of third parties. Whether one adopts this traditional argumentation or not, it fails to make a convincing claim in the context of interest here.¹⁸³

Additionally, risk-decoupling structures may not only be used to reduce or eliminate risk, but can even serve to create a situation where the negative interest *exceeds* the positive interest entirely.¹⁸⁴ Where a short position, created with derivatives, exceeds the value of the long position, it is in the immediate interest of the shareholder to support value-reducing activities that damage the company's business. An effective control of the administration to the benefit of all shareholders seems rather implausible in such a scenario. This point also highlights the main difference with the traditional "one share, one vote" debate: deviations from "one share, one vote" surely disturb the proportionality between ownership and voting rights.¹⁸⁵ For example, multiple voting rights are distortions of the influence of the voting shareholders, but unlike risk-decoupling structures, they do not permit the complete elimination of the risk, or even the creation of a negative interest, which exceeds the positive interest. Where both issues are treated similarly in the literature, they ignore a fundamental difference.

All of this should not undermine the possibility that risk-decoupling strategies may help overcome the principal-agent conflict in individual cases. For instance, in the case of *British Land*, the hedge fund Laxey's borrowed shares can be interpreted as an attempt to more efficiently monitor management in the interests of all shareholders.¹⁸⁶ The fundamental objection remains, however; there is no guarantee that the voting

183. Equally skeptical are Thompson & Edelman, *supra* note 182, at 163; Michael Schouten, *The Case for Mandatory Ownership Disclosure*, 15 STAN. J.L. BUS. & FIN. 127, 171 (2009).

184. See discussion *supra* Part III.C.1.

185. For more detail, see Ringe, *supra* note 161, at 209.

186. Laxey indeed claimed this. See sources cited *supra* note 59.

rights borrowed by Laxey will not be used for its own private advantages, contrary to the interests of other shareholders. Already, the theoretical possibility of being able to pursue such special benefits exacerbates the conflict among the various members or groups of shareholders.¹⁸⁷ The alleged claim that risk-decoupling structures are useful is not convincing as a whole; in individual situations, however, opinions may differ. This observation will be revisited in the pages that follow.

3. Objection

An additional counter-argument might be that similar conflicts often occur outside the risk-decoupling structure, and they have been unregulated so far. For example, institutional investors often hold shares in a large number of portfolio companies. This means that in particular circumstances, they may hold the shares of two direct competitors. Institutional investors will then determine their voting decision by pure arithmetic—where do they stand to win most?¹⁸⁸ This may mean that an institutional investor, A, is forced (by its individual portfolio composition) to exercise its voting power in a portfolio company, B, to the detriment of B's shareholders because A holds a much higher share in portfolio company C, a competitor of B, and will thus secure a net profit over both positions. A similar situation would be if company C is a takeover target of company B.¹⁸⁹ It could thus be argued that similar conflicts of interest can occur, without risk-decoupling structures or elegantly devised elaborate strategies, solely through the holding of shares in different companies.¹⁹⁰

While this objection is powerful, it must be ultimately rejected for several reasons. First, it can be assumed with great probability that, insofar as these conflict situations exist for institutional investors, they are caused by fortune, and are not caused deliberately. This means that in a random distribution of these situations in the market, the effects can cancel each other out due to individual investors and their opposite alignments. Hence, a potentially and individually arising conflict can be offset by a market diversification.¹⁹¹

187. See Jaffari & Deeney, *supra* note 16, at 7.

188. Thompson & Edelman, *supra* note 182, at 155.

189. This would correspond to the Mylan/Perry scenario. See *supra* note 29.

190. See Thompson & Edelman, *supra* note 182.

191. Kahan & Rock, *supra* note 23, at 1075; Thompson & Edelman, *supra* note 182, at 155. On the phenomenon of random biases that will cancel one another out, see generally Gilson & Kraakman, *Mechanisms*, *supra* note 91, at 581.

Second, the conflict situation imagined here would have an entirely different quality than the one created by a risk-decoupling structure. This can be demonstrated in two aspects. First, it is obvious (using the example above) that investor A meets the full economic risk on both sides of the equation in both portfolio companies. Its position is not hedged by derivatives, and it is not based only on temporary, borrowed shares. The interests thus differ significantly from that of a risk-decoupled position, and the probability that A manipulates the voting process is much lower. Moreover, the resulting agency costs will be significantly lower than in a risk-decoupling situation. In the cost calculation conducted above, we distinguished between costs due to a distortion of the voting incentives from those due to the pursuit of private benefits.¹⁹² While a risk-decoupled shareholder creates both components, A is biased by only possible private benefits. This is because A's influence and risk in portfolio company B are entirely proportionate. Only because of its stake in C does the opportunity arise to improve A's overall position. In other words, A's incentives are not distorted because of an increased risk friendliness per se, but solely because of a conflict situation, based on A's portfolio structure. This structure allows extraction of a number of private benefits. These benefits may simply be the well-known related party transactions, or other conflicts of interest, which are being controlled by traditional corporate law.¹⁹³ Overall, one must conclude that a conflict situation that exists solely on the basis of random fractional ownership in two or more competitors shows a fundamentally different quality than deliberately induced risk decoupling, like the scenario described here.

4. Implications

The analysis thus far shows that risk decoupling can create a principal-agent problem, which imposes costs on the company. There are also costs that take the form of distortion of voting incentives and private benefits for the decoupled shareholder, both with possible adverse consequences for minority shareholders and actual or potential investors. This finding is later taken up again in the development of concrete regulatory solutions.¹⁹⁴ First, however, the other problem perspectives will be discussed.

192. See *supra* text accompanying note 172.

193. See Luca Enriques, Gérard Hertig & Hideki Kanda, *Related Party Transactions*, in *THE ANATOMY OF CORPORATE LAW*, *supra* note 2, at 153.

194. See *infra* Part V.C.3.

B. Information Costs

The second perspective considers the problem of risk decoupling as an issue of information and transaction costs. The claim here is that all risk-decoupling strategies have the effect of imposing additional information costs for investors and shareholders, and thus ultimately create higher costs of capital for the company.

This thesis is developed in two steps. First, we have to understand a few basic aspects of the concept of information and transaction costs, and how instruments of corporate law traditionally contribute to their reduction. Second, we demonstrate how the topic under consideration here, risk decoupling, runs against this objective.

1. Information Costs and Corporate Law

Information costs are considered in law and economics literature as part of market transaction costs.¹⁹⁵ For example, if market participants consider entering into a particular transaction, they have to find a suitable contract partner, as well as information about the nature of the product to be sold, including its quality and price. Through this process of information gathering and verifying, the market participants incur costs.¹⁹⁶

Accordingly, the reduction of information costs is a priority objective of any jurisdiction. One conclusion of the Coase theorem is that transaction and information costs can lead to market distortions.¹⁹⁷ Because these costs are regularly nonnegotiable, the original specification and allocation of property rights is important for the expected transaction costs.

Market participants incur these same kinds of information costs when transacting over securities. Corporate law attempts to reduce these information costs in many ways. Two of these methods are important for the present analysis: the legal nature of shares as property rights, and the corporate *numerus clausus*.

First, consider the legal classification of a share as a property right, as opposed to a contractual position. A shareholder does not merely ac-

195. RUDOLF RICHTER AND EIRIK FURUBOTN, *NEUE INSTITUTIONENÖKONOMIK* 59 (4th ed. 2010).

196. In theory, questions of search and information costs are treated in the specialized field of information economics. See George Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961); see also Jack Hirshleifer, *Exchange Theory: The Missing Chapter*, 11 ECON. INQUIRY 129 (1973); Jack Hirshleifer & John G. Riley, *The Analytics of Uncertainty and Information – An Expository Survey*, 17 J. ECON. LIT. 1375 (1979).

197. R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* (1990); R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

quire a contractual, personal claim against the corporation, but rather acquires a right *in* the corporation.¹⁹⁸ This organization of the share as a property-type bundle of rights facilitates its transferability and tradability. The fungibility of shares is an essential criterion for the existence of modern capital markets. Share acquirers must not investigate the specific characteristics of the shares they purchase every time they do so because by virtue of the legal framework, they can expect to acquire a bundle of the usual characteristics (without which large-scale trades would be unthinkable). They can assume to obtain a more or less standardized security, so that it is sufficient for their trade to specify the type and number of pieces.

Thus, the creation of property rights overcomes some of the weaknesses of contract law and the principle of relativity. The economic consequences cannot be overestimated. Property rights can create markets: they allow the continuous exchange of goods—in this case shares in companies—on global markets.¹⁹⁹

This property law side of corporate law goes hand-in-hand with the principle of *numerus clausus*.²⁰⁰ Corporate law offers a limited number of legal forms at the disposal of firms to choose for their organization, including private limited or public limited companies, partnerships, etcetera. In the second instance, within the corporate form chosen, the law allows for a certain number of types of shares to be created, although the law is more generous here in permitting a certain variation of these features. Through standardization, the principle equally aims to reduce information costs for market participants, among other objectives.²⁰¹ Firms that must choose from a catalogue of permissible corporate forms and

198. This distinction is true in most if not all legal systems. For example, for the seminal case in the United Kingdom, see *Borland's Trustee v. Steel Bros. & Co.*, [1901] 1 Ch. 279, 288.

199. See Tamar Frankel, *The Legal Infrastructure of Markets: the Role of Contract and Property Law*, 73 B.U. L. REV. 389, 398 (1993); Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, 33 SEATTLE U. L. REV. 931, 934 (2010);

200. John Armour & Michael Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD J. LEGAL STUD. 429, 444 (2007).

201. On the *numerus clausus* discussion, see Ben McFarlane, *The Numerus Clausus Principle and Covenants Relating to Land*, in MODERN STUDIES IN PROPERTY LAW 6, 311 (Susan Bright ed., 2011); Bernarad Rudden, *Economic Theory v. Property Law: The Numerus Clausus Problem*, in OXFORD ESSAYS IN JURISPRUDENCE: THIRD SERIES 1987, 239 (John Eekelaar & John Bell eds., 1987); see also Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373 (2002); Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L. J. 1163, 1168 (1999); Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000). For an overview, see BRAM AKKERMANS, *THE PRINCIPLE OF NUMERUS CLAUSUS IN EUROPEAN PROPERTY LAW* (2008); Nester Davidson, *Standardization and Pluralism in Property Law*, 61 VAND. L. REV. 1597 (2008).

shares are thus prevented from creating opaque and nontransparent arrangements, which would be burdensome for third parties trying to evaluate them.

2. Risk Decoupling and Information Costs

After revisiting the traditional approach corporate law takes toward reducing information costs, it is now possible to turn our attention to the ways in which risk-decoupling activities interfere with the general objectives outlined above. The key point here is that risk-decoupling strategies, which are strategically used by market participants (in particular, hedge funds) undermine the main regulatory goals described above. Instead of striving to reduce information and transaction costs, these strategies create additional costs for market participants.

Distortions in the risk exposure of investors increase the information and transaction costs of other market participants. This primarily applies to investors who wish to acquire shares in the company, but also to co-shareholders. Under normal circumstances, they all stand to benefit from the standards described above because a limited number of legal forms and a limited number of share types would normally mean that an investor can usually assess the rights and properties they receive in a reliable manner. The “standard product” they purchase, is the traditional bundle of rights, consisting of the well-known management and property rights that accrue to the shareholders according to the paradigm of corporate law. The acquirer can therefore make a relatively simple purchasing decision, and is not obligated to conduct extensive research to evaluate the individual aspects of his shareholder position, or the potentially modified parts of the legal status to be acquired, or even engage external consultants.

As a general rule, the law creates a standardized bundle of rights and obligations, including the right to vote, and the corresponding economic risk exposure. Risk-decoupling strategies undermine this legislative choice to bundle together influence and risk. It is, in other words, an attempt to split the legislative bundle by way of private autonomy. It is the attempt to use contract law to undo what has been fixed together by property law. If, as we said above, property law is preferable over contract law for creating and supporting markets,²⁰² a reintroduction of the latter causes problems for the former. In our context, the presence of risk-modified shares among the usual shares of the company requires investors to take precautions, make investigations, and possibly even en-

202. See *supra* note 198.

gage external advice on the specific characteristics of the shares they are contemplating buying.²⁰³ In particular, the investor can no longer be sure that the normal combination of risk and influence is followed.²⁰⁴ The problem is exacerbated by the fact that the mere technical and abstract possibility of risk decoupling is sufficient for causing severe disruptions for the entire trade of the company's shares, regardless of whether they actually occur in the company. This is because once the investors are aware that the earlier assumption of a link between influence and risk can no longer be generally trusted, additional investigation costs are unavoidable.

3. Regulatory Target

The above analysis makes it clear that the problem under consideration here is specifically relevant to one particular area of corporate law. The phenomenon of risk decoupling will be most salient for large, listed companies, which rely on capital markets for financing. The problem of information cost will be most relevant in these companies, and investors must rely most heavily on the standardized aspects of securities. By contrast, small, private companies are usually governed by increased personal relationships. This means that personal information can overcome the problems of anonymity described above. Additionally, private companies will usually have different ways of conflict resolution and overall governance.²⁰⁵ To preempt the discussion on regulatory choices, any regulatory intervention should focus on the market segment of only public, listed companies.

C. Corporate Finance

Thus far, we have approached the analytical discussion from the vantage point of two perspectives: principal-agent conflict and information costs. An additional perspective offers promise; it looks at the phenomenon of risk decoupling from the view of corporate finance and it provides far-reaching insights into the financial law aspects of risk decoupling, in addition to the legal characteristics of shares.

The starting point is the traditional distinction between debt and equity. This distinction is fundamental to the structuring of corporate fi-

203. More precisely, the very shares an investor purchases won't be directly affected by risk-decoupling strategies because contracts have only relative effect. But the presence of *other* risk-decoupled shares in the company will trigger higher information costs for any new investor.

204. Armour & Whincop, *supra* note 200, at 444.

205. *See, e.g.*, JOSEPH McCahery & ERIK Vermeulen, CORPORATE GOVERNANCE OF NON-LISTED COMPANIES (2008).

nance, and gained importance, among other things, in tax, accounting, insolvency, and corporate law and governance.²⁰⁶

Crucial to the discussion is the corporate law side of this differentiation. Shareholders provide equity to the company, thereby enabling the shareholders to become part owners of the company. External parties provide borrowing, however, and they act as separate entities because they only sign a regular loan contract with the company. It follows that equity investors have rights *in* the company, and creditors have rights *against* the company. This distinction is significant, for example, when it comes to questions of control and strategic direction of the company. On both points, only the equity investor has influence, whereas the external creditor has only contractual claims arising out of his loan agreement.

What justifies this dramatic differentiation? The most important distinction between debt and equity capital is the risk that the respective provider of capital enters into.²⁰⁷ Without discussing the details, equity investment is perceived as much riskier than debt financing because equity holders' profit expectations are more closely attuned to the economic perspective of the company than the position of lenders. Lenders usually get a steady return on interest, usually a fixed rate per year, and at the end of the term, the repayment of the original loan amount. Equity investors, however, must bear a double burden of risk—the capital provided to finance the company will only bear interest if and when a profit has been generated, and ultimately it will only be refunded if liquidation proceeds cover the liabilities.²⁰⁸

This basic distinction allows us to understand the economic justification for voting rights in favor of the shareholders. Voting or control rights can be simultaneously understood as a type of compensation for the risk entered into, and as an incentive to invest. By virtue of the fact that providing equity capital is risky, the equity holders will receive a control device, a tool to at least partially influence the fate of the company and their own funds.²⁰⁹

It is now possible for us to understand the impact of risk-decoupling activities on the financing structure of the company. Risk-decoupled shareholders can be described as shareholders who reduce the

206. Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 761 (1997).

207. EILÍS FERRAN, *PRINCIPLES OF CORPORATE FINANCE LAW* 19 (2d ed. 2008).

208. Moreover, the claim to dividend payments is subject to management discretion. *See* Bond v. Barrow Haematite Steel Co., [1902] 1 Ch. 353. For more detail, see FERRAN, *supra* note 207, at 251; *see also* LOUISE GULLIFER & JENNIFER PAYNE, *CORPORATE FINANCE LAW – PRINCIPLES AND POLICY* 13 (2011).

209. *See* Shleifer & Vishny, *supra* note 206, at 750, 761.

inherent risk of the equity financing and, ideally, eliminate it completely. They want the best of both worlds. On the one hand, they want to be equity investors with ownership of the company's shares and control rights; on the other hand, they want the risk profile of an external debt investor without giving up their control rights, which are not provided for by the statutory system. In an extreme situation, a fully risk-decoupled shareholder can even reach the "best of three worlds" when they—in their position as shareholder, and with the risk profile of a debt holder—attract additional financial benefits from participating in a competitor (as in the *Mylan-Perry* example²¹⁰).²¹¹

The result is a contradiction between values. Economically, according to the above principles, a risk-decoupled share is more akin to debt than equity, but legally speaking, a risk decoupler remains a shareholder (of an empty shell) and retains the voting right.

In other words, the shareholder attempts to strip off the risk which is characteristic of equity investment, while formally remaining a shareholder. Herein lies the problem: according to the principles discussed above, shareholders are given the right to vote simply by virtue of the fact that they carry a distinctive economic risk. If this risk is eliminated, the justification for the assignment of voting rights disappears. For risk-decoupled shareholders, the legitimacy of exercising voting rights no longer exists.

Viewed in the broader context, scholars have long argued that shareholders bear the residual risk of the firm.²¹² That is, if the enterprise fails, shareholders only have a claim to what remains after all other constituencies are satisfied. This position of residual risk bearer provides shareholders with the (relatively speaking) best incentives to make the company profitable for their own interest. It also justifies granting them the right to make strategic decisions for both the benefit of the company and the economy as a whole.²¹³

This insight supports the point made here: If the risk exposure is the real justification for shareholders entitled to vote at all, this justification disappears where the shareholder is able to eliminate that risk. A risk-free shareholder cannot fulfill the function of the vote—to express the best possible decision for the strategic direction of the company. A risk-free shareholder will always exercise his voting rights for purely selfish

210. See *supra* text accompanying note 29.

211. Cf. The Use of Shareholder Voting Rights During the General Assembly of Company Shareholders, PARL. EUR. DOC. IP/A/ECON/2008-32, at 9 (2009).

212. EASTERBROOK & FISCHER, *supra* note 157, at 68; Alchian & Demsetz, *supra* note 165.

213. See sources cited *supra* note 212.

and potentially detrimental social considerations. The right to vote in this way loses its positive function, while a rational actor would exercise it in the spirit of the firm community. It potentially becomes an instrument prone to abuse, leading to self-benefit.

V. SOLUTIONS

Ever since risk-decoupling strategies have become known to the wider public and generally increased in significance, lawmakers and regulators have been looking for solutions. In 2007, then SEC Chairman Christopher Cox indicated that the various risk-decoupling strategies are “almost certainly going to force further regulatory response to ensure that investors’ interests are protected. This is already a serious issue and it is showing all signs of growing.”²¹⁴ Following up on this announcement, the SEC conducted a public consultation on the topic in 2010 in order to anticipate eventual regulation.²¹⁵ Likewise, the new European market authority, ESMA, has launched a consultation that assesses the case for regulatory intervention.²¹⁶

For several years, regulators in various jurisdictions have attempted to find answers to the multifaceted problems and conflicts. The following analysis does not discuss these attempts, but rather proceeds to examine the problem from the vantage point of each particular regulatory technique. All possible regulatory models are structured, assessed, and compared. They will be seen in the specific legal context of the European Union. The goal is to ultimately develop the most desirable regulatory response for EU institutions.

A. *Doing Nothing*

Any discussion of regulatory intervention begins with the option of doing nothing. It has become the standard in modern legislative “impact assessments” to discuss policy considerations in the context of “no action,” or “to do nothing.”²¹⁷ Thinking about this option is a helpful exercise. It shows the regulator what happens if no regulatory action is taken, and prevents the regulator from jumping into the various interventionist

214. Kara Scannell, *How Borrowed Shares Swing Company Votes – SEC and Others Fear Hedge-Fund Strategy May Subvert Elections*, WALL ST. J., Jan. 26, 2007, at A1.

215. Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42981, 43019 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275).

216. ESMA, *supra* note 132.

217. See for instance the famous impact assessment by the European Commission, Impact Assessment on the Directive on the Cross-Border Transfer of Registered Office, PARL. EUR. DOC. (SEC 1707) 3.5 (2007).

approaches without reflecting on whether the problem needs regulatory intervention in the first place. This forces the regulator to justify its final choice.

1. Immediate Consequences

In connection with the subject matter under consideration here, doing nothing would ultimately mean “nonregulation” of the various risk-decoupling constellations. Consequently, shareholders and investors could, as before, freely dispose over voting rights and economic risk. A few comments in the literature seem to be pointing toward that direction. For example, the eminent American academic Henry Manne argued nearly fifty years ago that the free exchange of voting rights would benefit shareholders in much the same way the exchange of goods brings welfare gains to other areas of the economy.²¹⁸ In a similar vein, Robert Clark advocated in 1979 that the free trade of votes in a company should be permitted.²¹⁹ According to Clark, the advantage of such an approach lies in the possibility of overcoming the free rider problem—an unrestricted accumulation of voting rights would allow shareholders to gain greater influence in the company and to exert stronger influence over management. Diversified, passive retail investors who are not interested in exercising control over management could thus forgo their voting rights and clear the way for others. This way, the apathy problem resulting from dispersed shareholder ownership could be overcome.²²⁰

In the United Kingdom, former City Minister Lord Paul Myners made policy recommendations in favor of readjusting the relationship between voting rights and share ownership.²²¹ In a number of reports, Lord Myners emphasized the need for a differentiated weighting of shares in order to encourage institutional investors to take up their ownership role more seriously.²²² According to his view, additional voting rights for long-term shareholders could create a more sustainable investment culture. This would remedy the perceived short-term orientation of investors during the global financial crisis. Lord Myners stigmatized the

218. Manne, *supra* note 180 at 1428.

219. Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776 (1979).

220. *Id.* at 793.

221. At the time, the “City Minister” was a Financial Services Secretary to the Treasury, thus a U.K. government official responsible for the City of London.

222. *Leading Questions: Interview of Lord Paul Myners* (BBC television broadcast Aug. 1, 2009).

current situation with the notion of the “ownerless corporation.”²²³ This suggestion has initiated a lively debate over the desirability of such differentiated voting rights. A few commentators gave a positive response,²²⁴ but the dominant view (particularly among institutional investors) expressed skepticism and outright rejection of the proposals.²²⁵ Lord Myners later went on to suggest an even more radical proposal by recommending that shareholders be given the ability to buy and sell their voting rights independently from their shareholding, namely, a complete separation of ownership and voting rights.²²⁶ According to this plan, shareholders who never vote could sell their voting rights to others who do want to vote. Again, reactions to this suggestion were negative.²²⁷ Finally, he proposed introducing the option of new nonvoting shares to existing shareholders, allowing them subsequently to concentrate their engagement with the company on either a voting or nonvoting position, thus fostering their identification with the company.²²⁸ It has to be noted that Myners’s remarks were delivered at the height of the global financial crisis and in the context of growing fear that liberal takeover laws could put British firms at an increased risk of falling into foreign hands. This fear is exemplified by Kraft’s takeover of the British company Cadbury.²²⁹ Lord Myners insisted that these fears were not merely xenophobic²³⁰, but it is well known that an effect of the crisis led an overwhelming number of Western economies to drift toward protectionist tendencies.²³¹ Ultimately, the proposals have not resulted in legislation in the United Kingdom.

These discussions from academia and politics lead, to a varying degree, into a liberalization of the relationship between share ownership and voting rights. The aforementioned reflections cannot simply be criticized as merely too “market believing.” However, it is obvious that they

223. Jane Croft & Kate Burgess, *Myners’ Two-Tier Shares Plan Under Fire*, FIN. TIMES, Aug. 3, 2009, at 1.

224. William Allen, *Disproportionate Voting Rights May be the Way to Better Governance*, FIN. TIMES, Aug. 4, 2009, at 8.

225. Kate Burgess, *Investors Wary of Myners’ Idea on Voting Rights*, FIN. TIMES, Aug. 4, 2009, at 16; Jonathan Russell, *ABI Leads Attack on Myners Over Shareholder Reform*, SUNDAY TELEGRAPH, Aug. 2, 2009, at 1.

226. William Hutchings, *Myners Proposes Sale of Voting Rights*, FIN. NEWS (Aug. 10, 2009), <http://www.efinancialnews.com/story/2009-08-10/myners-proposes-sale-of-voting-rights>.

227. Sam Jones, *Big Investors Cool on Myners’ Idea of Trade in Voting Rights*, FIN. TIMES, Aug. 11, 2009, at 1.

228. Tony Tassell, *Myners Eyes New Non-Voting Shares*, FIN. TIMES, Aug. 14, 2009 at 16.

229. Jill Treanor, *Too Many UK Firms Fall into Foreign Hands, Warns Crusading Myners*, GUARDIAN, Sept. 24, 2009, at 31.

230. *Id.*

231. See COMPANY LAW AND ECONOMIC PROTECTIONISM, *supra* note 161.

rely on two basic and implicit assumptions. First, they seem to assume that market forces are strong enough to form adequate prices for both full shares and mere voting rights. Second, it is assumed that the decoupling of shares and voting rights does not create other distorting effects. Already the first of these two assumptions, however, is not free from doubt. To be sure, the example of preference shares illustrates how the market price can adequately reflect the different voting entitlements of classes of shares.²³² However, the example of the extremely low borrowing fee²³³ for shares in the context of securities lending over the record date, as discussed above, casts doubts over the ability of the market to reflect the value of voting rights in all situations.²³⁴ There are good reasons to believe that lenders are faced with a free-rider problem in a way that they could expect remaining shareholders to vote, and thus entrust their own shares to the borrower at a fee that is too low.²³⁵

Additional questions arise when the perspective shifts from the pricing process of voting rights to the consequences felt by other market participants. Even if the pricing process works properly and produces efficient outcomes between the two parties, it imposes costs onto third parties such as shareholders and investors.

2. Self-regulation

A liberal market solution may have other advantages. The Coase theorem teaches us that market participants will enter into their own bargaining process and produce separate solutions based on their private autonomy.²³⁶ Can we expect such a solution to occur in the context of risk decoupling?

A few examples may make us optimistic.²³⁷ Consider the situation in the United States, where the business world has been waiting for long time for the SEC to act in response to risk-decoupling strategies.²³⁸ In the meantime, companies themselves have begun to impose disclosure obligations in their own bylaws in order to force publicity over decoupled shareholders.²³⁹ For example, Delaware-incorporated Pfizer, Inc. amend-

232. For detail on preference shares, see GULLIFER & PAYNE, *supra* note 208.

233. See Christoffersen et al., *supra* note 65, at 2912.

234. For a similar discussion, see Yermack, *supra* note 141, at 113.

235. Gregor Bachmann, *Rechtsfragen der Wertpapierleihe*, 173 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT 596, 613 (2009) (Ger.).

236. See Coase, *supra* note 197.

237. Lee, *supra* note 28.

238. *Id.* at 906.

239. Phred Dvorak, *Companies Alter Bylaws to Pry Data Out of Activists — Pfizer and Others Seek Better Understanding Of Investors' Motives*, WALL ST. J., July 14, 2008, at B4.

ed its bylaws in 2008 so that each shareholder who initiates a shareholder resolution, or an election of directors is obliged to make specific disclosures about their risk exposure.²⁴⁰ The amended, decisive part of the bylaws now reads as follows:

A Proponent's notice to the Secretary shall set forth as to each matter the Proponent proposes to bring before the annual meeting:

. . . .

(f) a description of any agreement, arrangement or understanding (including any derivative or short positions, profit interests, options, hedging transactions, and borrowed or loaned shares) that has been entered into as of the date of the Proponent's notice by, or on behalf of, the Proponent or any of its affiliates or associates, the effect or intent of which is to mitigate loss to, manage risk or benefit of share price changes for, or increase or decrease the voting power of the Proponent or any of its affiliates or associates with respect to shares of stock of the Corporation, and a representation that the Proponent will notify the Corporation in writing of any such agreement, arrangement or understanding in effect as of the record date for the meeting promptly following the later of the record date or the date notice of the record date is first publicly disclosed.²⁴¹

Sara Lee Corporation, an American consumer goods manufacturer, similarly changed its bylaws²⁴²:

Section 10(3)

Any stockholder's notice [for proposals to the general meeting] shall set forth . . . (iii) as to the stockholder giving the notice, any Proposed Nominee and any Stockholder Associated Person,

. . . .

(C) whether and the extent to which such stockholder, Proposed Nominee or Stockholder Associated Person, directly or indirectly (through brokers, nominees or otherwise), is subject to or during the last six months has engaged in any hedging, derivative or other transaction or series of transactions or entered into any other agree-

240. See also the suggestions by Lee, *supra* note 28, at 907.

241. Pfizer, Inc., By-laws as Amended June 25, 2008 (Form 8-K) (June 26, 2008), available at <http://www.sec.gov/Archives/edgar/data/78003/000007800308000142/pf8k0625.htm>. In 2010, the provision was slightly modified. See *By-laws as Amended April 22, 2010*, PFIZER, INC., available at <http://www.pfizer.com/files/investors/corporate/bylaws.pdf> (last visited Nov. 10, 2012).

242. See Matt Andrejczak, *Sara Lee, Coach Set Rules to Spot Shareholder Actions*, MARKET WATCH (Apr. 2, 2008), http://articles.marketwatch.com/2008-04-02/news/30698380_1_corporate-governance-corporate-governance-stockholder.

ment, arrangement or understanding (including any short interest, any borrowing or lending of securities or any proxy or voting agreement), the effect or intent of which is to

. . . .

(x) manage risk or benefit of changes in the price of Company Securities for such stockholder, Proposed Nominee or Stockholder Associated Person, or

(y) increase or decrease the voting power of such stockholder, Proposed Nominee or Stockholder Associated Person in the Corporation disproportionately to such person's economic interest in the Company Securities.²⁴³

In the meantime, other American corporations have introduced proposals to amend their bylaws.²⁴⁴ Just like the two passages cited above, the proposals would impose a comprehensive disclosure duty for every contractual arrangement, or even a tacit agreement, that decouples or intends to decouple voting right and economic risk. The disclosure duty applies only in a very specific situation, however: where the shareholder, on her own initiative, makes proposals for the agenda of the general meeting (this may be for the appointment of managers or any other resolution). These initiatives are rare in the U.S. corporate context. This is rare because, first, difficult legal and financial hurdles exist and, second, because the highly dispersed ownership means that it is very difficult to convince other shareholders to vote and to support an initiative. Only rarely will the shareholder be engaged in a "proxy fight," where activist shareholders compete with management (or other shareholders) to secure a maximum of proxies from other investors with the aim of reaching a majority for a specific resolution.²⁴⁵ All in all, the proposed amendments to bylaws of U.S. corporations will apply only in very limited circumstances, and are therefore of limited importance.

An alternative strategy of self-regulation might be more promising. The hedge fund industry in its entirety will not be interested in a development where singular events of risk decoupling are associated with the entire business sector. For this reason, the Hedge Fund Working Group,

243. See *Bylaws*, SARA LEE (June 30, 2011), http://www.saralee.com/~media/SaraLeeCorp/Corporate/Files/PDF/OurCompany/Bylaws_amended_063011.ashx.

244. See Alexia Robinson, *Addressing the Issue of Derivative Disclosure in Advance Notice Requirements*, RESEARCH SPOTLIGHT (Dec. 16, 2008), https://www.sharkrepellent.net/pubs/rs_20081216.html (providing a statistical overview).

245. See April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009).

an association of the hedge fund industry, conducted a consultation in 2007 which led to an instrument of self-governance.²⁴⁶ Aside from deliberate self-regulation, the threat of legal action may have played a role in initiating the document.²⁴⁷ The resulting Code of Conduct, entitled “HFSB Standards,” was adopted by the Working Group in 2008, and is now administered by the Hedge Fund Standard Board.²⁴⁸ It can be adopted by individual hedge funds on the basis of a “comply or explain” approach.²⁴⁹ The Code also takes on risk decoupling and securities lending:

A hedge fund manager should not borrow stock in order to vote. The HFSB acknowledges that there might be specific situations where it should be acceptable to vote on borrowed stock, e.g. when a fund is invested in shares (and the trade has settled), but the shares have not transferred into their name.²⁵⁰

As welcoming as the Code may be, it is nonetheless unsatisfactory in many respects. In principle, it seems positive that it discourages voting of borrowed shares generally, even though exceptions are available. However, several points are problematic. First, this code only covers one part of the entire risk-decoupling problem—that of securities lending. The Code seldom mentions the other aspects of the problem.²⁵¹ Second, the Code of Conduct is only voluntary in character, and can be disregarded when a sufficient explanation is given.²⁵² And third, after its adoption, the hedge fund community has become disappointed with its success. Only thirty-four hedge funds (out of a potential 1000 candidates) signed up for it.²⁵³ Out of these thirty-four hedge funds, fourteen had initially been responsible for the project. These numbers have been noticed at a hearing in the House of Commons, which has drawn consid-

246. Press Release, Hedge Fund Working Grp., Hedge Fund Working Group Focuses On Valuation And Risk Management Standards (Jan. 22, 2008), http://www.hfsb.org/sites/10188/files/hfwg_press_release_22_jan_08.pdf.

247. See James Mackintosh, *UK Draws Up Code for Hedge Funds*, FIN. TIMES, Oct. 11, 2007, at 1.

248. The current standards date from 2012. HEDGE FUND STANDARDS BD., THE HEDGE FUND STANDARDS (2012), available at http://www.hfsb.org/sites/10188/files/hedge_fund_standards_-_february_2012.pdf.

249. *Id.* para. 1.1.

250. *Id.* para. 28.

251. Symptomatically, the parties could not agree on a common position for the parallel problem of hidden ownership. See *id.* para. 27.

252. On self-regulation in this context more generally, see Marco Lamandini, *Self-Regulation – What Future in the Context of Hedge Funds?*, in RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS 244 (Phoebus Anthanassiou ed. 2012).

253. Kit Chellel, *Slammed Hedge Funds Shun Code to Await Make-or-Break EU Directive*, LAWYER, Oct. 26, 2009, at 13.

erable attention.²⁵⁴ Overall, most parties agree that the Code is not a successful project.²⁵⁵ This unsuccessful attempt at self-regulation by the hedge fund industry has ultimately paved the way for regulation of the industry through the infamous EU directive on alternative investment funds.²⁵⁶ This directive, however, does not contain a single provision on the whole subject matter of risk decoupling.²⁵⁷

Specifically for the field of securities lending, legislative inactivity may lead to other, unwanted consequences. Where self-regulation attempts do not bear fruit, securities lenders will lose their confidence in the market altogether, and thus reconsider their lending business. Evidence supporting this development has already surfaced: A number of lenders have started to appoint a special supervisor to ensure that the securities they lend out are given to responsible business participants.²⁵⁸ Others, in particular institutional lenders, are reported to have stopped their lending business altogether.²⁵⁹

Whether this trend is indeed affirmed may be doubted. The incentives for lenders appear too lucrative, and they stand too rationally apathetic towards an exercise of their voting rights.²⁶⁰

The data provided by the National Association of Pension Funds (NAPF) has shown that the lending business of British pension funds has remained relatively stable between 2006-2011, and even increased during 2011. In 2011, only 21% of surveyed pension funds stated that they would never lend any shares. In 2010, the figure had been 47%. The proportion of funds that never call back shares at a vote has increased significantly (2010: 16%; 2011: 28%).

254. See James Mackintosh, *MPs Grill Fund Managers on Bank Shorting*, FIN. TIMES, Jan. 28, 2009, at 2.

255. See Chellel, *supra* note 253.

256. Council Directive 2011/61/EU, art. 53(1), 2011 O.J. (L174/I) (EC).

257. See *supra* note 19.

258. Amanda Gerut, *Emerging Practices in Securities Lending and Proxy Voting Nexus*, BOARDIQ, Apr. 3, 2007; see also Hu & Black, *supra* note 8, at 896 (quoting a statement by CalPers, the largest Californian pension fund).

259. Hu & Black, *supra* note 8, at 897; see also Yvan Allaire & Mihaela Firsirotu, *Hedge funds as "Activist Shareholders": Passing Phenomenon or Grave-Diggers of Public Corporations?* 8 (Mar. 2, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=961828>.

260. Hu & Black, *supra* note 8.

Table 2: Securities Lending Activity by Pension Funds in the United Kingdom

	2006	2007	2008	2009	2010	2011
Never lend stock	36%	41%	25%	44%	47%	21%
Do carry out lending activity	64%	59%	75%	56%	53%	79%
<i>Recall stock for contentious resolutions only</i>	41%	36%	34%	29%	32%	38%
<i>Recall stock for all resolutions</i>	3%		4%	9%	3%	3%
<i>Never recall stock</i>	20%	23%	33%	18%	16%	28%
<i>Don't know</i>			4%		3%	10%
Number of respondents	39	39	53	45	38	39
Source: NAPF Engagement Surveys: pension funds' engagement with companies 2006-2011; own calculations						

3. Conclusion

The option to do nothing would liberalize the relationship between shares and voting rights. It is doubtful whether this approach is adequate for this subject matter. None of the self-regulation approaches presented here have been ultimately successful. Furthermore, it must be noted that the market does not seem positioned to properly price a separation of risk and voting rights.

B. Ban and Restriction

At the opposite end of the regulatory strategy spectrum lies the possibility of banning risk decoupling, either comprehensively or partly. In view of the fundamental problems and high costs that result from risk decoupling, this may seem a palatable approach to the phenomenon.

1. Ban on Decoupling

In academic circles, U.S. scholars Robert Thompson and Paul Edelman have advocated the option of banning risk-decoupling strategies.²⁶¹ Both scholars propose to introduce a comprehensive and manda-

261. Thompson & Edelman, *supra* note 182.

tory “one share, one vote” standard, supporting a ban on agreements that would circumvent or decouple this standard and ultimately favor an explicit restriction on vote buying.²⁶² These claims are supported by a theory that understands corporate voting as a mechanism of error correction for management decisions.²⁶³ The authors reject less restrictive solutions, which they argue are inadequate.

The suggestion of banning risk-decoupling strategies has appeared in discussions over possible reform in the form of the European Transparency Directive.²⁶⁴ The Mazars report commissioned by the European Commission, recommends the adoption of a ban as the only truly effective solution. However, the report acknowledges that the Transparency Directive is probably not the right legal tool to effectuate such a ban.²⁶⁵ The report distinguishes between two main strategies. The first is to restrict risk-decoupling phenomena, and the second is to ban risk-decoupling phenomena.

A classical strategy would be to require shareholders who have lent their shares to *recall them* before any general meeting. The report acknowledges, however, that there are limits to this option: first, it would be generally considered burdensome; second, it may be overreaching, as it would prevent stock lending at the time of the general meeting, whereas it is not the stock lending per se which is wrong but rather the use of borrowed shares to vote; third, this option would only address empty voting based on stock lending and would thus be limited in scope.²⁶⁶

A more radical system would be to ban empty voting altogether. In particular, voting with borrowed shares (or shares held under a temporary transfer agreement or pursuant to a scheme having a similar impact) could be prohibited. The report supports this solution as the most consistent decision to be taken in view of the principles at stake.²⁶⁷

Each variant of a regulation to ban, however, faces serious concerns.

First, any regulatory ban may be both under-inclusive and over-inclusive. Every decision to ban a certain product is a two-dimensional black-and-white solution, which does not provide leeway for a nuanced response to the specific problem at stake in individual risk-decoupling situations. Either the risk-decoupling activity is permitted, or it is not,

262. *Id.* at 158.

263. *Id.* at 135.

264. Council Directive 2004/109, arts. 44 & 95, 2004 O.J. L390/38 (EC).

265. MAZARS & MARCCUS PARTNERS, *supra* note 47, at 131.

266. *Id.* at 131–32.

267. *Id.* at 132.

there is no ground for an intermediate solution. Differentiated responses developed through a holistic approach, with regard for the specific and individual problem at stake, are not impossible. Such a regulatory structure will not yield satisfactory responses where the problem is neither black nor white, but grey. This may be the case where shareholders have reduced their risk exposure with the help of derivatives only partially, but not entirely. In consequence, difficult questions arise about the exact limits of this regime. Several questions remain: Should the ban only apply to situations where shareholders have reduced their risk entirely? How about situations where some residual risk remains? Which limit should apply to permissible hedging?

The second concern over a statutory ban relates to enforcement.²⁶⁸ A comprehensive ban on risk-decoupling structures will be difficult to control and enforce.²⁶⁹ This aspect has already been highlighted in the discussion of the one share, one vote standard a few years ago.²⁷⁰ The main problem is the possibility of circumventing the legally fixed regulation. The financial industry is notoriously well known for inventing new products within ever narrowing horizons.²⁷¹ In this way, new structures allow for the creation of economically similar results. Alternatively, opportunities for circumventing regulations arise where derivatives can be configured that do not reference the full value of the underlying securities, but rather only refer to several economic aspects of them, as is the case for some credit derivatives.²⁷² In the alternative, derivatives could be designed to avoid referencing shares directly, and instead mention the company's assets, which would economically create a similar effect.

Furthermore, it is unclear how regulators could assure that a ban would not impede the economically legitimate and useful activities of a business. Both the trade with borrowed securities and the derivatives businesses undisputedly fulfill serve important functions on the capital markets.²⁷³ The objective of restricting risk-decoupling structures for reasons of corporate governance risks catching innocent, and even desirable, situations, and thus becoming destructive and inefficient overall. To be sure, this problem could be addressed by utilizing various regulatory options. For instance, regulators could implement de minimis thresholds,

268. See Enriques, Hansmann & Kraakman, *supra* note 174, at 55, 60; Burkart & Lee, *supra* note 161, at 4.

269. See Wymeersch, *supra* note 178, at 70.

270. See Ringe, *supra* note 161, at 209.

271. Dan Awrey, *Complexity, Innovation and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. (forthcoming 2013).

272. Wymeersch, *supra* note 178, at 1573.

273. See *supra* Parts III.C.2 and III.C.1.

the surpassing of which would trigger the ban, or they might design person-related regulation, which only captures already existing shareholders. Nevertheless, a prohibitive system will always risk being over-inclusive, and thus hit economically desirable activities.

The British investment fund Hermes proposed a regulatory regime that should address the problem of voting with borrowed shares. According to Hermes, such an activity should be counted as market manipulation.²⁷⁴ This solution surely would have the advantage of not directly banning securities lending or restricting them in any way; it would only target the exercise of the voting rights. Nevertheless, this proposal has been heavily criticized. In 2004–2005, an independent investigation in the United Kingdom reported that such a regime would be highly impractical.²⁷⁵ According to Lord Myners, the chairman of the investigation, the fungibility of shares is the central problem, which makes the enforcement of the ban close to impossible. Lord Myners compared the situation with the payment of a check while insisting that the paid money should not be invested in the defense industry.²⁷⁶ Other than Myners, commentators and practitioners do not see a basis for, and acknowledge practical obstacles for, a prohibition in the sense of the proposal by Hermes.²⁷⁷ Moreover, it has been pointed out that this proposal addresses only part of the entire risk-decoupling dimension and would not extend to an equally effective derivatives structure.²⁷⁸

2. Difficulties for the Record Date Problem

Finally, proponents of a prohibitive regulation must accept that an implementation of such a regulation, albeit difficult to achieve, would be theoretically possible for risk-decoupling structures that rely on the usage

274. Letter from Hermes Equity Ownership Services Responding to ESMA's Call for Evidence on Empty Voting, (Nov. 25, 2011), available at http://www.esma.europa.eu/system/files/hermes_equity_0.pdf. For previously made statements, see Kit Bingham, *Concern Grows Over Borrowed Votes*, FIN. NEWS, May 9, 2005 ("By borrowing shares for voting purposes, a party misleads the market by paying only a stocklending interest rate, not a market price for the shares."); cf. Kara Scannell, *How Borrowed Shares Swing Company Votes – SEC and Others Fear Hedge-Fund Strategy May Subvert Elections*, WALL ST. J., Jan. 26, 2007, at A1.

275. Kit Bingham, *Myners Rejects Calls for Curbs on Stock Lending*, FIN. NEWS (Mar. 21, 2005), <http://www.efinancialnews.com/story/2005-03-21/myners-rejects-calls-for-curbs-on-stock-lending>.

276. "The problem is with the fungibility of shares. It is simply not enforceable. It's like paying your cheque into the bank and saying that you don't want it invested in the defence industry." Bingham, *supra* note 275 (quoting Lord Myners).

277. See, e.g., *id.* (relating comments by David Lapido, the director at Lintstock, a corporate governance advisory service).

278. Jonathon Cohen, *Negative Voting: Why It Destroys Shareholder Value and a Proposal to Prevent it*, 45 HARV. J. ON LEGIS. 237, 253 (2008).

of derivatives and securities lending. However, it appears virtually unworkable for the third of the categories—the exploitation of the record date capture.²⁷⁹ If our legal frameworks intend to retain the record date system in principle, it will be inevitable to see a certain level of divergence between economic interest and voting power. This is simply because the record date and general meeting are separated by a certain—longer or shorter—time period. A prohibition would correspondingly be at odds with the entire system, unless the record date system as a whole is called into question. It lies in this logic that the Mazars report, discussed above, modifies its call for a prohibition when turning to the issue of record date capture. The report advises that lenders of securities should be legally required to call back their shares before the record date.²⁸⁰ Admittedly, however, such a solution would be subject to significant objections. As their proponents accept, such an obligation would be seriously intrusive on the contractual freedom of market participants. Moreover, it can be argued that it would be an inconsistent intrusion because the problem does not lie in borrowing the shares at the moment of the general meeting, but rather in voting with borrowed shares. Finally, the solution only captures part of the risk-decoupling problem (in form of record date capture) and not the deeper issues of share lending more generally and the use of derivatives.²⁸¹ Beyond these arguments, the European Securities Markets Expert Group (ESME) has raised even more serious objections. ESME argues that any positive obligation to call back shares ahead of each general meeting would potentially be disruptive to the market because it may result in the loss of liquidity in a certain stock during the general meeting season.²⁸²

Even if the obligation to call back lent shares is diluted into a legal possibility to call them back, it is doubtful such a move would be successful. This is because the collective action problem on the part of the lenders, as described above in detail,²⁸³ does not give them any incentive to actually recall the shares. Quite the contrary, a rational lender would actually not recall the shares.²⁸⁴

279. See *supra* Part III.C.3. But see Wymeersch, *supra* note 178, at 1573. “Regular and justified practices – voting on the basis of the reference date e.g. – would become forbidden.” *Id.*

280. MAZARS & MARCCUS PARTNERS, *supra* note 47, at 131.

281. *Id.*

282. ESME, *supra* note 47, at 7.

283. See *supra* text accompanying note 76.

284. *Id.*

C. Transparency

Among the solutions proposed for responding to risk-decoupling strategies, transparency plays a key role. In the pages that follow, I argue that transparency is indeed an adequate means to tackle the economic problems associated with risk decoupling; on this basis, a legislative proposal can be developed.

1. Transparency as a Response to Decoupling Problems

As I have shown above, the key problem underlying risk-decoupling structures today is their lack of transparency.²⁸⁵ In particular, information costs for shareholders and external investors are high because risk-decoupling structures are not disclosed to the market. Agency costs are incurred without the market knowing the level of risk exposure company actors face. Risk-decoupled shares are not priced adequately, which differs from other instruments that attempt to overcome the debt-equity divide, such as preference shares, due to a lack of transparency.²⁸⁶

In addition, a disclosure obligation would most certainly deter hedge funds and other savvy investors from entering into risk-decoupling structures in the first place. That is, the private benefits that are pursued and the agency costs that are produced are only seen as an attractive business model for some market actors for the very reason that they can be pursued unnoticed on the market. Disclosing these strategies could result in negative reputational consequences. Moreover, other shareholder groups can react: they can form alliances, propose counter-measures, etcetera; and ultimately they can sell—the strongest and easiest reaction to a problem in the company.

Finally, we have seen that one of the current problems with risk decoupling is that many regulators across the world are unsure about the extent of their occurrence in daily life. An obligation to disclose risk-decoupling structures would give regulators an idea of their pervasiveness in practice and would help to assess the case to take additional steps.

The idea of responding to the risk-decoupling phenomenon with increased disclosure obligations thus has strong appeal. In addition to these initial reflections, information and disclosure obligations are always a less restrictive regulatory intervention when compared with prohibition laws. This choice of legal instrument would therefore also be preferable under proportionality considerations.²⁸⁷ Not surprisingly, therefore, many

285. *See supra* Part IV.

286. *See supra* text accompanying note 232.

287. For the principle of proportionality in the European context, see TFEU, art. 5(4).

commentators in academia and practice have advocated for a transparency-based solution to the problems described in this article. In particular, the early, tentative comments from the literature suggested—due to the still prevailing uncertainty about the extent, significance, and weightiness of the issue—to tighten transparency requirements as an initial step.²⁸⁸ These commentators hoped for a gentle and cautious approach to the problem and expected to gain access to more information in order to measure the extent of risk-decoupling activity in the market and to assess potential follow-up measures.²⁸⁹

2. Legislative Activity

In the first instance, lawmakers have reacted by realizing that the disclosure system plays a key role in the overall problem. For example, France was among the first jurisdictions to respond to the perceived empty voting problem by modifying its existing disclosure law in 2010. The new provision addresses the problem of risk decoupling in the form of securities lending.²⁹⁰ A law enacted on October 22, 2010,²⁹¹ inserted a new article, Article L225-126, into the Code de commerce.²⁹² The article

288. Hu & Black, *supra* note 8, at 875; Hu & Black, *supra* note 29, at 1047; Hu & Black, *supra* note 28, at 359; Kahan & Rock, *supra* note 23, at 1077; Anish Monga, *Using Derivatives to Manipulate the Market for Corporate Control*, 12 STAN. J.L. BUS. & FIN. 186, 216 (2006); see also MICHAEL SCHOUTEN, THE DECOUPLING OF VOTING AND ECONOMIC OWNERSHIP 49 (2012); Holger Fleischer, *Finanzinvestoren im ordnungspolitischen Gesamtgefüge von Aktien-, Bankaufsichts- und Kapitalmarktrecht* [2008] ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 185, 217.

289. See, e.g., Hu & Black, *supra* note 8, at 886 (“Disclosure should also provide the information required to assess the need for further empty voting reforms.”).

290. See *supra* Part III.C.2.

291. *Loi 2010-1249 du 22 Octobre 2010 de Régulation Bancaire et Financière*, JOURNAL OFFICIEL DE LA REPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Oct. 23, 2010, at 18,984. On this new law generally, see Michel Storck & Jérôme Lasserre Capdeville, *Panorama Général de la Loi de Régulation Bancaire et Financière*, 250 PETITES AFFICHES 3 (2010) (Fr.).

292. The key passage of Article L225-126 reads:

[T]oute personne, . . . qui détient, seule ou de concert, au titre d’une ou plusieurs opérations de cession temporaire portant sur ces actions ou de toute opération lui donnant le droit ou lui faisant obligation de revendre ou de restituer ces actions au cédant, un nombre d’actions représentant plus du deux-centième des droits de vote, informe la société et l’Autorité des marchés financiers, au plus tard le troisième jour ouvré précédant l’assemblée générale à zéro heure, heure de Paris, et lorsque le contrat organisant cette opération demeure en vigueur à cette date, du nombre total d’actions qu’elle possède à titre temporaire

An English translation is as follows:

[A]ny person . . . who holds, alone or together, under one or more temporary transactions or any transaction entitling him or requiring him to sell or return the share to the transferor, a number of shares representing more than two-hundredth of the voting rights, informs the company and the AMF no later than the third business day preceding the gen-

stipulates that every shareholder holding borrowed shares, or shares from a similar transaction, that surpasses 0.5% of the voting rights of the issuer must disclose this fact to the issuer and to the French supervisor *Autorité des Marchés Financiers* (AMF).²⁹³ During the legislative process, the 0.5% threshold has been very controversial and modified several times.²⁹⁴ The disclosure obligation arises at least three days before the date of the general meeting, provided that the lending agreement is still in force on the day of the general meeting.²⁹⁵ In addition to the number of shares acquired by way of this transaction, the disclosure needs to include: the identity of the lender and details about the expiry date of the agreement, its way of operation, and a voting agreement, if any.²⁹⁶ Finally, the issuer has to publish the information.²⁹⁷

Moreover, the new regime provides for drastic sanctions. If the borrower does not comply with the disclosure obligation, the shares will lose their voting entitlement at the general meeting.²⁹⁸ In addition, a court can separately prohibit the exercise of the voting right of a noncomplying shareholder for up to five years. Finally, a shareholder resolution that involved a noncomplying shareholder can be challenged in court and declared invalid.²⁹⁹ This legislative reform draws on the original suggestions of a working group appointed by the AMF and chaired by Yves Mansion.³⁰⁰

eral meeting at midnight, Paris time, the total number of shares held temporarily if when the contract organizing the transaction remains in effect to this date.” (author’s translation).

293. See Bruno Zabala, *Action de Concert et Transparence Préassemblées Générales: Les Nouveaux Equilibres Actionnariaux sous l’Œil du Législateur et de la Cour de Cassation*, 5 REVUE LAMY DROIT DES AFFAIRES [RLDA] 110, 112 (2011) (Fr.).

294. Catherine Maison-Blanche & Antoine Barat, *La Nouvelle Obligation de Transparence sur les Opérations de Détentions Temporaires Avant Tenue des Assemblées: Réflexions Préliminaires*, 1/2 REVUE TRIMESTRIELLE DE DROIT FINANCIER [RTDF] 80, 83 (2011) (Fr.).

295. On this specific aspect of the law, see Hervé Le Nabasque, *Commentaire des Principales Dispositions de la Loi de Régulation Bancaire et Financière du 22 Octobre 2010 Intéressant le Droit des Sociétés et le Droit Financier*, REVUE DES SOCIÉTÉS 547 (2010) (Fr.).

296. For a helpful form, see *Instruction n° 2011-04 du 2 Février 2011 relative aux modalités de communication des opérations de cession temporaire portant sur des actions à l’AMF*, AUTORITE DES MARCHÉS FINANCIERS (2011), available at http://www.amf-france.org/documents/general/9847_1.pdf.

297. CODE DE COMMERCE, [C. COM.] art. L225-126(I) (Fr.).

298. CODE DE COMMERCE, [C. COM.] art. L225-126(II) (Fr.).

299. Zabala, *supra* note 293, at 113.

300. Autorité des Marchés Financiers (AMF), *Rapport sur les opérations de prêt emprunt de titres en période d’assemblée générale d’actionnaires*, (Groupe de place présidé par Yves Mansion, 2008).

The choice of a reference date as the third day before the general meeting corresponds to the French record date.³⁰¹ In this way, the described reform intends to include all temporarily held shares at the moment of the record date and to disclose them to the market. The French business world has accepted this reform, and French institutions have suggested that their new law should serve as a blueprint for a potential European reform directive.³⁰²

The French approach is a first step, but there are several objections. First, it is obvious that the French law deals with only part of the problem: the risk-decoupling problem in the form of securities lending. Because several other decoupling strategies are not included in the regime, the law facilitates arbitrage strategies. In particular, using derivatives for risk-decoupling does not fall under the scope of the French system, and even the potentially problematic trading of shares between the record date and the general meeting remains unregulated.³⁰³ Several other aspects of the new regime are questionable. While the sanction of disenfranchisement applies only where disclosure is omitted, it is not tied to an abuse of the voting right. This has two important implications. First, the regulation seems to allow and even to legitimize the lending and borrowing of shares over the record date (including voting right); the heavy sanction of disenfranchisement applies only where the duty of disclosure is not complied with. Moreover, the choice of a very low disclosure threshold seems flawed because, with a borrowed stake of 0.5% of the voting rights, the potential for abuse of a risk-decoupled position—described above—seems very unlikely to materialize. Second, it seems questionable whether the one-off disclosure duty on the record date gives market participants sufficient information to respond. All of these issues will be revisited in the pages that follow—the proposal section of this Article.³⁰⁴

Beyond this French advance, the European Commission increasingly sees a necessity for an EU-wide transparency obligation. Released by the EU Commission in 2010, the consultation paper on Corporate Governance in Financial Institutions carefully attempts to first ask whether

301. CODE DE COMMERCE, [C. COM.] art. R225-85 (Fr.).

302. For the responses to the consultation by BNP Paribas, see Société Générale, AMF, AFEP (p. 2), Trésor (p. 4) and AFAMI (p. 9f), available at <https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp>.

303. In its response to the proposed reform of the Transparency Directive, the French bank BNP Paribas states that it is not aware of a problem of trading between record date and general meeting. In its view, the record date according to French law is close enough to the date of the general meeting. *See id.*

304. *See* Part V.E.

greater transparency as to the identity of shareholders could help reduce the risk of risk-decoupling structures.³⁰⁵ The majority of respondents support the call for enhanced transparency, for example, in the realm of securities lending.³⁰⁶ At the same time, it had been pointed out that the introduction of a general disclosure obligation would not be an adequate means to solve the entire problem, as it does not focus on the cardinal point of the record date.³⁰⁷ So far, the review process and this suggestion have not triggered any legislative activity.

The consultation paper has displaced the topic from the scope of company law to the field of capital markets disclosure duties. EU officials from the latter area at first graciously accepted the invitation and seemed positive about bolstering regulation. This was the reaction to a conference on the reform of the (capital markets oriented) Transparency Directive, which was held in Brussels on June 11, 2010.³⁰⁸ Building up on an external report,³⁰⁹ a subsequently published EU working document on the reform of the Transparency Directive³¹⁰ discussed various legislative options:

- (1) The first option would require borrowers of shares to disclose and specify that they hold their shares as borrower (or, more generally, under a temporary transfer agreement). This would be a simple solution, but, as the Commission acknowledges itself, it would not address all decoupling issues.³¹¹
- (2) Specifically addressing the problem of record date capture, the Commission discussed whether to introduce a requirement that any sale of shares above a certain threshold (or other reduction in the net economic exposure of a shareholder of record) between the record date and the date of the general meeting should be immediately notified to the issuer and to the market in such a way that the relevant

305. *Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*, COM (2010) 284 final (June 2, 2010), question 5.3.

306. *See generally* EUROPEAN COMM'N, FEEDBACK STATEMENT OF THE EUROPEAN COMMISSION ON THE SUMMARY OF RESPONSES TO COMMISSION GREEN PAPER ON CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS (2011), available at http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf.

307. *Id.* at 18.

308. *Cf.* Claire Bury, Closing Remarks at the Conference on the Reform of the Transparency Directive (June 11, 2010) (on file with the author).

309. MAZARS & MARCCUS PARTNERS, *supra* note 47, at 128

310. *Commission Staff Working Document – The Review of the Operation of Directive 2004/109/EC: Emerging Issues*, SEC (2010) 611 (May 2010) [hereinafter *Commission Staff Working Document*].

311. *Id.* at ¶ 10.19.

information is fully disclosed prior to the date of the general meeting.³¹²

(3) Another solution would be to require the shareholders to immediately disclose any change, above a certain threshold, in their net economic exposure within a certain period of time before and up to a general meeting of shareholders (for instance, during the thirty days preceding a general meeting). This requirement would provide a complete picture of the shareholder base at the time when the information is most meaningful. The Commission acknowledges that such a system would be comprehensive—indeed, it would comprise and go beyond proposal (2)—but that it may be viewed as too burdensome.³¹³

(4) Another way to improve transparency would be to require, as proposed in the Mazars Study,³¹⁴ that the economic exposure of all shareholders, above a certain threshold, be disclosed on the day of the record date, to the extent this net economic exposure was not disclosed pursuant to a previous notification (no double notification should be required if it does not provide new information). This system would be comprehensive and would not be equally burdensome because only one extra notification would be required (subject to updates, which should be limited).³¹⁵

(5) Finally, the European Corporate Governance Forum (the Forum), an advisory body to the Commission, proposed in its February 2010 statement that a borrower of shares should notify the company prior to the general meeting that he does not have the full financial interest in the shares if he intends to exercise his voting rights on the shares. According to the Forum, this duty to notify should apply to positions that correspond to a certain threshold, for example, 1% or more of the outstanding shares with voting rights. Any false or omitted statement in this context should be dealt with under the national rules on misleading information. Furthermore, the Forum recommends introducing a rule that the company and its subsidiaries may only lend the company's own shares if the lending contract stipulates these shares will not be voted upon by the borrower. The company should disclose prior to the general meeting to what extent

312. *Id.* at ¶ 10.15; see MAZARS & MARCCUS PARTNERS, *supra* note 47, at 131.

313. *Commission Staff Working Document*, *supra* note 310, at ¶ 10.20.

314. MAZARS & MARCCUS PARTNERS, *supra* note 47, at 131.

315. *Commission Staff Working Document*, *supra* note 310, at ¶ 10.21.

it and its subsidiaries have lent the company's own shares to third parties.³¹⁶

Overall, none of the papers specifically define what constitutes “net economic exposure.” Deducing the writers’ intentions, we can assume the term refers to the risk a shareholder factually bears with respect to a particular stake in the company, that which results from the regular (positive) risk and the reduced (negative) risk, as potentially following from risk-decoupling mechanisms. In the normal scenario, where a shareholder only holds (long) shares, without additionally having entered into hedging transactions, the net economic exposure will correspond to the positive share position. Where the long position coincides with derivatives transactions in one of the described ways,³¹⁷ this exposure can, however, be reduced. It is important to understand that the Commission’s reasoning seems to be based on the fact that borrowed shares only increase the positive risk, but not the net risk exposure. However, commentators have rightly pointed out that the decisive information relates to the *relationship* between voting rights held by the shareholder and the net economic exposure, the latter alone being little meaningful.³¹⁸ To be sure, the positive risk exposure is to be disclosed according to the regular disclosure rules for large shareholdings,³¹⁹ so that—according to the obvious reasoning by the Commission—the joint information between these two items (long and net short exposure) will yield the decisive information value. In other words, the net economic exposure is only an additional, ancillary piece of information.

The outlined proposals by the Commission and the European Corporate Governance Forum were part of the consultation on the reform of the Transparency Directive, which was initiated in May of 2010.³²⁰ The responses by the consultation participants disagreed on how to respond to this specific problem, which proved inconclusive. Many advocated in

316. European Corp. Governance Forum, *Statement on Empty Voting and Transparency of Shareholder Positions* (Feb. 20 2010), at ¶ 5; see *Commission Staff Working Document, supra* note 310, at ¶ 10.22.

317. See *supra* Part III.C.1.

318. Andreas Merkner & Marco Sustmann, *Wertpapierleihe und Empty Voting – Weitergehender Transparenzbedarf im WpHG?*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT [NZG] 1170, 1174 (2010).

319. Transparency Directive 2004/109/EC, art. 9, 2004 O.J. 109 (EC).

320. *Consultation Document on the Modernisation of the Directive 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market* (2010) EC (May 27, 2010).

favor of more research and factual evaluation.³²¹ Following up on these preparatory steps, the Commission published its official proposal in October 2011.³²² Utilizing the feedback received, the proposal did not contain a direct response to the issue of empty voting—the subject matter of interest. The proposal includes rules for the twin problems of *positive* decoupling³²³ (in particular, hidden stake building with the help of contracts for difference),³²⁴ but it does not address “empty voting” as an example for *negative* risk decoupling mechanisms. At the same time, the center of legal policy was transferred from the Commission to ESMA, the new European market supervisor. The latter body published a “Call for Evidence” in September of 2011 in order to evaluate the case for regulatory intervention in this field.³²⁵ This document cites the preparatory work completed by the Commission and the inconclusiveness with respect to a possible regulatory response.³²⁶ At the same time, it emphasizes the need to strive for a comprehensive solution to the problem.³²⁷ In December of 2011, several responses prompted by the consultation were published.³²⁸ After a thorough investigation, ESMA concluded in June of 2012 that there was no case for regulatory intervention for time being.³²⁹ The ball is back in the Commission’s field, and the reforms of the Transparency Directive are still pending.

3. Costs and Critique

The introduction of new disclosure obligations is always accompanied by additional costs. The most obvious costs are so-called compliance costs, which are simply caused by complying with the new obligations. In addition, we can expect that efforts to access information about new rules, to make them known within a company, and to implement

321. *Commission Feedback Statement on the Summary of Responses to the Consultation by DG Internal Market and Services on the Modernisation of the Transparency Directive (2004/109/EC)*, 23 (Dec. 17, 2010) [hereinafter *Feedback Statement*].

322. *Commission Proposal for a Directive of the European Parliament and of the Council Amending Directive 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Commission Directive 2007/14/EC*, COM (2011) 683 (Oct. 25, 2011), available at http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf.

323. *See id.* at 20 (draft modification of Article 13).

324. *See Kettunen & Ringe, supra* note 9, at 227.

325. ESMA, ESMA/2011/288, CALL FOR EVIDENCE – EMPTY VOTING (2011); *see Kelleher, supra* note 151, at 3.

326. ESMA, *supra* note 325, at para. 9-10.

327. *Id.* at para. 8-12.

328. *Call for Evidence on Empty Voting, supra* note 133 (containing these responses).

329. ESMA, *supra* note 132.

them are costly. Beyond these firm-level costs, legislative activity itself creates costs: resources are spent and civil servants are employed to develop new rules and to monitor compliance. In this particular context, opportunity costs are crucial, including the cost measured in terms of the value of alternatives that are forgone and not chosen.

On the other hand, a new system will create indirect costs. For example, avoidance costs, which are notoriously difficult to quantify. Issuers will be able to avoid securities regulation by not going public. If a company refrains from an Initial Public Offering because of legal requirements that are too far-reaching, and if the company in question accordingly foregoes an otherwise optimal method of financing, then, from an overall welfare perspective, costs will emerge, which are empirically difficult to quantify.³³⁰ In our case, for example, if market participants were to refrain from many securities lending transactions because of new disclosure laws, market liquidity would be seriously impeded.³³¹ Further, indirect costs could result from the disincentive of hedge funds initiating investigations on potential targets. These investigations are useful for the development of efficient capital markets and provide signals to other market participants.³³²

Any exercise that aims to quantify costs arising from regulation faces issues of evaluation. Without going into details here, it is important to bear in mind that costs are created even by seemingly harmless disclosure obligations. For instance, choosing a relatively high, initial disclosure threshold could counterbalance some of the issues raised above. Where disclosure of everyday transactions below a threshold would not be required, the costs could be kept to a minimum. Equally, disclosure would then only really target those situations that potentially lead to potential governance problems.³³³

4. Key Issues of a Transparency Regime

Considering the advantages and direct and indirect costs of a disclosure system provides us with the ability develop a regime that includes certain key features.

330. See Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 J. ACCT. & ECON. 146 (2007).

331. ESME, *supra* note 47.

332. See Financial Services Authority, *Disclosure of Contracts for Differences, Consultation and Draft Handbook Text*, (CP 07/20) annex 1, ¶ 39 (2007); see also Gilson & Kraakman, *Mechanisms*, *supra* note 91.

333. See FSA, *supra* note 332, at annex 1, para. 43.

a. Subject Matter and Addressee

First and foremost, it is important to consider the question of what, precisely, should be disclosed. Common to all the constellations discussed above are the existing shareholders that engage in risk decoupling and thereby create costs for their fellow shareholders and for (external) investors. A regulatory response needs to ensure that all relevant constellations, but also all potentially future cases, are caught. This response requires that we develop a general clause that could encompass all relevant and known constellations. The law might stipulate a nonexhaustive list of examples, which could be a more concrete option. A general clause of this nature needs to be wide enough to cover parallel, future, and not yet known strategies, however.

According to the findings shown above, the key problem arises when: (1) existing shareholders reduce the risk inherent in their shares; and (2) market participants hold their shareholder position only temporarily, for example over the record date. Both situations have to be included in a regulatory response. Common to both is the fact that shareholders do not bear full risk. By contrast, a regulatory rule should *not* encompass nonshareholders who acquire a purely negative interest in shares. This rule could concern investors who engage in short selling over certain securities. It is true that these investors are financially interested in a negative development of the share price, but the situation is not comparable with the circumstances of interest here. A nonshareholder is neither able to influence the voting outcomes of the general meeting in the same way as shareholders, nor able to threaten to use his influence in such a way. The possibility of an intra-company manipulation does not exist in the same manner.

Equally, it follows from the discussion that this paper is not concerned with pure potential conflicts of interest that result from a shareholder's stake in a competitor. Recall that this was the case in the *Mylan-Perry* situation,³³⁴ but it is not the specific problem of interest here. In this instance, we expect that these conflicts will be evened out by random distribution. On the other hand, the fact that shareholders hold a stake in a competing company is a traditional conflict of interest, which is of an entirely different quality than the problems analyzed here. Told differently, the problem of interest here does not result from the conflict of interest, but rather from the distorted incentive underlying the voting right. We will accordingly target the latter because other areas of corporate law specifically dealing with conflicts of interest address the former.

334. See *supra* text accompanying note 29.

b. Disclosure Frequency

The success of a disclosure regime is dependent upon the appropriate moment at which disclosure is fixed to occur. Only timely disclosure will allow market participants to react appropriately.

Several options are feasible. On the one hand, the disclosure obligation could be designed in relation to an event—for instance, the obligation of disclosure arises before the record date³³⁵ or a general meeting.³³⁶ Alternatively, the disclosure obligation could only be applicable to those shareholders who request an item to be placed on the agenda of the general meeting or who request a general meeting be held.³³⁷ On the other hand, the obligation of disclosure could be continuous and steady, triggered whenever a specific and relevant event occurs.

Overall, the latter option—continuous disclosure—is preferable. A singular disclosure obligation leading up to the moment of a general meeting would surely place a minimal burden on investors. Moreover, information on the risk exposure of shareholders is most relevant in the context of the general meeting. After all, it is only at this moment that the much-discussed distortion of voting incentives becomes relevant and concrete.

Nevertheless, three main reasons support a continuous disclosure obligation over the entire business year. First, it is important to consider the short timeframe during which shareholders are expected to adequately respond to disclosed information. If publication occurs only briefly before the general meeting, many shareholders will not be able to react promptly.³³⁸ For example, it will not be possible for shareholders to form a viable opposition against the goals proposed by the risk-decoupled hedge funds. This will certainly be relevant when a disclosure obligation exists immediately before the general meeting, or before the record date. After the record date, shareholders are no longer able to acquire voting

335. See Luca Enriques, Conference on the Operation of the Transparency Directive (June 11, 2010); cf. *supra* text accompanying note 289 (discussing the French law reform from 2010 concerning securities lending).

336. See Deutscher Investor Relations Verband e.V., Response of Deutscher Investor Relations Verband e.V. (German Investor Relations Association) to the EU Commission's Public Consultation on the Revision of the Transparency Directive 10 (Aug. 23, 2010), available at https://circabc.europa.eu/sd/d/b5aff1c8-0a3d-46a9-b41a-cc6e049d7f59/German_Investor_Relations_Association_en.pdf.

337. This will, of course, be subject to the usual hurdles for convening a general meeting. On such a proposal, see Eumedion, Position Paper on the Consequences of Synthetic Structures for Dutch Securities Law and Company Law 10 (Nov. 17, 2008).

338. See, e.g., Jean-François Biard, *Proposition de Loi Relative au Régime des Prêts Emprunts de Titres*, REVUE DE DROIT BANCAIRE ET FINANCIER 155 (2010) (relating to the French reform, as discussed above).

rights; the resistance of regular shareholders who wish to acquire more shares is no longer an issue. As a consequence, there would be a dramatic “exit,” that is, the sale of shares on a big scale. This sale would likely trigger a massive decline of the share price that would not concern the risk-decoupled shareholder in any way. Quite the contrary, a large-scale exit of shareholders would even exacerbate the risk-decoupling problem because these activities would create fresh disparities between voting entitlements and share ownership.

Second, and more importantly, the process of voting at the general meeting is not alone crucial for the effects of risk-decoupling strategies. At this point it is important to reconsider the previous discussions of agency and information costs.³³⁹ As explained above, the costs created by risk-decoupling strategies are incurred at any time, throughout the entire business year. The threat of calling a meeting is one of several options hedge funds have at any given time. Otherwise, a risk-decoupled investor can informally influence the management at any moment, even on an unofficial basis.

Especially for institutional investors and hedge funds, these informal ways of influencing companies, coupled with the threat of exercising their voting power, are often much more important than the vote itself. A constant dialogue, away from the public, will pressure the administration to act in a certain way. This type of influence is always available during and outside of the general meeting. By exercising this power, a risk-decoupled shareholder puts considerable pressure on other shareholders and potential investors alike, both outside the formal meeting and during the entire business year.

Third and relatedly, in some situations the written consent of shareholders can replace formal resolutions. For example, according to Delaware law, if the majority consents in writing, action can be taken without a meeting.³⁴⁰ The same or similar rules exist in several jurisdictions.³⁴¹

c. Disclosure Threshold

It follows from the analysis that relatively high disclosure thresholds are required for an adequate and balanced disclosure regime. This goes hand-in-hand with the assertion that a continuous disclosure obligation is needed. If we require market participants to disclose their negative

339. See *supra* Parts IV.1–IV.2.

340. DEL. CODE § 228 (2009).

341. JAY W. EISENHOFER & MICHAEL K. BARRY, SHAREHOLDER ACTIVISM HANDBOOK 9-8.1 (2011).

interest at all times, we need another filter to single out meaningful disclosure information.

It appears that a reasonably high threshold, such as 5%, is appropriate for several reasons. First, it would better serve the purpose identified here; we are concerned with shareholders who hold a particular stake but at the same time have reduced or eliminated their risk. Only the kind of stake accumulated in the first instance will give a shareholder the necessary voting power to influence the target company, and only a sufficiently high risk elimination will distort her incentives in a meaningful way. Take, for example, a 10% long shareholder who has reduced her risk exposure by one percentage point. She will still be risk-exposed to 9% of the share capital, which is not a significant distortion. The shareholder will not be induced to pervert her shares for a dramatic purpose. It can be argued that significant clout is needed, around 5% of the issued share capital, or more.

Second, a high threshold conforms to our goal of minimizing the administrative costs for market participants.³⁴² Low threshold disclosure rules risk being over-inclusive and force the disclosure of harmless trading activity, which is not intended to influence corporate governance arrangements within a company. In particular, institutional investors might easily cross lower thresholds through normal trading positions.³⁴³

Third, too frequent disclosure of a short position is the downside of encouraging market overreactions. It may trigger herd behavior or accelerate downward movements. That is, if short positions are frequently disclosed, unsophisticated investors are more likely to sell in response to seeing a more sophisticated investor with a short position, exacerbating market declines.³⁴⁴ Finally, the circumstances could reduce market liquidity because investors do not like to reveal their short positions to companies. Thus, these investors prefer to avoid taking short positions altogether.

342. Cf. IOSCO TECHNICAL COMM., REGULATION OF SHORT SELLING – FINAL REPORT, at para. 3.23.5 (2009).

343. In the particular context of short selling disclosure, see *Reflections on the New Pan-European Regime for Short Selling and Credit Default Swaps*, HERBERT SMITH 4 (Feb. 2012), <http://www.herbertsmithfreehills.com/-/media/HS/L230212219.pdf>. On short selling disclosure generally, see *infra* Part V.C.5.

344. EUR. PARL. COMM. ON ECONOMIC & MONETARY AFFAIRS, REPORT ON THE PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS 45 (2009).

5. Coordination with Transparency of Short Selling

In early 2012, the EU institutions adopted a regulation on short selling.³⁴⁵ Following protracted negotiations,³⁴⁶ they agreed on a regulation that introduced a pan-European regulatory approach to short selling.³⁴⁷ In essence, the proposal follows previous work done by CESR³⁴⁸ and IOSCO.^{349 350} The new regime provides for a two-tiered transparency system, encompassing all net short positions that can arise not only through short sales, but also through the use of various derivatives.³⁵¹ The threshold values are 0.2% for a disclosure to the respective national supervisory authority and 0.5% for public release (in both cases plus 0.1 percentage point increments).³⁵² The net short position shall be determined on each trading day at midnight and is to be reported by 3:30 p.m. on the following day.³⁵³ Originally, the EU Commission had also intended that any short sale orders in the daily operations should be labeled as such in order to distinguish them from regular sales orders (flagging principle).³⁵⁴ This area was not included in the final text of the regulation, however.

345. Short selling has been associated during the 2007–2008 crisis with a negative role, allegedly exacerbating a downward trend in the market. *See, e.g.*, Letter from International Organization of Securities Commissions (IOSCO) to the G20 (Nov. 12, 2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD282.pdf>. Generally, on the economic role of short sales, see ESME, POSITION ON SHORT SELLING (2009), available at http://ec.europa.eu/internal_market/securities/docs/esme/report_20090319_en.pdf.

346. *See Commission Proposal for a Regulation of the European Parliament and of The Council on Short Selling and Certain Aspects of Credit Default Swaps*, COM (2010) 482 final (Sept. 15 2010) [hereinafter *Commission Proposal*]; *Council Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps – Text Provisionally Agreed with the European Parliament*, Council Document 16338/11 (Nov. 4, 2011) [hereinafter *Council Proposal*]. On the various drafts, see Emilios Avgouleas, *The Regulation of Short Sales Revisited*, L. & FIN. MARKETS REV. 333 (2011).

347. Regulation 236/2012, of the European Parliament and the European Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps, O.J. (L 86) 1 [hereinafter *Short Selling Regulation*].

348. The Committee of European Securities Regulators (CESR), is the predecessor of the new European regulatory body ESMA. *See supra* note 130.

349. IOSCO is the International Organization of Securities Commissions.

350. CESR, MODEL FOR A PAN-EUROPEAN SHORT SELLING DISCLOSURE REGIME, CESR/10-088 (2010); IOSCO TECHNICAL COMM., *supra* note 342.

351. Short Selling Regulation, *supra* note 347, at recital 10; *see Commission Proposal, supra* note 346, at 6; *Council Proposal, supra* note 346, recitals 6, 9.

352. Short Selling Regulation, *supra* note 347, at arts. 5(1)-(2), 6(1)-(2).

353. *Id.* at art. 9(2).

354. *Commission Proposal, supra* note 346, at art. 6; *see also* CESR, *Proposal for a Pan-European Short Selling Disclosure Regime*, at paras 18–20 (CESR, Consultation Paper 09-581, 2009) (flagging is already required in certain jurisdictions such as Australia, Canada, Japan, Hong Kong and the United States).

Overall, the Commission expects the new harmonized transparency requirements to ensure information on short positions is provided to regulators and that the market is complete and accurate.³⁵⁵ Article 3(1) of the regulation defines a short position as follows:

- (1) For the purposes of this Regulation, a position resulting from either of the following shall be considered to be a short position relating to issued share capital or issued sovereign debt:
 - (a) a short sale of a share issued by a company or of a debt instrument issued by a sovereign issuer;
 - (b) entering into a transaction which creates or relates to a financial instrument other than an instrument referred to in point (a) where the effect or one of the effects of the transaction is to confer a financial advantage on the natural or legal person entering into that transaction in the event of a decrease in the price or value of the share or debt instrument.³⁵⁶

The definition is an attempt to capture all positions that give their holder a negative interest in shares. Of the various constellations examined in this paper, securities lending alone is not captured. In contrast to the original version of the Commission proposal, the regulation explicitly does not cover repurchase agreements (repos), derivatives, or securities lending.³⁵⁷

For the purpose of the current inquiry, it is important to note that the new EU regime (along with other international efforts) approaches the issue of net short positions from a market stability perspective. This accounts for the way the regime introduces relatively low thresholds and for the disclosure of net values. However, the low initial threshold values of net 0.2% and 0.5% have attracted criticism. Market participants have expressed concern over institutional investors, who invest in small or medium-sized enterprises, because they may often exceed the values relatively quickly.³⁵⁸ Accordingly, the Committee on Legal Affairs of the European Parliament called to raise the threshold to 1%.³⁵⁹ As a consequence of these criticisms, the regulation now expressly provides for the possibility that the Commission has the power to adjust the thresholds to

355. *Commission Proposal*, *supra* note 346, at 7.

356. Short Selling Regulation, *supra* note 347, at art. 3(1).

357. *See id.* at recital 17 & art. 2(1)(b).

358. *Reflections on the New Pan-European Regime for Short Selling and Credit Default Swaps*, *supra* note 343, at 4.

359. EUR. PARL., A7/0055/2011, REPORT ON THE PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS 48 (2011).

market realities if necessary, as prompted by ESMA.³⁶⁰ The other problem is the omission of securities lending from the scope of the regulation.

Overall, the thrust of the regulation does not correspond to the regulatory goals defined in this paper. Risk decoupling does not approach the problem from the market stability perspective, but instead it considers corporate governance and investor protection central. As seen above, this implies that a disclosure regulation that aims to remedy risk decoupling will have features that diverge considerably from the Short Selling Regulation.

6. Further Specifications

The following additional suggestions to a disclosure regime are relevant given the comparison to the short selling regime.

a. Gross Position Disclosure

Different from the short selling regime, a disclosure regulation of risk-decoupling strategies would have to reflect *gross* positions and refrain from automatic netting. This reality is based on the following considerations.

As indicated above, the Short Selling Regulation and the risk-decoupling issues presented here rely on different fundamental values. The financial crisis of 2008–2009 inspired the regulation of short sales, and the regulations primarily targeted short sales that may be susceptible to manipulation, investor confidence, and the overall stability of the financial markets.³⁶¹ Lawmakers have been mainly concerned with price stability affected by several activities: (1) the frequent use of short selling; (2) an increased supply of securities in circulation as a result of short sales and thus a self-fulfilling prophecy of falling prices; and (3) the temptation of short sellers to accelerate price decline through a targeted distribution of negative information and even higher price reductions.³⁶² By contrast, the present study looks at investors not from a market stability perspective, but from an intra-company governance perspective. In other words, this paper is preoccupied with individual investor protection, not market stability.

In addition, some fear that circumvention strategies and abuse attempts will result from the netting of long and short positions. In Hong

360. Short Selling Regulation, *supra* note 347, at arts. 5(3)-(4), 6(3)-(4).

361. See CESR, *supra* note 350, at 5.

362. See Jennifer Payne, *The Regulation of Short Selling and Its Reform in Europe*, 13 EUROPEAN BUS. ORG. L. REV. 413 (2012).

Kong, where a disclosure regime for negative interests was introduced in 2003, this was one of the main reasons for insisting on a separate disclosure of long and short positions and for not allowing netting between both sides.³⁶³ Moreover, netted information would be significantly weaker in comparison with separate positive and negative messages.³⁶⁴

What information do shareholders and investors really need? Information on aggregated risk exposure, as required in the Short Selling Regulation, does not satisfy the requirements posed by the information problem developed in this paper. Instead, this paper advocates for a separate (gross) reporting requirement for a negative interest in shares.³⁶⁵ Only when such a disclosure is concurrently applicable with the existing regime of positive interests pursuant to the Transparency Directive will sufficient information be provided to market players. A few examples illustrate this concept.

Example (a) Hedge fund A holds 7% of the shares in the listed company G, which it discloses according to the national law implementing Article 9 of the Transparency Directive. A enters into derivative transactions totaling well over 7 per cent of the shares of G, which eliminate its risk in the shares of G completely. Its “net short position” is zero, so there is no reporting requirement under the Short Selling Regulation.³⁶⁶ From the corporate governance angle developed in this paper, however, it is extremely important for the other shareholders and potential investors of G to learn about this derivatives business. Mindful of the legal and political insights stemming from the perspective of the principal-agent conflict and cost information, as discussed above, a duty to inform the market should be introduced for this scenario.

Example (b) Hedge fund B owns 1% of the shares in G, which is not discoverable under the Transparency Directive. B enters into comparable derivatives transactions in the amount equivalent to 1.5% of the shares in G. The net short position of B is -0.5, so this is to be notified under the new Short Selling Regulation both to the national regulator and to the public.³⁶⁷ But it follows from our reflections above that the reasons of risk decoupling would *not* necessarily require disclosure here. B only

363. *Proposed Amendments to The Securities (Disclosure of Interests) Ordinance – Consultation Conclusions*, SEC. & FUTURES COMM’N 42 (Mar. 1999), <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=98CP4>.

364. *Id.*

365. See Eumedion, *supra* note 337, at 9. *But see* Shareholders.org Response to SEC Concept Release on the U.S. Proxy System, File No. S7 1410, at 7 (Oct. 20, 2010).

366. See Short Selling Regulation, *supra* note 347, at arts. 3(4), 5(1).

367. *Id.* at arts. 5(1), 6(1).

holds a voting power of 1%, which is too small to have a lasting impact on the company's strategy or to pursue or convene a general meeting.

In addition, it is possible that netting the two positions can be misleading or ambiguous. Shareholders and investors who learn about such a notification would be unaware of how strong B's influence in G really is. There is a noticeable difference between a 0.1% shareholder, who holds risk-eliminating derivatives of 0.6%, and a 4.9% shareholder,³⁶⁸ whose risk is reduced by 5.4%. Hence, two separate notifications are much more informative.

Example (c) Hedge Fund C holds a 10% stake in G, which it discloses according to the Transparency Directive. C enters into derivatives transactions amounting to 5% over shares of G, which reduce its risk to that extent, namely, a partial risk elimination. Because C is far from reaching a negative "net short position," a disclosure requirement under the Short Selling Regulation is not required, which is consistent from the perspective of market stability, as there is no incentive for C to artificially bring down the share price of G. Given our considerations here, however, distorted incentives for C's voting decisions arise. The principal-agent theory shows that C will not make optimal decisions for the benefit of all shareholders and potential investors. Because the distortion is significant, comprising five percentage points, the information is crucial to shareholders and investors.

b. Comprehensive Definition

The Short Selling Regulation intends to comprise of all situations of overall prevailing negative interest under the notion of "net short position." This position exists by virtue of Article 3(4) of the regulation: "[A]fter deducting any long position that a natural or legal person holds in relation to the issued share capital from any short position that that natural or legal person holds in relation to that capital." In turn, Article 3(1) defines "short position":

- (a) a short sale of a share issued by a company . . . or (b) entering into a transaction which creates or relates to a financial instrument other than an instrument referred to in point (a) where the effect or

368. This would be just under the initial disclosure threshold for long positions according to article nine of the Transparency Directive. Most EU member states are following this regime, although some have reduced it to 3% or even to 2%. See *Report on More Stringent National Measures Concerning Directive 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market*, SEC (2008) 3033 final, 6. The United States also has a 5% initial threshold. See Securities Exchange Act 1934, Pub. L. No. 73-291, § 13(d), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78j).

one of the effects of the transaction is to confer a financial advantage on the natural or legal person entering into that transaction, in the event of a decrease in the price or value of the share or debt instrument.

The term “financial instrument” is broad and defined in EU Market Infrastructure Directive (MiFID).³⁶⁹

Nevertheless, it is obvious that the regulation provides for a few gaps. Most notably, our cases of share lending or repurchase agreements are explicitly not covered by the regulation.³⁷⁰ After all, the disclosure of a borrowed share position is extremely controversial and treated very differently as between Member States.³⁷¹ The disclosure regime developed here therefore needs to find a coherent approach.

In the quest for the right approach, a law reform in Hong Kong may serve as an illustration of a successful integration of the various aspects of “negative interest.” Already in 2003, Hong Kong introduced a disclosure regime for short positions of all types, with the aim of capturing the economic interests of major shareholders of a company and of making these interests more transparent. For this purpose, the revised Securities and Futures Ordinance (SFO)³⁷² provides that shareholders whose stake exceeds 5% need to disclose if they hold beyond the long position also a short position of at least 1% of the share capital of the same issuer.³⁷³ Long and short positions cannot be aggregated, but they must be specified separately.³⁷⁴ Remarkably, securities borrowing positions are to be explicitly included in the calculation of the short position, since section 308 defines a short position as follows:

‘short position’ (淡倉) means the position which a person has-

(a) where the person is the holder, writer or issuer of any equity derivatives, by virtue of which the person-

(i) has a right to require another person to take delivery of the underlying shares of the equity derivatives;

369. Council Directive 2004/39/EC, annex I, part C, 2004 O.J. (L 145) 1.

370. See Short Selling Regulation, *supra* note 347, at recital 17 & art. 2(1)(b).

371. See, e.g., MAZARS & MARCCUS PARTNERS, *supra* note 47; see also *Feedback Statement*, *supra* note 321, at 41; cf. Wymeersch, *supra* note 178.

372. Hong Kong, China, Securities & Futures Ordinance, ch. 571, L.N. 12 (2003) [hereinafter *Securities & Futures Ordinance*].

373. *Id.* at Part XV.

374. See IOSCO TECHNICAL COMM., REPORT ON TRANSPARENCY OF SHORT SELLING 17 (2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD147.pdf>.

(ii) is under an obligation to deliver the underlying shares of the equity derivatives to another person, if called upon to do so;

(iii) has a right to receive from another person an amount if the price of the underlying shares of the equity derivatives declines; or

(iv) has a right to avoid or reduce a loss if the price of the underlying shares of the equity derivatives declines,

before or on a certain date or within a certain period, whether in any case the right or obligation is conditional or absolute; or

(b) where the person is the borrower of shares under a securities borrowing and lending agreement, by virtue of which the person is under an obligation to deliver shares to another person who has lent shares, if called upon to do so, before or on a certain date or within a certain period, whether or not the obligation to deliver shares is to be settled by payment of cash or by delivery of shares or otherwise.³⁷⁵

Paragraph (a) refers to the various derivatives, whereas paragraph (b) determines that the borrower of shares holds a negative position as well. According to the Securities and Futures Commission (SFC), the Hong Kong market regulator, the borrower of securities may acquire a long and a short position at the same time, so he may be required to issue a double notification.³⁷⁶ A number of exceptions are stipulated.³⁷⁷

In summary, the different points developed here will be elaborated into a concrete legislative proposal further below.³⁷⁸ For now, we can summarize that we have identified the need for a: (1) continuous disclosure obligation (2) by existing shareholders, who hold a sizeable long position, such as 5% of the voting rights, (3) along with an equally significant short position, (4) both positions should not be aggregated but disclosed separately, (5) and the definition of a short position needs to cover all relevant scenarios, including borrowed securities.

375. Securities & Futures Ordinance, *supra* note 372, § 308.

376. Sec. & Futures Comm., *Outline of Part XV of the Securities and Futures Ordinance (Cap. 571) – Disclosure of Interests*, at para 2.4.2 (Aug. 6, 2003).

377. Securities & Futures Ordinance, *supra* note 372, § 309.

378. *See infra* Part V.

D. Disenfranchisement

A recent and seminal academic article on the modified risk structure of shares comes to the emphatic conclusion: “Scholars (and legal rules) should recognize what is apparent from financial innovation: *not every share should be entitled to a vote.*”³⁷⁹ Similar to the present analysis, this plea is based on the insight that risk-reduced or even risk-eliminated shareholders have entirely changed interests compared to regular shareholders, which makes voting for these shares a problem. In this context, some scholars have made proposals to deprive risk-decoupled shareholders of their voting right. For instance, Henry Hu and Bernard Black, in the last of several articles on the subject, propose to withdraw the voting right from every shareholder whose risk exposure is negative, by simple operation of corporate law.³⁸⁰ However, they leave open the question of whether a direct ban or a rebuttable legal presumption should be introduced.³⁸¹ In a similar vein, David Skeel wants to grant courts a stronger role in deciding to withdraw the voting entitlement from individual shareholders.³⁸² A French working group chaired by Yves Mansion, Board Member of the Autorité des Marchés Financiers, also came to the conclusion that a statutory loss of the voting right is the most effective way to combat risk-decoupling strategies.³⁸³ Even the so-called Hedge Fund Working Group, a self-organization of the sector, indirectly suggested limiting the voting rights in target companies to regular shareholders.³⁸⁴

1. A General Prohibition to Vote?

To understand the theoretical underpinnings of this approach, we can revert to the considerations discussed above, which draw upon the perspective of corporate finance.³⁸⁵ One of the arguments developed—based on work by Gilson and Whitehead in particular—is that risk-decoupled shares are in substance closer to debt than to equity.³⁸⁶ Volatil-

379. Martin & Partnoy, *supra* note 24, at 813.

380. Hu & Black, *supra* note 24, at 701.

381. *Id.* at 702.

382. David Skeel, *Behind the Hedge*, 11/12 LEGAL AFF., 2005, at 28.

383. AMF, *supra* note 300, at 13.

384. HEDGE FUND WORKING GRP., HEDGE FUND STANDARDS CONSULTATION PAPER PART 2: THE BEST PRACTICE STANDARDS 61 (2007); *see also* Press Release, Hedge Fund Working Grp., *supra* note 246.

385. *See supra* Part IV.C.3.

386. Ronald J. Gilson & Charles Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 251 (2008); *see supra* Part IV.C.3.

ity risk is characteristic of equity investors, and for that very reason these investors are granted the right to vote. In the absence of this risk, it is logical to conclude that the vote must be omitted.

In various jurisdictions, the legal reality corresponds to this rationale. The Second Company Law Directive, for example, introduced into all EU member states' company law the rule that the company itself cannot exercise the voting right in its own shares.³⁸⁷ In a similar vein, the English law on schemes of arrangement recognizes the principle that the exercise of a right to vote requires an economic interest in the outcome of the vote, which is settled case law.³⁸⁸ German law, moreover, recognizes prohibitions to vote in cases where votes are bought or otherwise abusively used.³⁸⁹ All of these instances have in common the legal principle that a voting entitlement should only be attributed to those shareholders who have a real risk exposure in the shares.

The key question, then, is whether it is overall desirable to respond to our risk-decoupling analysis with a prohibition to vote. As a starting point, it should be noted that a voting ban is certainly a suitable instrument to prevent the above-described undesirable and cost-creating effects of risk-decoupling conduct. The exercise of voting rights, where risk is eliminated or reduced, has been identified above as the main problem, even if shareholders can exercise informal pressure on the administration as an addition to the formal voting process at the general meeting.

Doubts arise from other quarters, however, chiefly related to similar delimitation problems that have emerged from discussions over a possible ban on risk-decoupling structures altogether.³⁹⁰ Just like a prohibition, a disenfranchisement rule is a "black and white" instrument, which offers two options: either the shareholder is disenfranchised, or he is not disenfranchised. Accordingly, no room for a "grey" solution remains, which might be desirable in a partly risk-reduced situation, for example. An automatic deprivation of the right to vote will therefore often yield inappropriate results.

387. Second Directive 77/91/EEC, art. 22(1), § 2 (Feb. 2010) ("Where the laws of a Member State permit a company to acquire its own shares, either itself or through a person acting in his own name but on the company's behalf, they shall make the holding of these shares at all times subject to at least the following conditions: (a) among the rights attaching to the shares, the right to vote attaching to the company's own shares shall in any event be suspended."); see also European Corp. Governance Forum, *supra* note 316.

388. *Bluebrook Ltd.*, [2009] EWHC 2114 (Ch.) (U.K.); see also *In re Tea Corp.*, [1904] 1 Ch. 12 (U.K.). On this more generally, see GULLIFER & PAYNE, *supra* note 208, at 639.

389. Aktiengesetz [AktG] §§ 136, 405.

390. See *supra* Part V.C.2.

In addition, as described above, a reduced risk position may also produce positive effects, which can be subject to elimination through imposing a voting ban. With this, I refer to above-described activist shareholders who may obtain additional voting power to effectively monitor the management.³⁹¹ Individual shareholders are given a way to exercise additional influence—a possibility to overcome a normalized state of “rational apathy.” Again, an automatic prohibition or an automatic voting ban would go too far and would restrict this certainly desirable situation.

Finally, we must recognize that the loss of a voting right is a far-going intervention and an extensive interference with the membership rights of shareholders, which should be limited to exceptional cases. Such a rule could also affect the guarantee of property in the European Convention of Human Rights and, more generally, the principle of proportionality.

2. Case-by-Case Decision by Regulator

The discussion presented here can serve as a guide to developing an ideal response to the problem at issue here, which would not be as restrictive as an outright disenfranchisement. If a *general* voting ban goes too far such that individual situations are not adequately taken into account, the voting restriction should be designed in a way that it can be imposed *in each individual case*. This power could be given, for example, to national market supervisors such as BaFin in Germany or the FSA in the United Kingdom. The role of a national regulator would draw on the transparency regime developed in this paper and complete it. The following key points outline the benefits of these powers conferred on a regulator:

- (1) Any intervention of a national regulator requires the regulating body to become aware of all potentially relevant facts. In this respect, transparency and voting prohibition could be said to go hand-in-hand: the above-developed disclosure regime³⁹² would supply the regulator with the information on the basis of which an intervention may be initiated.
- (2) Furthermore, a voting restriction that can be imposed in an individual situation covering an otherwise open gap of legal protection that remains even after the introduction of a comprehensive disclosure system. Despite the potential deterrent effect of

391. See *supra* Part IV.A.2.

392. See *supra* Part V.C.3.

a transparency obligation, it is still possible for some investors to surprise shareholders by using a well-timed stake building strategy. If, for example, a hedge fund reveals a risk-decoupling structure during the last possible moment before the record date, the rest of the shareholders are no longer able to react accordingly. It is inherent in the record date system that shifts after the record date will no longer affect the voting entitlement.³⁹³ Therefore, counter-alliances cannot be effectively formed and counter-proposals or counter-strategies cannot be formulated and put on the agenda. In this respect, depriving the voting right would be the only viable option.

- (3) In comparison with a general statutory scheme, the greatest advantage of a system where the regulator is responsible for individual decisions is that these decisions can account for the individual facts of the situation. The regulator may in particular consider:
 - i. the actual scope and extent of the risk-decoupling situation, in particular the extent of the voting rights owned by the investor and the risk reduced;
 - ii. the timing of the situation, for example, how close to a general meeting or other decision the risk decoupling occurs—depending on the result, the regulator may assess how much time remains for the market to develop independent solutions, be it counter alliances, counter proposals, management action, etcetera;
 - iii. the potential harm of the risk-decoupled situation. The regulator will want to analyze whether the initiative was created for good reasons and in good faith, so as to for example to control management for the benefit of all shareholders, to assess whether the risk-decoupled shareholders are likely to pursue only their own interests.

It becomes clear from the points discussed that the power to regulate a voting ban in individual cases complements the transparency regime and offers enforcement through real sanctions. Again, the hope is that the mere possibility of issuing a ban is enough of a deterrence to using risk decoupling in the first place.

Finally, the path suggested here—to equip the regulator with the power of withdrawing the voting right—would harmonize the currently

393. See *supra* Part III.C.

proposed reform of the Transparency Directive on “long positions.”³⁹⁴ Striving to further harmonize the sanctions in the Directive, the Commission proposes to introduce new article 28a into the Transparency Directive, which stipulates that national supervisory authorities are, *inter alia*, empowered to “suspend the exercise of voting rights attached to shares admitted to trading on a regulated market if the competent authority finds that the provisions of this Directive, concerning notification of major holdings have been infringed by the holder of shares or other financial instruments.”³⁹⁵ In this regard, the Commission is focusing on an area that has not been subject to harmonization thus far; it is based on the Commission Communication on “[r]einforcing sanctioning regimes in the financial services sector.”³⁹⁶ In favor of the power to suspend voting rights, the Commission submits that the sanctions could prevent violations of transparency requirements in the most effective way.³⁹⁷ It seems that a coherent legal system should have corresponding sanctions for both positive and negative interests in securities. In this respect, the solution proposed here would harmonize well with the Commission’s present efforts.

By contrast, the elimination of other shareholder rights, such as the right to dividends, would appear to be unnecessary. The main economic problem that is addressed here results from an exercise of the voting right, and not the dividend right or other rights. An extension of the regulator’s powers to suspending other shareholder rights would therefore be disproportionate.

In sum, a regulator’s well-defined power of suspending the voting right—targeting risk-decoupled shareholders in individual situations—seems to accompany the developed disclosure system well. Together,

394. *Commission Proposal for a Directive of the European Parliament and of the Council Amending Directive 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Commission Directive 2007/14/EC*, COM (2011) 683, art. 1(8)(b) (Oct. 25, 2011) [hereinafter *Commission Proposal for a Directive*].

395. *Id.* at art. 1(16).

396. *Commission Communication of 8 December 2010 on Reinforcing Sanctioning Regimes in the Financial Services Sector*, COM (2010) 716.

397. *Commission Proposal for a Directive*, *supra* note 394, at 9 (“[T]he competent authorities in the Member States should have the power to suspend the exercise of voting rights of the issuer who had breached the notification rules on major holdings, as this is the most efficient sanction to prevent a breach of these rules. In order to ensure consistent application of sanctions, uniform criteria should be set for determining the actual sanction applicable to a person or a company.”); *see also Commission Staff Working Paper Executive Summary of the Impact Statement*, SEC (2011) 1279, at 41.

these two components build a helpful combination that can address all problematic situations that arise.

E. A Concrete Proposal

The analysis thus far has led to the following conclusions: the best regulatory response to the phenomenon of risk decoupling would be a combination of (1) disclosing negative positions in shares, and (2) allowing regulators to suspend voting rights in individual cases.

Given the arguments put forth in this Article, a new system is prescribed to meet the policy considerations discussed. The key solution advanced here for the problem of risk decoupling is based on an integrated disclosure system for a negative interest in shares. The basic idea is that shareholders and investors should be informed about (1) significant short positions and (2) existing (long) shareholders. Therefore, the definition of the “short” position is crucial.

Accordingly, the following new article, to be inserted into the Transparency Directive, is suggested here:

Article 10a. Notification of risk-modifying agreements.

(1) The home Member State shall ensure that where a shareholder is obliged to notify according to Article 9, such a shareholder notifies the issuer of any agreement, arrangement or mutual consent, the aim or effect of which is to modify the shareholder’s risk structure with respect to the issuer, provided that this agreement refers to at least 5 percent of the voting rights of the same issuer. In particular, this includes but is not limited to arrangements to reduce the shareholder’s risk structure, to benefit from share price changes, or to modify the voting power of the shareholder. The same notification obligation shall apply to the obligation or intent to transfer shares within a specified time period to another person.

(2) The same notification obligation shall apply to any subsequent modification to the agreement.

(3) The notification to the issuer shall be effected as soon as possible, but not later than three trading days, the first of which shall be the day after the date on which the shareholder

(a) learns of the acquisition or disposal or of the possibility of exercising voting rights, or on which, having regard to the circumstances, should have learned of it, regardless of the date on which the acquisition, disposal or possibility of exercising voting rights takes effect; or

(b) enters into the agreement mentioned in paragraph (1).

(4) Upon receipt of the notification under paragraphs 1 or 2, but no later than three trading days thereafter, the issuer shall make public all the information contained in the notification.

(5) A home Member State may exempt issuers from the requirement in paragraph 3 if the information contained in the notification is made public by its competent authority upon receipt of the notification, but no later than three trading days thereafter.

(6) The Commission shall, in accordance with the procedure referred to in Article 27(2), adopt implementing measures in order to take account of technical developments on financial markets and to ensure the uniform application of paragraphs 1 and 2 of this Article.

As to the power to disenfranchise shareholders in individual situations, I suggest the following wording:

Article 10b. Sanctions.

(1) Without prejudice to the supervisory powers of competent authorities under this Directive or under national law, Member States shall ensure that in the situations referred to Article 10a, administrative sanctions and measures that can be applied include at least the power to suspend the exercise of voting rights attached to shares admitted to trading on a regulated market, if the competent authority finds that disclosure is not sufficient to address the problems resulting from the risk-modifying agreement.

(2) In assessing this, the competent authority shall have regard, *inter alia*, to

(a) scope and extent of the risk-decoupling situation, in particular the amount of voting rights notified under Article 9, the extent of the risk-modifying agreements notified under Article 10a, and the relationship between these two notifications;

(b) the urgency of the situation, in particular how close to a general meeting the notification under Article 10a was made;

(c) the intentions of the shareholder making the notification under Article 10a.

These two proposals are underpinned by the reasoning developed above.³⁹⁸ To reiterate, they ensure that disclosure is the first and most important means to address risk-decoupling structures. A continuous dis-

398. See *supra* Parts V.C.3, C.4.

closure obligation addresses most of the concerns developed in Part IV above. In order to reduce the disruptive effects on the market, a relatively high threshold (of 5%) is appropriate; with a lower threshold, a company may not feel compelled to change its strategy. The disclosure obligation does not aggregate short and long positions, but rather mandates a separated disclosure. The definition of a “short position” intends to cover all relevant scenarios, including borrowed securities.

The disclosure obligation is accompanied by a sanctioning regime with which European regulators should be equipped. The regime can be understood to close those loopholes against legal protection that may remain. In contrast to a general statutory voting restriction, the regime can take into account the specific aspects of each individual situation. For further details, I refer to the elaborated discussion above.³⁹⁹

VI. CONCLUSION

Activist hedge funds often employ the strategy of risk decoupling. Regulators worldwide are rightly on alert because risk decoupling creates strong policy concerns. This Article has looked at the phenomenon from three different policy perspectives—agency costs, information and transaction costs, and corporate finance theory. In essence, negative risk decoupling deviates from traditional assumptions of corporate governance and finance as it creates agency and information costs, both for internal shareholders and external investors alike. On the other hand, risk decoupling may mitigate shareholder coordination problems in individual cases by allowing for the transfer of votes from less informed to specialized, active shareholders.

The remedy proposed in this Article addresses both aspects. The preferable approach would be to adopt a comprehensive disclosure system for negative positions. Care should be taken to ensure that disclosure is meaningful and not overly burdensome. Therefore, there should be a relatively high initial disclosure threshold. By contrast, the requirement of reporting gross positions (rather than netted long and short positions) ensures that the market can clearly distinguish between the shareholder’s voting influence in the company and the shareholder’s economic exposure. The high initial threshold ensures that only those positions need be disclosed where an influence on the company’s strategy seems likely. Moreover, daily lending activity or derivatives trading will be left untouched, avoiding a disruptive impact on the market. Based on these considerations, I developed a concrete legislative proposal to amend the Eu-

399. See *supra* Parts V.C.3, C.4.

ropean Transparency Directive. Similar considerations would apply to other jurisdictions.

The disclosure of negative decoupling situations should allow the market to respond adequately, and it will also strongly deter harmful decoupling activity. For the few situations where the market is unable to react, national regulators should be equipped with the power to suspend decoupled shareholders' voting rights. This is preferable over a blanket disenfranchisement rule as regulators can assess the facts of the individual situation. Clear guidance criteria are provided.

The concrete proposals made in this Article are pitched to the European market. However, the policy considerations and the reasoning behind the regulatory tools should hold true for any jurisdiction in the world. The SEC, for example, is also considering imposing new regulatory action.⁴⁰⁰ It is the author's hope that the present study will encourage worldwide thinking about the phenomenon.

400. SEC. & EXCH. COMM'N, R34-62495, IA-3052, IC-29340, File No. S7-14-10, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM (2010).