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When the Voting Is 'Empty'

No quick fix is seen in record date reform proposals.

BY BONNIE J. ROE

RECENT corporate governance reforms have sought to strengthen the role of shareholders through changes in the shareholder voting process, such as majority voting, proxy access or say on pay. These measures assume on a fundamental level that persons having an economic stake in the corporation as shareholders will have the right to vote their shares or instruct record holders to vote their shares.

In some cases, however, the right to vote is divorced from the economic interest in the shares, resulting in what is sometimes called "empty voting" by persons who have no economic interest in the equity of the company. This may occur for a variety of reasons, including share lending practices (in which the right to vote is transferred to the borrower of the shares), hedging or short sales by the beneficial owner, or transfers of the shares between the record date and meeting date.

Procedural problems with voting or tabulating the vote of street name shares may also contribute to undervoting or overvoting of shares.

This article will examine measures designed to address the gap between economic interest and voting rights through changes in practices concerning the record date of the meeting.

For example, corporations could be required to announce the record date and agenda for the meeting a sufficient time in advance of the record date to enable institutional holders to call back shares lent to other parties, as suggested in the recent concept release on the proxy voting system issued by the Securities and Exchange Commission (SEC).[1]

Corporations could also establish both a record date for notice of the meeting and a later record date for purposes of voting.

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This would require amendments to the proxy rules for publicly traded companies, but has recently been permitted by Delaware corporate law.[2]

Measures such as these, however, that focus on the record date do not address the underlying problems of the shareholder voting system, and might actually facilitate the manipulation of record date ownership for voting purposes by short term traders.

Share Lending

One impediment to shares being voted in accordance with economic interest is the practice of share lending.

Large institutional holders, such as insurance companies, pension plans, mutual funds and college endowments, hold their shares through banks that act as custodians and charge a fee for custodial services. This fee can be offset, directly or indirectly, by allowing the bank to lend the shares to short sellers or other traders, who need the shares to cover their short positions or meet delivery obligations.

The share lending transaction typically passes voting control and other incidents of ownership (such as rights to dividends) to the borrower of the shares. As a result, the institutional holder may not appear as the beneficial owner on the record date and therefore may not have the right to vote at a shareholder meeting.

In order to obtain the right to vote, the holder would need to terminate the loan and retrieve the loaned securities prior to the record date.

A possible regulatory re-sponse explored in the SEC's concept release would be to require companies to announce their record date and meeting agendas sufficiently in advance of the meeting, so that shareholders could reclaim their shares before the record date. The viability of this proposal would depend on three factors:

• the ability of companies to finalize their agendas a sufficient time in advance of the record date;

BONNIE J. ROE *is a partner in the corporate department of Cohen & Gresser.*

• the willingness and ability of institutional holders to take notice of announcements and retrieve their shares before the record date; and

• the increased potential for manipulation by market participants with little or no economic stake in the company.

While the potential for manipulation deserves the most attention, the other considerations are important, too.

Currently companies plan their record date and meeting agenda well in advance of the record date; indeed, for an annual meeting a company must initiate the broker search process at least 20 business days in advance of the record date.

In addition, New York Stock Exchange companies are required to notify the exchange at least 10 days in advance of the record date, indicating at least in general terms what the agenda items are. These communications, however, are not typically made public.

In fact, companies often finalize the meeting agenda very close to, or even after, the record date because they will not release the proxy statement until after the list of persons to whom the proxy statement is sent can be established.

A company that had received shareholder proposals, for example, might still be in the process of determining whether the proposal could be excluded from the company's proxy statement in accordance with the no-action letter process under Rule 14a-8 of the Securities Exchange Act of 1934, as amended (Exchange Act).

Nevertheless, the record date can often be estimated, if not with precision, based on the prior year's meeting. In the context of a merger or other significant corporate transaction, the record date is often publicly known (or at least can be estimated within a reasonable time period) in advance of the date itself as a result of the filing of a preliminary proxy statement with the SEC or other public statements by the parties.

In short, it does not seem to be that unusual for companies to provide information as to their record date and meeting agendas, or for shareholders to be able to estimate approximately when the record date will be based on prior practice or publicly available information. Requiring companies to pre-announce the agenda and record date might nonetheless impose some scheduling burdens and make it more difficult to make last minute changes.

Further Complications

But what if you announced a record date and agenda, and nobody came? Shareholder inattention can be a problem, particularly for ordinary course annual meetings, and portfolio managers often have difficulty keeping up with developments affecting the companies that are represented in their portfolios. That is why institutional shareholders hire proxy advisory firms.

Proxy advisory firms, of course, might keep track of upcoming record dates, and inform shareholders of when they needed to retrieve their shares out of share lending arrangements. Shareholders would still have the headache (and presumably also the expense) of retrieving their shares of a number of companies during proxy season, and might want to engage in this process for only a limited number of companies.

When the right to vote is divorced from the economic interest in the shares, 'empty voting' by persons who have no economic interest in the equity of the company is the result; this may occur for various reasons, including share lending, hedging or short sales by the beneficial owner.

Shareholders could use the announcement of meeting agendas to determine which votes were important to them, or they might simply focus on companies where they had the most significant investments. Many meetings and many companies would slip below the radar, which would not improve corporate governance.

Even when investors are motivated to retrieve their shares from share lending arrangements, it can be difficult to do. Investors do not always keep track of which shares have been lent. In addition, the bank or broker intermediary may actually lend a gross amount of the shares that it holds on behalf of beneficial owners without allocating the loaned securities to specific accounts, thus raising fundamental questions about how many shares each beneficial owner has the right to vote.

In other situations, the bank or broker intermediary may use the loaned shares as collateral for other trading on behalf of the beneficial owner, a practice that has received attention in the media recently as some of the investments in those trading account arrangements have gone bad. In cases like these, though the shares can be traced back to a specific beneficial owner, it could be quite costly for the beneficial owner to unwind the trading account arrangements in order to receive the shares.

In order to engage in share lending and exercise the right to vote, an investor needs to monitor the types of share lending it engages in, and be willing to put a price on the right to vote. This predicament will not fundamentally change if companies are required to pre-announce their record dates.

The Real Problem

The real problem with the pre-announcement of record dates, however, is the potential for manipulation where a meeting or an issue is important for a particular investor or other market participant.

As discussed below, there are a number of examples of persons acquiring the power to vote on a merger or similar transaction where their actual economic interest was opposed to that of the shareholders of the corporation generally. Various mechanisms have been used for this purpose.

While there would probably not be much interest in acquiring empty voting power for an ordinary annual meeting, a contested election of directors, shareholder proposal or other controversial issue might draw attention from persons who had no long-term interest in owning shares.

Indeed, majority voting for members of the board of directors makes it more likely that ordinary elections will become contentious. With knowledge of the one date on which it is necessary to hold voting power in order to vote at the meeting, a market participant could potentially acquire a significant voting interest without much expense.

"Record date capture," or the process of obtaining the right to vote as of the record date, can be achieved fairly easily and cheaply through short term trading, borrowing shares or engaging in various derivative transactions. The person who

acquires voting power can hedge the risk so as to benefit if the price goes down, or to be insulated against both upward and downward movements in price.

The long party to a derivatives transaction can also achieve de facto voting power through the ability to unwind the derivatives transaction before a record date, if that record date is known in advance.[3]

An illustration of voting by a party that had an interest adverse to that of shareholders as a whole is *In re Perry Corp.*, a July 2009 SEC administrative order that ultimately turned on the proper reporting of a voting interest acquired solely for purposes of influencing the vote on a merger.[4]

Perry Corp. was an investment adviser that held a substantial economic interest in the target company (King). Perry Corp. acquired a voting interest in Mylan, a potential bidder for King, solely for the purpose of voting the Mylan shares in favor of the proposed merger with King.

Perry Corp. acquired almost 10 percent of the voting interest in Mylan, having a market value of just under $500 million, through a series of equity swaps, of which the net cost was under $6 million. Through these swap arrangements, Perry Corp. was entirely hedged against movements in the Mylan stock price, so that its sole economic interest in the transaction was through the target, King.

Moreover, Perry Corp. was able to accumulate its interest rapidly without a noticeable impact on trading prices and without its transactions being included in reported trades. In the SEC administrative action, Perry Corp. was censured and fined for failure to timely report its interest in Mylan on a Schedule 13D under the Exchange Act, rather than on the longer timeline of a Schedule 13G.

Dual Record Dates

In current practice, the list of holders as of the record date is used for two purposes: to determine who is to receive notice of the meeting and to determine who can vote.

Under a dual record date system, one date would be used for notice of the meeting and a second (later) date would be used to determine who could vote. The principal advantage of the dual record date system is that it eliminates "empty" voting by persons who sell their shares between the initial record date and the later date closer to the meeting.

A second benefit might be that it would provide notice to institutional holders that had lent their shares, so as to enable them to retrieve their shares in advance of the record date for voting. Under a dual record date system, the record date for voting would presumably need to be quite close to the actual date of the meeting, perhaps no more than 10 days before the meeting date, or there would be little advantage in having the second record date.

The chief logistical problem posed by a dual record date system is created by the compressed timetable between the voting record date and the date of the meeting. With the current system of record ownership of street name shares by the Depository Trust Company and the holding of shares through overlapping levels of securities intermediaries, it is hard to imagine how all of the steps involved in transmitting materials and gathering the vote could be accomplished within a timeframe of, for example, 10 days before the meeting.

With greater transparency as to beneficial ownership and an efficient system of electronic delivery of disclosure documents, as well as perhaps Internet voting directly by beneficial owners, these problems might not be insurmountable. But this in itself would involve significant changes to the proxy delivery and vote gathering mechanisms that currently exist.

The use of dual record dates would also require amendments to the U.S. proxy rules. The SEC's July 2010 concept release on the proxy voting system includes a preliminary list of rules that might be violated by the more compressed timelines of a dual record date system.[5]

While Regulation 14A under the Exchange Act does not require that proxy materials be sent a specific number of days in advance of the meeting, the SEC does stipulate that there be "ample time for the delivery of the material, consideration of the material by the beneficial owners…and transmittal of the vote."[6] This fundamental principle would need to be satisfied, even for investors that were not holders on the initial record date for notice.

In short, the adoption of a dual record date system is not a quick fix for various voting problems, but would be likely to require a reworking of at least some of the architecture of the proxy system. If the logistical problems could be solved, however, there would still be the risk of manipulation of the voting power between the record date for notice and the record date for voting.

With advance notice of the agenda and record date for voting, persons with little or no long term economic interest in the company could acquire voting power and influence the vote.

The Danger of Small Steps

It is at least superficially tempting to address the problems of empty voting through apparently small steps like providing advance notice of the agenda and record date or using dual record dates, because the changes seem easy in comparison to the Herculean task of reforming the U.S. proxy system.

The small steps, however, may not lead to the desired solution, and may carry with them problems of their own.

1. Concept Release on the U.S. Proxy System, SEC Release No. 34-62495; IA-3052; IC-29340 (July 22, 2010) (the "Concept Release") at 75 FR 42994. The suggestion was also made in Henry T.C. Hu and Bernard Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions," 156 U. Pa L. Rev. 625, 715 (January 2008).

2. 2009 amendments to §213 of the General Corporation Law of the State of Delaware, 8 Del.C. §213(a). Similar amendments to the Model Business Corporation Act have been adopted. See "Changes in the Model Business Corporation Act—Amendments to Shareholder Voting Provisions Authorizing Remote Participation in Shareholder Meetings and Bifurcated Record Dates," 65 Bus. Law. 1119-1120 (August 2010).

3. A table showing various methods by which voting power can be acquired without an interest in the economic value of the shares is included in Henry T.C. Hu and Bernard Black, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms," 61 Bus. Law. 1011, 1023 (May 2006).

4. *In the Matter of Perry Corp.*, Release No. 34-60351, IA-2907 (July 21, 2009).

5. Concept Release at 75 FR 43015.

6. Timely Distribution of Proxy and Other Soliciting Material, SEC Rel. No. 34-33768 (March 16, 1994) [59 FR 13517], cited in the Concept Release at 75 FR 43015.

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COHEN & GRESSER LLP

800 Third Avenue
New York, NY 10022
Ph 212 957 7600
Fax 212 957 4514
www.cohengresser.com