Ways of exercising empty voting

Q1. Please identify the different types of empty voting practices and the frequency with which you think they occur within the EU. Where possible, please provide data supporting your response.

Lately, empty voting has been known as "the new vote buying" or "decoupling". There are a number of different ways to decouple votes from economic ownership:

1.- Empty Voting Through Equity Derivatives

This method relies on the share lending market, which lets one investor borrow shares from another. Under standard lending arrangements, the borrower has voting rights but no economic ownership, while the lender has economic ownership without voting rights.

2.- Empty Voting Through Record Date Capture

The second type of empty voting employs an equity swap, in which the person with the long equity side (the "equity leg") of the swap acquires economic ownership of shares (but not voting rights) from the short side (the "interest leg")

Q2. Please identify specific examples where empty voting practices have occurred within the EU. Where possible, please provide data supporting your response.

United Kingdom: P&O Princess, 2002

P&O shareholders who favoured Carnival's bid reportedly borrowed shares in order to vote for acceptance.

A proposed merger between P&O Princess and Royal Caribbean Cruise Line (RCCL) in 2001 provoked a hostile takeover bid for P&O Princess by Carnival, the market leader and arch rival of RCCL in America. The hostility between the protagonists grew, in part fuelled by a dispute over a poison pill arrangement which underpinned the P&O Princess/RCCL merger. The intervention of competition regulators in both America and Europe became inevitable. P&O Princess refused to negotiate with Carnival. RCCL accused Carnival of merely engaging in spoiling tactics, claiming there was no real commitment to a takeover. In the end the shareholders in P&O Princess would have to choose, but the view of the competition authorities in Europe and America would be critical. Whilst the terms of the P&O Princess/RCCL merger remained constant, the Carnival offer terms were changed several times as the market leader fought hard to retain its dominant position.

United Kingdom: British Land, 2002

The Laxey Partners-British Land incident offers an example of record date capture. Laxey sought a breakup of British Land and opposed the re-election of British Land's chairman. British Land's chairman was rather displeased with what he called Laxey's "rent-a-vote" strategy. There was irony all around. British Land saw Laxey as abusing

the voting system, while Laxey perceived itself as calling weak management to account. Meanwhile, fund manager Hermes, one of the City's champions of good corporate governance, was (unknowingly) one of the lenders. Hermes did apologize.

Germany: Deutsche Boerse, 2005

In December 2004, Deutsche Boerse proposed buying the LSE. In January 2005, two hedge funds, Children's Investment Fund and Atticus Capital, together holding 8% of Deutsche Boerse's shares, publicly opposed the bid as against shareholder interests. The acquisition was opposed by other major shareholders and was eventually abandoned. What connects this story to vote buying is that certain hedge funds shorted a significant number of LSE shares soon after the opposition was announced. Assuming that some hedge funds were both long Deutsche Boerse and short LSE, they were betting that the acquisition would fail, in which case Deutsche Boerse shares would rise and LSE shares would fall.

These hedge funds' overall economic interest in defeating the merger was larger than if they held only Deutsche Boerse shares. This would tend to offset the usual collective action problem that anyone Deutsche Boerse shareholder would bear much of the cost of opposing the merger, but would benefit only in proportion to its fractional Deutsche Boerse stake. A shortsale of LSE shares might provide sufficient additional incentives for large shareholders to undertake the cost of this potentially beneficial activity.

Variants on the same coupled-asset position, however, could have the opposite effect. If an investor's short position in LSE were large relative to its long position in Deutsche Boerse, it would be more interested in LSE shares dropping in price than in Deutsche Boerse shares rising. The investor would have an incentive to oppose an acquisition that would benefit Deutsche Boerse, or indeed both companies combined. Conversely, merger arbitrageurs who follow the common strategy of going long target, short acquirer would have incentives to support the merger regardless of its merits. Thus, the new vote buying could both empower Children's Investment Fund and Atticus to pressure Deutsche Boerse to make a "good" decision, and empower others, such as classic merger arbitrageurs, to support misguided mergers.

Consequences of empty voting

Q3. a) What in your view are the negative consequences that can occur as a result of empty voting? (Relating to e.g. transparency, corporate governance, market abuse)?

Empty voting may cause a strategic trader to sometimes “vote the wrong way” and could be used to manipulate shareholder vote outcomes and generate trading gains.

The derivatives development in finance and the growth in equity swaps and other “over the counter” operations are making it easier and cheaper to decouple economic ownership from voting power. Therefore, hedge funds and company insiders are taking advantage of this new opportunity. In an extreme case, an investor can vote despite

having negative economic ownership, which gives the investor an incentive to vote in ways that would reduce the company's share price.

According to the Transparency Directive Assessment Report there is a wide consensus that empty voting is a practice which is contrary to the basic principles of company law. The position in support of further regulation is based on the idea that voting power is conferred to the shareholders in view of the fact that they will bear the positive and negative consequences of their decisions. On the contrary, empty voting includes the possibility to exert influence on companies without any financial consequences for the investors. In other words, the person who exercises the voting rights is not the one who bears the consequences of the decision. As a result, decisions detrimental to other investors and to the issuer could be decided. A number of high profile cases have shown the potential for abuse resulting from this type of conduct (for the instance the Laxey Partners case in the UK, the OMV / MOL case in Hungary, the Perry/Milan case in the US or the Henderson Land case in Hong Kong).

Empty voting can also be used to multiply the voting power of an existing long ownership position. For example, a shareholder can borrow shares just before the record date for a shareholder vote, and then reverse the transaction afterward. An investor may vote against the interest of the company and/or its shareholders without or at minimal financial exposure in order to further his own interests. This is a particular problem when the voting rights are obtained purely for the purpose of voting at the General Meeting of Shareholders.

b) To what extent do you consider those consequences to occur in practice?
c) To what extent have you encountered those consequences in your own experience? Where possible, please provide data supporting your response.

In Spain, there are no specific cases of Empty voting practices.

Q4. a) Do you believe that empty voting has influenced the results of voting at the general meeting of shareholders within the EU?

The first publicly reported instance of this "record date capture" strategy occurred in the United Kingdom in 2002. Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a property company. At the annual general meeting, Laxey voted over 9% of British Land's shares to support a proposal to dismember British Land. Just before the record date, Laxey had borrowed almost 42 million shares.

b) Has this ever occurred in your own experience?
Where possible, please provide data supporting your response (including the type of empty voting that you are referring to)

In our own experience, these kinds of practices have never occurred.

Internal policies relating to voting practices

Q5. What kind of internal policies, if any, do you have governing the exercise of voting rights in respect of securities held as collateral or as a hedge against positions with another counterparty?

Securities lending is generally defined as a transaction in which the beneficial owner of the securities, normally a large institutional investor such as a pension fund or mutual fund, agrees to lend its securities to a borrower, such as a hedge fund, in exchange for collateral consisting of cash and/or government securities. Securities lending activity has grown tremendously in the last decade. By 2007, the total value of securities on loan was estimated at $5 trillion. Research estimates that securities lending reaps $8 billion to $10 billion annually in fees for Wall Street.

Most large institutional investors have a securities lending program and consider securities lending as a key source of revenue. The owner/lender earns a spread by investing the collateral in low-risk short-term securities. In a normal U.S. loan, the collateral is 102% on domestic securities and 105% for international securities.

Institutional investors suffered large losses in their securities lending program in 2008 that led to lawsuits against big custodial banks. The allegation was that custodians did not invest the collateral in safe, plain-vanilla securities, resulting in large losses for their clients.

As is evident from the SEC's concept release of July 2010, there are questions about whether securities lending has contributed to proxy abuse. The concern is that market participants can obtain voting rights in a firm by borrowing shares, but without having any real economic ownership. Some researchers assume that activist investors borrow shares for the sole purpose of obtaining voting rights to exert influence or gain control of a company, and do so without corresponding economic ownership in the company. Most securities lending involves shares borrowed from pension funds, mutual funds, and other large institutional investors. These institutions tend to have proxy voting guidelines that often contain policies on securities lending. Although lenders refer to these shares as being "on loan", the lender actually transfers ownership and voting rights to the borrower. Shares may be borrowed for a variety of reasons, including covering a short position, or for arbitrage strategies such as convertible bond arbitrage and merger arbitrage.

Institutions have started to include policies on securities lending in their proxy guidelines. These policies vary considerably. Some funds require a total recall of shares, while others weigh the lost revenue against the benefits of voting on a case-by-case basis.

Need for regulatory action

Q6. Do you think that regulatory action is needed and justifiable in cost-benefit terms? If so, which type of empty voting should be addressed and what are the potential options that could be used to do this? Please, provide reasons for your

answer. Kindly also provide an estimate of the associated costs and benefits in case of any proposed regulatory action.

Although concerns over empty voting in various forms have continued to grow in the last few years, due to data limitations there is little in the way of empirical evidence to determine whether there is a significant problem that needs new regulation.

Regulators in several countries, including the UK, Hong Kong, Switzerland, Italy, and Australia, have already introduced new regulations and/or disclosure requirements with respect to securities lending. The Hedge Fund Working Group (2008) recommends that "A hedge fund manager should not borrow stock in order to vote."

Some regulatory action will eventually be needed. For takeover bids, an unregulated market for shares, coupled with votes, has well-known problems, driven by the high value ascribed to the marginal shares that just convey control, and the lower value thereafter ascribed to remaining shares. These problems have led to regulation of takeover bids, including a minimum offer period and a ban on two-tier offers.

In our opinion, it would be necessary to find a way to reward, from a legal and a corporative point of view, to the shareholders of the companies that have a permanent commitment of remaining in the share capital of such companies.

It would also be recommendable to open a debate on the way to reward the committed shareholders, not only from an economic point of view but from a political view, which could make it easier for such shareholders to participate on the maintenance of their shares.

It is crucial to try to defend the principle of the loyalty of shareholders within the Codes of Good Governance, not only for those shareholders who are part of the Board of Directors, but for all the shareholders in the company.

To conclude, we would like to add that it would be necessary to improve the regulation on the significant holdings portfolio in quoted companies and on the identification of the ultimate shareholders through the chains of custodians.

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