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Empty voting and the efficiency of corporate governance ☆

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ABSTRACT

We model corporate voting outcomes when an informed trader, such as a hedge fund, can establish separate positions in a firm's shares and votes (empty voting). The positions are separated by borrowing shares on the record date, hedging economic exposure, or trading between record and voting dates. We find that the trader's presence can improve efficiency overall despite the fact that it sometimes ends up selling to a net short position and then voting to decrease firm value. An efficiency improvement is likely if other shareholders' votes are not highly correlated with the correct decision *or* if it is relatively expensive to separate votes from shares on the record date. On the other hand, empty voting will tend to decrease efficiency if it is relatively inexpensive to separate votes from shares *and* other shareholders are likely to vote the right way.

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1. Introduction

The impact of hedge funds on corporate governance has received considerable attention recently as the rise in popularity of hedge funds has coincided with an increased focus on governance in general. Much of the attention has been devoted to "activist" funds that take significant stakes in firms and then advocate for change.[2] However, other more subtle strategies undertaken by hedge funds or other strategic traders can also significantly affect the efficiency of the corporate governance system.

In particular, recent work has shown that some funds may use "empty voting"—a practice whereby they accumulate voting power in excess of their economic share ownership—to manipulate shareholder vote outcomes and generate trading gains. This practice is possible even when one share, one vote is the explicit rule. It can be accomplished, for example, by borrowing shares of stock on the record date or hedging economic exposure in the derivatives markets. Hu and Black (2006, 2007) provide a number of examples where such behavior seems to result in perverse voting incentives. In one case, a hedge fund acquired votes by borrowing shares, then voted against a buyout proposal and apparently profited from a short position when the share price dropped following the vote.[3] These authors suggest that some form of regulation, starting with additional disclosure

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[2] See Kahan and Rock (2007), Clifford (2008), Klein and Zur (2009), Greenwood and Schor (2009), and Brav, Jiang, Partnoy, and Thomas (2008).

[3] This incident involved a Hong Kong company named Henderson Land, which wanted to buy out a 25% minority interest in its publicly traded affiliate Henderson Investment.

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requirements, may be necessary to curb the negative effects of such activities.

Regulators have expressed significant concern over empty voting, particularly given the boom in the hedge fund industry and the increasing number and importance of items requiring a shareholder vote. *The Wall Street Journal* (January 26, 2007, p. A1) quotes Securities and Exchange Commission chairman Christopher Cox as saying that the practice of empty voting "is 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." Many large institutional shareholders are examining their share lending practices in response to these concerns. In addition, some companies have recently amended their bylaws to force additional disclosure of complex transactions in their securities due to concerns about corporate governance implications (*The Wall Street Journal*, July 14, 2008, p. B4).

On the other hand, Christoffersen, Geczy, Musto, and Reed (2007) argue that "vote trading" in the share lending market can increase efficiency because information about proposals can be costly to acquire. Uninformed shareholders who are not willing to pay the cost to become informed can sell their votes to informed parties in order to increase the efficiency of the voting outcome. Of course, this argument requires that the vote buyer and vote seller have coincident interests, which often seems to be violated in the examples cited by Hu and Black (2006, 2007). To date, there is no agreement on whether empty voting constitutes a significant problem that should be regulated. Importantly, the literature does not currently provide an integrated theoretical framework to help assess the tradeoff between increased information efficiency and the cost of possible manipulations via empty voting.

In this paper, we develop a theoretical model to explore this tradeoff. We derive the optimal share and vote position of a strategic trader that has the ability to acquire unique information about the value of a management proposal and the ability to acquire votes separately from shares. We show that while the trader may sometimes reduce efficiency by ultimately selling to a net short position and then "voting the wrong way" (from a firm value perspective), the cost of these possible manipulations can be offset by a greater probability that the trader will "do the right thing" and vote to maximize firm value. In other words, in equilibrium both the presence of the strategic trader and the ability to separate votes from economic ownership can increase overall efficiency by making the "right" outcome more likely. This occurs when *either* the establishment of an empty voting stake on the record date is relatively expensive *or* other shareholders' votes are not very highly correlated with the true state. However, we find that a negative efficiency effect is likely when separating votes from shares is relatively inexpensive *and* other shareholders are relatively likely to vote the right way.

Our analysis deals with deviations from the one share, one vote rule, on which there is a large existing literature dating back to at least Manne (1964). Much of the modern literature focuses on how the one share, one vote rule affects the efficiency of the market for corporate control (see, e.g., Harris and Raviv, 1988; Grossman and Hart, 1988; Burkart and Lee, 2008), or how disparities between cash flow and voting rights held by *insiders* affects efficiency (e.g., DeAngelo and DeAngelo, 1985; Gilson, 1987). These studies generally focus on long-term deviations from one share, one vote that are codified in the corporate charter. An important recent exception is Kalay and Pant (2009), which shows that the ability to separate economic and voting interests via derivatives markets can increase efficiency by allowing shareholders to extract more surplus in a control contest. Like Kalay and Pant (2009), we examine short-term deviations arising from activities in the derivatives or share lending markets. However, we focus on how these deviations affect the efficiency of voting by outsiders on regular proposals (as opposed to control contests). We think of outsiders as parties who do not make proposals themselves, but face uncertainty over whether an insider's proposal is value-increasing or instead self-serving. There are many types of proposals other than proxy contests or takeover bids for control that can have important value implications for the firm. Examples include proposals for the purchase of another firm, a divestiture, or a change in the corporate charter (often involving a takeover defense).

In our model, the firm's management initially proposes an action that requires shareholder approval. The proposed action may be either good or bad (i.e., its approval may either increase or decrease firm value), and its value is not observable at this stage. All shares are initially held by atomistic shareholders. After the proposal is announced, a single strategic trader can buy or sell shares in a transparent market prior to the record date (i.e., with no noise trading) and can also acquire "extra" votes in excess of its economic ownership by paying a convex cost. This cost represents, for example, increasing difficulty in finding shareholders from whom to borrow shares, or the increasing cost of finding counterparties to hedge a large economic interest.

On the record date, voting interests are set according to share or vote ownership on that day. After the record date, there is a significant time lag before the actual date of the vote, so the strategic trader is able to further adjust its economic ownership (but not its voting interest) as well as learn about the value of the proposal.[4] At this intermediate trading stage, however, the market is not completely transparent because there is noise trading by atomistic investors. Finally, on the voting date the strategic trader votes according to its economic incentives, as determined by its net economic position in the firm, while the voting of atomistic shareholders is effectively random. We do not explicitly model the atomistic holders' voting decisions; the important feature is that their behavior induces randomness in the final voting outcome.

[4] The timing of when the trader becomes informed does not matter—it can occur either before or after the record date with no significant change in the analysis.

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