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Centre for International Finance and Regulation Project: Evaluating the Impact of Securities Loans on Shareholder Rights and the Governance of Listed Companies

RESEARCH REPORT 2: Securities Lending, Empty Voting and Corporate Governance

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Overview

This paper examines the corporate governance implications of securities loans, in particular the impact of securities loans on shareholders’ voting rights and the control of listed Australian companies. The paper considers whether the current regulatory framework for securities loans in Australia adequately addresses the concerns associated with securities loans and whether reform is required in order to protect the interests of shareholders in listed Australian companies and to ensure that the governance of these companies is not undermined by securities loans.

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I. INTRODUCTION

In a series of articles commencing in 2006, Professors Henry Hu and Bernard Black analysed the phenomenon they termed “empty voting”\(^1\). They expressed concern that securities lending and other financial market developments enabled investors to acquire voting stakes in listed companies without the corresponding economic ownership normally attached to voting rights. As a result, those investors do not have the proper incentives to exercise their voting rights in the interests of the shareholders as a whole. An infamous example of the problems that empty voting can cause, which has been cited on many occasions, is the Henderson Land case.

In January 2005 Henderson Land Development Co, a listed Hong Kong property developer with businesses in Hong Kong and mainland China, attempted to acquire full ownership of Henderson Investment, in which it held 73% of the shares. Although expected to be approved, minority shareholders of Henderson Investment voted against the proposal, so that the required approval thresholds were not met.\(^2\) This was despite strong approval for the transaction by most large shareholders.\(^3\) Under Hong Kong law, minority shareholders holding 10% of the shares can block an offer.\(^4\) As minority shareholders holding approximately 14.26% of the Henderson Investment shares that were voted cast votes against the

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\(^4\) Hong Kong Securities and Futures Commission, The Codes on Takeovers and Mergers and Share Repurchases (June 2010) rule 2.10.
scheme, this meant that the “privatisation” could not proceed.\(^5\) It was reported that there was an increase in borrowing of Henderson shares prior to the vote, which suggested that hedge funds had borrowed the shares in order to vote down the proposal.\(^6\) The explanation reached by most onlookers was that a scheme which was desired by the shareholders was blocked by unscrupulous hedge funds with no economic stake in the company. However, although Henderson Investments shares fell in value after the vote, reports suggested there was not a correlative increase in short-selling of Henderson Investments shares, suggesting that hedge funds did not block the takeover in order to sell the shares short, benefiting from the fall in share price.\(^7\)

Cases such as these\(^8\) have led scholars to conclude that there is a widespread global problem of “decoupling” – that is, the separation of voting rights from economic ownership – which requires urgent regulatory reform. The two main culprits are considered to be “empty voting”, namely where shareholders exercise voting rights where their voting rights exceed their economic exposure in the company, and “hidden ownership”, which is where a shareholder acquires economic interests in a company through equity swaps or other derivative instruments but without obtaining legal title to the shares or the voting rights. In Australia, a small number of concerns have been expressed about empty voting. RiskMetrics, in its submission to the Australian Securities and Investments Commission’s Consultation Paper on Securities Lending and Substantial Holding Disclosure, argued that a voting result that has been secured using votes attaching to borrowed shares may not necessarily reflect the views of the majority of the company’s shareholders.\(^9\) It also published a detailed report in 2007 noting concerns with “vote renting”, namely where a person borrows shares to obtain the right to vote those shares in order to influence the outcome of a company vote.\(^10\) Submissions to two other inquires have expressed opposition to the practice of vote renting.\(^11\) The Commonwealth Parliamentary Joint Committee on Corporations and Financial Services agreed that vote renting ‘in no way contributes to good corporate governance’.\(^12\) Many proposals have been put forward to address these problems and regulatory reviews have been prompted around the globe to enquire into the problem of empty voting.

\(^5\) Henderson Land Development Co Ltd and Henderson Investment, ‘Joint Announcement: Proposed Privatisation of Henderson Investment Ltd by Henderson Land Development Co Ltd by way of a Scheme of Arrangement under Section 166 of the Companies Ordinance: Results of Court Meeting and Extraordinary General Meeting’ (20 January 2006), 2.


\(^8\) Another prominent case is the Perry/Mylan case, which involved equity swaps and is hence beyond the scope of this paper. In September 2004 Perry Corp acquired 9.9% of the shares in Mylan Inc in order to vote in favour of the merger of Mylan with King Pharmaceuticals and counter opposition from other shareholders. At the same time, Perry had hedged its exposure by entering into swaps with Bear Stearns and Goldman Sachs, leaving Perry able to vote yet it had no net economic interest. For discussion see Joseph A Giannone, ‘Perry hedge fund settles with SEC over Mylan stake’, Reuters (New York), 21 July 2009 <http://www.reuters.com/article/2009/07/21/perrycorp-sec-idUSN2126137920090721>.


\(^10\) RiskMetrics Group, Securities Lending and Voting Entitlements (December 2007).


\(^12\) Parliamentary Joint Committee on Corporations and Financial Services, Better Shareholders – Better Company: Shareholder Engagement and Participation in Australia (June 2008), 50 (recommendation 16).
This paper examines the impact of securities loans on shareholders’ voting rights and the governance of listed Australian companies. We consider whether the current regulatory framework for securities loans in Australia adequately addresses the concerns associated with securities loans and whether reform is required in order to protect the interests of shareholders in listed Australian companies and to ensure that the governance of these companies is not undermined by securities loans. This paper is confined to securities lending and does not consider the issues relating to hidden ownership or other means of acquiring empty voting stakes, because securities lending seems to be the most common method of engaging in the practice of empty voting.

II. EMPTY VOTING: A DESCRIPTION OF THE PROBLEM

A. Securities Lending and “Empty Voting”

Despite the terminology of lending, a “loan” of securities involves an absolute transfer of title to the loaned securities to the borrower. The borrower obtains title to the securities together with all rights and entitlements attaching to the securities. The borrower is thus able to vote those securities. Clause 4.3 of the Australian standard securities lending agreement, the Australian Master Securities Lending Agreement (AMSLA), provides that unless otherwise specified in the agreement, when a right to vote arises in respect of borrowed securities, the borrower must ‘use its best endeavours to arrange for the voting rights attached to such securities to be exercised in accordance with the instructions of the other party’. This contemplates that it is the borrower, and not the lender, of the securities who has the right to exercise any voting rights attaching to the securities. The clause also confirms that any voting rights are exercisable by the party in whose name the securities are registered, which would be the borrower where securities are loaned pursuant to the agreement.

This position leads to a divergence between the legal nature of securities lending and its economic substance. Although the lender does not have legal title to the loaned shares during the currency of the loan, the underlying economic reality is that the lender remains the “owner” of the securities. At the termination of the loan transaction the borrower is required to re-deliver an equivalent number of identical securities, irrespective of the value at the time of re-delivery. Thus, the lender and not the borrower is exposed to any change in the value of the securities; any increase in the value of the securities is gained, and any decrease suffered, by the lender. The AMSLA requires the borrower to “manufacture” to the lender the economic benefits of ownership during the term of the loan. The borrower’s stake or interest in the securities is therefore only temporary; upon re-delivery of the borrowed securities, the borrower’s interest ceases.

This leads to a situation where the party controlling the voting rights attaching to borrowed securities (the borrower) has no underlying economic interest in those securities. A loan of securities thus separates the voting rights attached to the borrowed securities from the economic ownership of those securities. This upsets the foundational understanding that shareholders who vote possess an economic interest in the company and may be problematic from the point of view of corporate governance.

One of the earliest articles to analyse the implications of this situation was published by Professors Martin and Partnoy in 2005. Martin and Partnoy argued that the assumptions underlying the “one share – one vote” principle, which informs much of corporate law voting rules, were no longer valid, because

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15 Produced by the Australian Securities Lending Association and adapted from the International Securities Lending Association’s Overseas Securities Lender’s Agreement.
16 Australian Securities Lending Association, Australian Master Securities Lending Agreement, clause 1.4(b).
17 Australian Securities Lending Association, Australian Master Securities Lending Agreement, clauses 4.2 and 4.3.
investors are now able to hedge their share ownership through the use of equity derivatives. Martin and Partnoy used the term “encumbered shares” to describe the position of a shareholder who votes shares without the full economic interest in the shares.

The seminal work assessing the corporate governance implications of this situation is that of Professors Henry Hu and Bernard Black, in a series of articles commencing in 2006. Hu and Black noted that developments in financial markets allowed voting rights attached to securities to be separated or “decoupled” from the corresponding economic ownership. Investors are now able to obtain an economic interest only in shares without the corresponding voting rights by entering into equity swap transactions. Hu and Black referred to this as “hidden ownership”. These strategies may allow an investor to avoid disclosing their stake and may also enable the investor to convert the swaps into voting rights in order to vote.

The Henderson Land case was noted by Hu and Black as a key example of the problems with empty voting by borrowing securities. Conversely, it is also possible to obtain voting rights without the corresponding economic interest. The primary way of achieving this is through securities lending. An investor who borrows shares obtains legal title to the shares including any voting rights attached to the shares, and so is able to vote those shares at a shareholder meeting. However, the borrower’s interest in the shares is only temporary and the borrower has no economic interest in the company. A variant of this strategy is “record date capture”. Company laws typically specify a “record date” for determining eligibility to vote at a shareholders meeting, which in some jurisdictions can be many days prior to the relevant meeting. Securities lending allows a person to borrow shares in order to be registered on the record date and thus be entitled to vote. The borrower can then dispose of the shares prior to the meeting, retaining the right to vote at the meeting but without holding the relevant shares. Hu and Black used the term “empty voting” to describe the situation where a person’s voting rights exceed their economic ownership, so called because the votes have been emptied of their associated economic interest.

Hu and Black noted that the classic theory of voting rights, upon which corporate voting rules are predicated, was based on the status of shareholders as claimants to the company’s value, which gives them appropriate incentives to make value-enhancing decisions relating to the firm and monitor management performance. Making voting rights proportional to a person’s share in the firm’s residual value matches economic incentives with voting power and thus reduces agency costs: ‘Voting flows with the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management’. Vote buying upsets this proportionality; as a result vote buying ‘strikes directly at both the economic and legal logic behind

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20 See the articles cited in above n 1.
24 For the position in Australia, see Corporations and Markets Advisory Committee, The AGM and Shareholder Engagement, Discussion Paper (September 2012), 81–3.
shareholder voting rights’. Put simply, ‘the person who exercises the voting rights is not the one who bears the consequences of the decision’. Empty voting thus distorts the incentives of shareholders. A large gap between voting rights and economic ownership could distort a company’s investment decisions.

Hu and Black argued that it was unlikely that lenders consciously yield shares for voting purposes; rather their purpose is to earn fee income and the lenders are unlikely to pay attention to record dates. It was more likely that borrowers are the active agents. This means that it is more likely that empty votes will be used to influence the outcomes of shareholder meetings. Hu and Black noted several potential options for reform, starting with reforms to the disclosure system.

B. Is Empty Voting a Problem?

While in their earlier work, Hu and Black considered that there was not sufficient evidence to state with confidence which reforms should be adopted, in a later article published in 2008, Hu and Black argued that the problem of empty voting had become more urgent. They argued that there was now substantial evidence that ‘decoupling is important and common, and that it can materially affect the control of major companies throughout the world’. They collected over 80 examples of situations involving vote buying from around the world between 1988 and 2007; securities lending accounted for 10 of these examples.

Many scholars have accepted Hu and Black’s analysis and argued that empty voting is problematic. Their work has also been quoted with apparent approval by regulators. Other authors have noted that empty voting upsets the assumptions on which the allocation of corporate voting rights to shareholders rests and compromises the ability of shareholder voting to perform its proper role. Shareholders who hold no

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economic interest have no incentive to exercise the voting rights in the bests interests of the company.\(^{41}\) Thus, when securities are loaned, the voting rights may not be exercised in the best interests of the company or the lender of the securities.\(^{42}\) Empty voters may prefer that the company’s share price fall rather than rise.\(^{43}\) The borrower may be perceived to be using its voting power contrary to the interests of the company.\(^{44}\) For these reasons, it is not regarded as acceptable market practice to borrow securities for the specific purpose of influencing a shareholder vote. As put by one commentator:

The most troubling aspects of empty voting arise when an investor with substantial votes succeeds in removing any price risk, insulating himself from any valuation consequences that may be associated with his voting strategy, and then proceeds to vote differently than he might have in the presence of price risk.\(^ {45}\) This may be particularly problematic where borrowed shares have a decisive influence on voting outcomes, which will often be the case where resolutions are decided by narrow majorities.\(^ {46}\) It is a source of concern that key resolutions relating to a company may be decided by persons who have an incentive to vote in ways harmful to the company, for example by blocking actions that are in the interests of the shareholders.\(^ {47}\)

Thus, many scholars consider that empty voting is largely a harmful practice. However, this view is by no means unanimous. Hu and Black themselves acknowledged that empty voting or decoupling is not always a bad thing.\(^ {48}\) Other commentators have argued that empty voting could have positive effects in some situations. One commentator has argued that empty voting by ‘committed shareholders’ may be beneficial.\(^ {49}\) The abusive empty voting transactions highlighted by Hu and Black are effected not by insiders and existing shareholders, but by outsiders.\(^ {50}\) However, where existing shareholders – those with a long-term stake in the company, and who are committed to its profitability – borrow shares in excess of their stake in connection with a particular vote, this will concentrate voting rights in the hands of shareholders who actively seek to participate in a shareholder meeting. Vote buying may thus intensify the preferences of engaged shareholders and empower institutional shareholders to improve corporate governance.\(^ {51}\) The same author also argued that prohibiting empty voting may be largely ineffective to prevent voting abuses.\(^ {52}\)

A similar argument was made by Christofferson et al, noting that vote trading may increase efficiency in the market because uninformed shareholders can sell their votes to more informed investors to increase

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the value of the voting outcome. Another commentator argues that hidden ownership encourages activism by large shareholders, who are realistically the only shareholders who are able to engage in activism, increasing board accountability and equalising the balance of power which is skewed in favour of directors. Another article argues that hedge funds may play a useful corporate governance role using empty voting strategies. In 1964 Henry Manne had argued that trading of votes would be beneficial to shareholders in the same way the exchange of goods and services by free individuals benefits the participants.

Kobayashi and Ribstein argued that vote selling may be beneficial in facilitating an active market for corporate control and acting as a monitoring device. Vote selling and buying can be viewed as an efficiency-enhancing mechanism, a way for voting rights to flow to the person with the most reliable information, thus maximising the most profitable use of those rights. Views such as these have been countered by scholars who have argued that the voting rights are not always used in a way that is in the interests of all shareholders. Nevertheless, this discussion demonstrates that there is far from a unanimous view that empty voting is generally harmful.

Finally, in a study published in 2010, Brav and Mathews developed a theoretical model designed to provide a framework for analysing whether empty voting is a problem that requires regulatory intervention. They argued that empty voting is likely to result in ‘both positive and negative outcomes from an efficiency perspective’ and thus the negative anecdotes described by Hu and Black are likely to be only one side of the story. Where the votes of other shareholders are not correlated with a good decision, or when the ability to separate votes from shares is highly restricted, a strategic trader will be good for efficiency overall, by bringing new information and increasing the probability of a correct decision. However, where other shareholders’ votes are biased towards the correct decision and it is not too expensive to separate votes from shares, a strategic trader (such as a hedge fund) may reduce efficiency. They also noted that it would be difficult or impossible to gather large-scale empirical evidence of favourable empty voting behaviour.

57 Bruce H Kobayashi and Larry E Ribstein, ‘Outsider Trading as an Incentive Device’ (2006) 40 UC Davis Law Review 21, 39–40. They also argued that, contrary to the assumptions of most commentators, the Perry/Mylan situation (see above n 8) likely produced gains for both parties, or at worst only a small loss for Mylan, and that Perry likely had information which indicated an overall net benefit from the transaction, and acquired voting rights to the Mylan shares so as to ensure the deal went through. Viewed from this perspective, ‘the Perry gambit was not pernicious, but rather a way to maximize the joint capital of the participating firms without interference from self-interested managers or undiversified shareholders’ (at 43–4).
C. How Widespread is the Practice of Vote Buying?

Many commentators have taken the view that the borrowing of shares in order to vote is a widespread practice. This originates primarily from the empirical research of Susan Christoffersen and others in a study published in 2007. The Christoffersen study, utilising US data for the period November 1998 to October 1999, found that the borrowing of securities significantly increases around the record date (ie, the date set by a firm for the purpose of determining eligibility to vote at a shareholder meeting). The authors concluded that there is an active market for voting rights and that the increase in voting is driven by an increase in demand, namely borrower driven. They also suggested that vote trading generally corresponds to support for shareholder proposals and opposition to management proposals. Further, the authors concluded that no additional fee was charged for the votes over the prevailing price for short exposure, suggesting that information asymmetry was the cause.

Later authors have considered that the Christoffersen study provides evidence that ‘there is an active market for voting rights’ and that there is a widespread practice of record date capture. Such authors consider that securities lending is frequently used to engage in the abusive market practice of capturing corporate proxy votes. However, these findings have been contradicted by a later study by Moser and others, which suggests that the increase in securities lending around proxy record dates is dividend-related and not voting-related. The Moser study, which was motivated by the findings of the Christoffersen study, aimed to examine whether there was in fact evidence of proxy abuse, as the authors believed that there were other explanations for their findings, for example legitimate tax-related arbitrage reasons. The authors found that the evidence verified that there is an increase in securities lending around proxy dates, however, the authors also found that the proxy record date does not influence the percentage of shares loaned, but the dividend record date does. The Moser study therefore suggests that the increased borrowing activity around record dates is not connected to voting but is driven rather by lending and borrowing around dividend record dates.

If correct, the Moser study suggests that, beyond the high-profile cases that have been brought to public view, evidence of widespread proxy abuse in the US securities lending market is lacking, and that there are other, less sinister, explanations for the market practices noted by earlier studies. Other reports have suggested a similar explanation for the increase in securities lending around the time of a company’s AGM. In its recent examination of empty voting the European Securities and Markets Authority concluded that there was insufficient information available to be able to assess the extent of empty voting.

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or the appropriate response.\textsuperscript{73} This, of course, does not demonstrate that vote buying does not take place, nor that is it not a problem. The individual cases that have been noted in key studies suggest that the practice does occur, with potentially deleterious consequences.\textsuperscript{74} There is, however, no comprehensive information as to how prevalent these strategies are in the major securities markets.\textsuperscript{75}

\section*{D. Industry Views on Empty Voting}

Many industry bodies have condemned the practice of vote buying. In a report prepared for the Shareholder Voting Working Group, Paul Myners argued that ‘borrowing shares for the purpose of acquiring the vote is inappropriate, as it gives a proportion of the vote to the borrower which has no relation to their economic stake in the company’.\textsuperscript{76} The \textit{Securities Borrowing and Lending Code of Guidance} prepared by the Bank of England’s Securities Lending and Repo Committee states as follows:

\begin{quote}
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.\textsuperscript{77}
\end{quote}

The International Securities Lending Association (ISLA) document \textit{Securities Lending and Corporate Governance} also states: ‘[i]t is clear from the SLRC Code of Guidance and the Myners reports on the subject of securities lending and voting that the practice of borrowing shares specifically to vote is unacceptable’.\textsuperscript{78}

The International Corporate Governance Network \textit{Securities Lending Code of Best Practice} states that borrowers of shares who have ‘only a temporary interest in the shares’ who exercise voting rights attached to the shares ‘can distort the result of general meetings, bring the governance process into disrepute and undermine confidence in the market’.\textsuperscript{79} Borrowing shares for the primary purpose of exerting influence, deliberately reducing or suppressing the vote at a shareholders’ meeting or gaining control of a company without sharing the risks of ownership is a violation of best practice.\textsuperscript{80} ‘Accordingly, the borrowing of shares for the purpose of exercising the right of the shareholder’s vote is to be discouraged by all lenders’.\textsuperscript{81} The \textit{Hedge Fund Standards Final Report} prepared by the Hedge Fund Working Group stated that ‘[a] hedge fund manager should not borrow stock in order to vote’.\textsuperscript{82}

\section*{III. Regulatory Responses to Empty Voting}

This Part discusses the inquiries and responses to empty voting that regulators have undertaken around the globe. It focuses on those jurisdictions that have examined the problems or potential problems arising from empty voting and considered whether a regulatory response is warranted to address those problems.

\begin{table}[h]
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\begin{tabular}{|c|c|}
\hline
\textbf{Table 1} & \textbf{Description} \\
\hline
European Securities and Markets Authority, \textit{Call For Evidence On Empty Voting: Feedback Statement}, ESMA/2012/415 (29 June 2012). & \textsuperscript{73}  \\
Henry T C Hu and Bernard Black, ‘Equity and Debt Decoupling and Empty Voting II: Importance and Extensions’ (2008) 156 \textit{University of Pennsylvania Law Review} 625, 661–681. & \textsuperscript{74}  \\
Bank of England Securities Lending and Repo Committee, \textit{Securities Borrowing and Lending Code of Guidance} (July 2009), 18. & \textsuperscript{77}  \\
International Corporate Governance Network, \textit{Securities Lending Code of Best Practice} (2007), 5. & \textsuperscript{79}  \\
International Corporate Governance Network, \textit{Securities Lending Code of Best Practice} (2007), 9. & \textsuperscript{80}  \\
International Corporate Governance Network, \textit{Securities Lending Code of Best Practice} (2007), 9. & \textsuperscript{81}  \\
Hedge Fund Working Group, \textit{Hedge Fund Standards: Final Report} (2008) 81. & \textsuperscript{82}  \\
\hline
\end{tabular}
\caption{Regulatory Responses to Empty Voting}
\end{table}
A. Australia

To date, empty voting has received little attention in Australia. The issue was briefly considered in the 2008 Commonwealth Parliamentary Joint Committee on Corporations and Financial Services Report Better Shareholders – Better Company: Shareholder Engagement and Participation in Australia. Several submissions received by the Committee expressed opposition to the practice of “vote renting”, namely where a person borrows shares to obtain the right to vote those shares in order to influence the outcome of a company vote. The Committee considered that vote renting “in no way contributes to good corporate governance” and should not be permitted. It recommended that “[t]he government should investigate the most appropriate regulatory framework for ensuring that stock lenders retain the voting rights attached to the lent shares”.

The Corporations and Markets Advisory Committee (CAMAC) is currently undertaking a review of shareholder engagement in the context of the annual general meeting. The Discussion Paper noted that there is the possibility of shareholders ‘renting’ shares to another party, so that the other party has power to cast the votes attached to those shares. It has sought submissions on whether changes should be made to the current requirements relating to renting shares. This review is also considering the role of institutional shareholders in corporate governance more broadly.

B. Europe

Empty voting has been considered on several occasions by European regulators. On 15 December 2004 the European Union (EU) adopted a directive, known as the Transparency Directive, intended to harmonise the disclosure obligations of entities listed on a stock exchange within the European Union. In 2009 the European Commission commissioned a review of the operation of the Transparency Directive. The resulting report, the Transparency Directive Assessment Report, considered how the disclosure requirements of the Transparency Directive applied to securities lending, and also considered the broader question of the legitimacy of empty voting. Article 9, paragraph 1, of the Transparency Directive requires member states to ensure that shareholders whose holding of voting rights in a listed entity reaches, exceeds or falls below a specified threshold notify the issuer of that fact. Article 10 also provides that the notification requirement in paragraph 1 of Article 9 also applies where a person is entitled to acquire, dispose of, or exercise ‘voting rights held by a third party under an agreement concluded with that person or entity providing for the temporary transfer for consideration of the voting rights in question’. The Assessment Report considered that Article 9 read with Article 10 of the Transparency Directive required notification of a securities lending transaction by both the borrower and lender. This interpretation has not been adopted uniformly by EU member states. The underlying
rationale for the Transparency Directive requirement, according to the report, was that disclosure by both borrower and lender was the only way to provide a complete picture of the transaction to the market. The Report stated that although it was not possible to quantify the extent of empty voting, there was ‘significant anecdotal evidence that this practice is regularly used’. A later inquiry was initiated by the European Securities and Markets Authority (ESMA) to specifically consider the problem of empty voting. In September 2011 ESMA issued a Call For Evidence on Empty Voting, seeking information as to the level and frequency of empty voting, including whether it has influenced the results of voting at general meetings of shareholders, and whether regulatory action was needed. ESMA released its response to the submissions in June 2012. ESMA noted that ‘contributors were not able to provide the evidence needed to corroborate their answers about the frequency and intensity of empty voting practices and, therefore, the overall conclusion of the consultation is that there appears to be insufficient evidence to require further analysis or action at this stage’. ESMA agreed with the view of most of the responses that ‘the most risky practice related to empty voting is when an investor borrows shares … in order to vote in a way that is perceived to be against the long-term interest of the company’.

In January 2008 the French stock market regulator, the Autorité des Marchés Financiers (AMF), in its Report Improving the Exercise of Shareholder Voting Rights at General Meetings in France, noted concerns with securities lending and recommended greater transparency in relation to the voting of loaned securities. In a subsequent more detailed study specifically targeted at securities lending around the time of shareholder meetings, the AMF recommended a disclosure regime so that ‘borrowers should have to make specific disclosures when engaging in temporary transfers of shares that involve a percentage of capital or voting rights in excess of a statutory threshold’. The AMF considered more restrictive measures, including requiring lenders to recall shares during the general meeting season or banning lending transactions, however, it considered these were too restrictive given that securities lending performs a legitimate market function. It proposed instead that the voting rights of shares acquired through a temporary transfer or hedged shares should be suspended.

C. United States

The US Securities and Exchange Commission (SEC) has also considered empty voting. In July 2010 the SEC issued a Concept Release on the US Proxy System, seeking comments and submissions as to whether the US proxy system was operating with the ‘accuracy, reliability, transparency, accountability, and integrity’ that should rightly be expected by issuers and shareholders. The SEC noted that these expectations were based on the ‘foundational understanding’ that a shareholder possesses both voting rights and an economic stake in the company, and that decoupling challenges this foundational

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95 European Securities and Markets Authority, Call For Evidence on Empty Voting: Feedback Statement, ESMA/2012/415 (29 June 2012), 5.
Empty voters may have an incentive to exercise their votes in ways that are detrimental to the interests of the shareholders as a whole. The SEC considered that there was a strong case for ensuring increased transparency about the use of empty voting. The SEC noted four possible reform options:

- require voters to certify on the proxy form that they hold the full economic interest in the shares being voted;
- require disclosure of the meeting agenda ahead of the record date to enable institutional investors to recall their securities in order to vote;
- permit only holders with long positions in the shares to vote by proxy;
- prohibit empty voting.

The SEC has sought further information and comments in relation to empty voting. No further action has been taken at the date of writing.

D. United Kingdom

In 2003, following concerns that the system for voting shares in the United Kingdom was not functioning as effectively and efficiently as it should, Paul Myners was commissioned by the Shareholder Voting Working Group to recommend reforms to the system. The Report considered that beneficial owners such as institutional investors should drive improvements to voting standards. The Report argued that ‘borrowing of shares for the purpose of voting is not appropriate as it gives a proportion of the vote to an agent which has no relation to the agent’s economic stake in the company’. Beneficial owners ought to understand that the loan of shares transfers the voting rights attached to those shares and be aware of the consequences of lending the shares. More specifically, the Report recommended that for contentious resolutions, ‘the lender should automatically recall the related stock, unless there are good economic reasons for not doing so. Failure to take such action could be extremely detrimental’. However, it was not suggested that this should be prescribed in legislation.

In 2009 the UK Panel on Takeovers and Mergers Code Committee issued a consultation paper examining the disclosure requirements contained in the Takeover Code. The Code Committee noted that the prevailing view was that it was not considered appropriate for a person to borrow securities for the purpose of exercising the voting rights attached to them. The Committee’s consultation indicated that ‘the voting of borrowed securities on offer-related resolutions’ was not common practice; but it was not

possible to borrow securities in order to vote them without breaching applicable law or regulations. The Code Committee proposed 3 changes to the requirements relating to securities borrowing and lending:

(a) a borrower of securities would be treated under the Code as having acquired “control” of, and therefore as interested in, any relevant securities which he has borrowed;

(b) a lender of securities would be treated under the Code as, in effect, continuing to “own”, and therefore as continuing to be interested in, any relevant securities which he has lent, but as having temporarily lost “control” of those relevant securities; and

(c) the Code’s disclosure regime would treat securities borrowing and lending transactions as dealings and would require a person to disclose his borrowing or lending position in relevant securities.

However, the Committee considered that the costs of implementing such reforms would be disproportionate to the increase in market transparency that would result and so were not warranted at that time. The Committee noted that it intended to keep these issues under review.

The UK Financial Services Authority has also introduced disclosure requirements for holdings of contracts for difference (derivatives that give the holder an economic interest in company shares).

E. Canada

In December 2008 the Canadian Securities Administrators (CSA), an umbrella organisation of Canada’s securities regulators (securities laws are primarily a matter for provincial and territorial law) whose objective is to improve and harmonise the regulation of Canadian securities markets, issued a Notice and Request for Comment in relation to Insider Reporting Requirements and Exemptions. The Notice referred to Hu and Black’s research and noted that investors can, through derivatives or securities borrowing arrangements, acquire voting rights without having an economic stake in the issuer, or can acquire such rights while having an economic interest contrary to the issuer, and seek to exert influence on the outcome of a shareholder vote. It noted that the CSA would monitor developments in other jurisdictions and invited feedback on empty voting.

In March 2013 it issued a further Notice and Request for Comment in relation to disclosure of shareholdings. The Notice proposed reforms to require investors who hold “hidden” stakes in a company to disclose those interests. It also proposed to clarify that securities lending arrangements

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were to be taken into account in calculating the disclosure thresholds. However, the existing laws would not need to be substantially amended to achieve this, because the Notice considered that existing disclosure requirements \(^{119}\) applied to both lenders and borrowers in securities lending arrangements because both parties would acquire ‘beneficial ownership of, or control or direction over, 5% or more of the outstanding common shares of the issuer’. \(^{120}\) Borrowers would also be empty voters because they lacked an economic interest in the shares.

IV. INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE

Any analysis of empty voting must consider the broader context of institutional shareholding and corporate governance. Lenders of securities are institutional shareholders, especially insurance companies, superannuation funds and investment funds which lend out securities forming part of their asset portfolios in order to generate lending fee income. Many reform suggestions centre on the role of institutional shareholders, such as requiring or encouraging them to recall their shares for the purpose of a shareholder vote. This Part considers key aspects of institutional shareholding and corporate governance which relate to securities lending and empty voting.

A. Institutional Investors and Voting: Legal Issues

The Corporations Act does not impose a specific duty on institutional investors such as fund managers or superannuation funds to vote their shares. Such a rule has been considered by the Companies and Securities Advisory Committee (CASAC). In its 2000 report *Shareholder Participation in the Modern Listed Public Company*, CASAC considered whether scheme managers or institutional shareholders should be required to attend or vote at general meetings of listed public companies. \(^{121}\) In CASAC’s view, it would be difficult to frame a mandatory rule applying only to institutional investors and such a rule could be largely ineffective as institutional investors would likely go through the motions without giving genuine consideration to the resolutions being voted on. \(^{122}\) The better approach was to develop best practice guidelines regarding participation at company meetings by institutional shareholders. However, the level and nature of institutional shareholders’ involvement in particular companies was better left to their commercial judgment and market pressures. \(^{123}\) CASAC thus recommended that ‘[t]here should be no statutory obligation for scheme managers or institutional shareholders to attend or vote at general meetings of listed public companies’. \(^{124}\)

Superannuation funds have fiduciary obligations to beneficiaries, including a duty to act in the best interests of the beneficiaries. However, this falls short of a specific duty to exercise voting rights, for a range of different courses of action may be appropriate depending on the circumstances, including selling underperforming shares; and it is unlikely that superannuation funds would be required to vote their

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shares on ‘uncontroversial or unexceptional resolutions’. These obligations would apply to institutional shareholders who loan portfolio shares as part of a securities lending arrangement. Such investors would have a duty to act in the best interests of their beneficiaries, but there would be no specific duty to recall those shares and exercise any associated voting rights.

This position is also relevant to potential regulatory responses to empty voting. One reform proposal that has been canvassed in the literature is to require shareholders who have lent shares to recall them before a shareholder meeting for the purpose of voting those shares. However, such a rule would be incongruous with the existing requirements applicable to shareholders. If it is not considered appropriate or feasible to require shareholders to attend and vote at a general meeting, then similar reasoning would suggest that a rule requiring shareholders to recall their loaned shares is also inappropriate or not feasible. Such a rule would, however, have the effect of removing such shares from the pool of shares which can be voted, thus achieving the goal of eliminating empty voting in relation to those shares.

Of course, the fact that there is no requirement to do so does not mean that institutional investors do not exercise their voting rights or participate in corporate governance in other meaningful ways.

B. Institutional Investors and Voting: Market Practice

Institutional shareholders hold an increasingly large proportion of corporate equities in Australia and worldwide. They are therefore an important part of the structure of corporate governance. The role that institutional shareholders do, and should, play in corporate governance has been debated by corporate law scholars and others. Some commentators have argued that many shareholders in publicly listed companies have ‘short-term investment horizons that can be measured in months, or even days’, and thus cannot be expected to perform the role of sophisticated long-term investors that have the incentive to closely monitor public companies. On this view, government regulation should be targeted to ‘realign the incentives of institutional investors with those of long-term shareholders’.

Other commentators have strongly defended the value of shareholder engagement. It is argued that institutional shareholders can contribute to effective corporate governance by monitoring the performance of listed companies and their boards, providing scrutiny and accountability. Where shareholders, particularly institutional shareholders, fail to carry out this role, corporate governance suffers. Active engagement by institutional shareholders including voting at general meetings is considered essential to this accountability function. Thus, the shareholder franchise is regarded as an important accountability

mechanism for companies. Shareholder voting ‘is the bedrock of governance’ and the process must be ‘efficient, effective and transparent’.

Many concerns regarding the lack of shareholder engagement have been expressed. Concerns are periodically raised that voting levels are too low. Across the globe, inquiries have been undertaken into the effectiveness of shareholder voting systems. Early studies noted the limits of effective institutional engagement with companies. An Australian study published in 2000 found that many institutional investors did not routinely exercise voting rights but voted only on contentious or significant matters. Indeed, many institutional investors did not even attend general meetings. Further, many institutions did not control sufficient shares to make a successful institutional intervention possible.

The European Commission Internal Market and Services Directorate General has initiated several reviews into shareholder voting, expressing concerns about the lack of shareholder engagement and seeking to encourage shareholders to take a more active role in corporate governance. The recent European Commission Roadmap on the Revision of the Shareholders’ Rights Directive noted that:

> there is a perceived lack of shareholder interest in holding management accountable for their decisions and actions, compounded by the fact that many shareholders appear to hold their shares for only a short period of time. If the majority of shareholders remain passive, do not seek interaction with the company and do not vote, the functioning of the current corporate governance system is less effective. … There is therefore a perceived need to encourage shareholders to engage more in corporate governance.

However, recent studies of institutional share voting in Australia have found that, in contrast to attitudes in earlier years, institutional investors are becoming increasingly active in the voting of their shares. A recent, detailed study of institutional share voting in Australia found that an industry standard that institutional shareholders have an obligation to vote their shares has emerged. In addition, many industry participants consider that institutional share owners have a duty to make the voting decision themselves and that it is not acceptable merely to outsource decision-making to a third party. However, many listed companies hold their AGMs within a very short period of time, with a “mini” proxy season in April-May and a main proxy season in October-early December. A large number of these are held in

142 European Commission Internal Market and Services Directorate General, The EU Corporate Governance Framework, Green Paper (April 2011); European Commission Internal Market and Services Directorate General, Corporate Governance in Financial Institutions and Remuneration Policies, Green Paper (June 2010).
October-November each year. This compressed timeframe has the consequence that there is little time to give proper consideration to voting decisions, undermining genuine engagement with the process and forcing institutional holders to outsource much of this work to third parties such as proxy advisory firms, whose recommendations, it is argued, are often accepted with little contestation.146

There are additional factors which limit the effectiveness of institutional investors’ engagement with corporate governance. The efficacy of institutional voting depends to a large degree on the machinery for implementing the voting intentions of institutional investors, who often outsource parts of the process to proxy advisors and other service providers. The information and instruction flows involved in institutional proxy voting are complex. A recent study commissioned by the Australian Council of Superannuation Investors found that there are various operational weaknesses in the integrity of the proxy voting system in Australia, which result in errors such as instructions not being followed by voting agents, shares not being reflected in final voting results and proxies being lodged in respect of incorrect resolutions.147 Similar issues have been noted in other jurisdictions where problems such as “lost” votes and double voting occur.148

However, voting is not the only means of influencing companies, and so the level and effectiveness of voting does not present a complete picture of the influence and activity of institutional investors: “[v]oting is merely one method by which institutional investors participate in corporate governance”.149 Institutional investors will often have other avenues available to monitor portfolio companies and influence or seek to induce change, such as engaging in discussions with management on key issues.150 Often, contentious matters will be resolved behind the scenes rather than be put to a vote.151 Thus, long-term institutional investors holding shares in a company may have significant influence over that company even where they have temporarily loaned their shares to borrowers.

Any reform proposals made in relation to empty voting must take account of these broader issues in corporate governance. If shareholders are apathetic and engage little with the shareholder voting process, requiring them to recall shares and vote prior to a shareholder meeting is unlikely to contribute meaningfully to corporate governance. Further, if there are impediments to effective shareholder engagement, such as an inability to give proper consideration to voting decisions due to the compressed timeframe in which many listed companies hold their AGMs and complexities and inefficiencies in the proxy process, shareholder votes may not be properly considered, and even where they are, voting intentions may not be communicated effectively. Accordingly, broader reforms to the voting systems and processes may be necessary to deal with these problems.

On the other hand, recent research suggests that institutional investors are increasingly active in corporate voting and take corporate governance seriously. Institutional investors often have avenues other than a vote cast at a general meeting available to monitor portfolio companies and exercise influence. Where

150 Paolo Santella, Enrico Baffi, Carlo Drago and Dino Lattuca, A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US, Munich Personal RePEc Archive Paper 8929 (2008), 8.
151 See also Corporations and Markets Advisory Committee, The AGM and Shareholder Engagement, Discussion Paper (September 2012), 15.
institutional investors monitor and engage with portfolio companies, even where they have loaned shares in those companies as part of a securities lending arrangement, mandating that such shareholders ought to be more active in voting may yield little additional benefits.

C. Voting and the Recall of Loaned Shares

As noted above, several US studies have shown that there is an increase in securities lending around proxy dates. A 2002 study suggested that the recall of securities to vote by investors is rare. However, a recent study found that the supply of shares available to lend decreases prior to the record date and returns to pre-event levels on the first day after the record date. This is consistent with institutions recalling their shares at the time of a vote, withdrawing them from the available pool of lendable securities in order to vote. A small number of institutions always recall their shares in order to vote, however, the majority only recall their shares selectively, depending on the proposed resolutions. The authors also found evidence which suggested that institutional investors actively analyse proposed resolutions and decide whether to restrict or recall shares in order to exercise their vote based on the importance of the items on the ballot. Institutions are more likely to recall shares when a proposed vote relates to corporate control and remuneration proposals. This suggests that institutional shareholders take the responsibility of voting seriously, and make the effort to determine when shares should be recalled in order to exercise voting rights.

The actual process by which the recall of loaned shares takes place in Australia has been described as follows. According to the Australian Institute of Company Directors Report Institutional Share Voting and Engagement, it is common for institutional shareholders to recall any shares they have loaned. Where an institutional shareholder intends to recall shares it has out on loan, it will instruct its custodian to recall those shares. Custodians generally implement this instruction ‘by redistributing shares within their total pool of votes aggregated across all clients’. For example, if a custodian holds a total pool of a million shares and voting instructions have not been delivered in relation to 100,000 of those shares, the custodian will use those shares for loan recall purposes.

D. Institutional Investor Policies

It is becoming more common for institutional shareholders to develop and publish policies relating to securities lending. Peak industry bodies have also adopted policies and guidance notes recommending their members develop such policies. In 2009 the Investment and Financial Services Association Limited (now the Financial Services Council) published a guidance note recommending that its members develop policies dealing with securities lending arrangements and ensuring that voting rights are exercised appropriately. While not specifically referring to securities lending, the Australian Council of Superannuation Investors Governance Guidelines state that participation in company meetings is ‘a

critical right of shareholders and a cornerstone of corporate governance practice’ and that ‘all superannuation funds should be exercising all of the votes associated with their shares, all of the time’. In the US, key institutional investors have adopted policies specifically relating to securities lending. In Australia, however, institutional investors typically publish their corporate governance or share voting policies more generally, which do not mention securities lending. If Australian funds have adopted policies relating to the lending of their portfolio shares, these do not appear to have been made publicly available.

V. OPTIONS FOR REFORM

This Part outlines the reform suggestions that have been made in the literature to address the problem of empty voting.

A. Disclosure

One of the main reform proposals that has been widely canvassed is to improve shareholder holding disclosure requirements, including imposing a specific requirement to make disclosure of empty voting positions. Hu and Black proposed reforms to US disclosure rules to address the problem of empty voting, because those rules ‘are highly complex, treat substantively identical positions inconsistently both across and within disclosure regimes, do not effectively address either empty voting or hidden (morphable) ownership, and for the most part do not cover share lending and borrowing’. They proposed a simplified disclosure regime with a single set of rules relating to which ownership positions to disclose, including requiring disclosure of lending and borrowing of shares, and voting ownership. Lenders would be required to report their loans and borrowers would be required to report their borrowings and whether they retained the borrowed shares or sold them short. They considered that disclosure is likely to reduce the occurrence of empty voting.

In a recent detailed study of empty voting in Europe, Wolf-George Ringe proposed an improved disclosure regime to deter empty voting and provide further information on the extent of its occurrence. In Ringe’s view, the key problem relating to empty voting is the lack of transparency; accordingly, ensuring transparency by disclosing the existence of such positions is the appropriate way to solve the problem.

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166 Henry T C Hu and Bernard Black, ‘Equity and Debt Decoupling and Empty Voting II: Importance and Extensions’ (2008) 156 University of Pennsylvania Law Review 625, 694. This article also updated their original disclosure proposal.
Further, disclosure would deter hedge funds and other investors from utilising empty voting strategies. 167 Ringe’s proposed continuous disclosure regime would capture all known constellations of risk decoupling, especially where shareholders reduce their risk exposure in relation to their shares and where investors hold shares only temporarily. 168 Ringe proposed a threshold of a 5% empty voting position, which in his view achieved an appropriate balance between ensuring meaningful information was disclosed in situations where a shareholder acquired sufficient voting power to influence a vote, and minimising costs imposed on market participants. 169

Other scholars have argued that disclosure alone is not sufficient to address the problems created by empty voting. 170 Hu and Black’s proposed US disclosure reforms were only intended to be a first step in addressing the problem of empty voting. The Transparency Directive Assessment Report concluded that if empty voting is considered to be an improper practice, disclosure is not an adequate remedy, 171 and similarly the AMF considered that disclosure alone would be insufficient to correct the distortions that have occurred as a result of empty voting. 172 These authors and reviews have proposed more radical reforms, which are discussed in the following sections. The following sections also discuss the regulatory responses implemented in various jurisdictions.

B. Prohibiting or Limiting Empty Voting

Prohibiting decoupling outright has been canvassed by some scholars, however it has been acknowledged that such a regulatory approach would not be appropriate because securities lending, short selling and equity derivatives perform economically legitimate and desirable functions. A more targeted form of this approach would be to ban or restrict securities lending and short selling around shareholder meetings. Yet it is acknowledged that such a ban would be impracticable and would also restrict desirable activity. 173

Another approach is to restrict the voting of shares which relate to empty voting positions. There have been calls for empty voting to be banned altogether. 174 This could be achieved by banning voting with borrowed shares, 175 banning voting where an investor’s voting rights exceed their underlying economic ownership, or banning at least voting where the voter has a negative economic interest, that is, a net short position. 176 Hu and Black argued that in order to be effective, a rule would need to address the many ways in which votes can be decoupled from economic ownership. 177 This paper is concerned only with securities lending. It is acknowledged that this would be a radical solution; however, some consider this to be justified in light of the serious consequences of empty voting. The authors of the Transparency Directive Assessment Report argued that this ‘would be the most consistent decision to be taken in view

168 Ibid, 1096.
169 Ibid, 1099.
of the principles at stake. Some scholars have argued that where shareholders have greater voting power than economic ownership, the voting rights should be reduced. Martin and Partnoy argued that ‘[a]t a minimum, shareholders with substantial short positions should not be entitled to vote’. Another suggestion is to deem voting with borrowed shares to be prohibited market manipulation. As opposed to a blanket rule, some commentators advocate conferring powers on regulators to impose voting restrictions on shareholders in certain circumstances, taking into account the timing of the situation (such as the proximity to a general meeting) and the likely harm to result from the situation. A further suggestion has been to allow only large shareholders who have a ‘continuing economic interest in a corporation’s shares’ to appoint proxies to vote on their behalf.

In France, where any person or entity comes into possession of voting rights which exceed specified thresholds the investor must inform the company of that fact. This includes shares or voting rights owned by a third party with whom that person has entered into a temporary transfer agreement covering those shares or voting rights. Where disclosure is not made as required, shares in excess of the fraction which should have been declared ‘are stripped of the voting right for any shareholders’ meeting held within two years of the date of effective notification’.

There are several difficulties with these solutions. First, a ban on empty voting will apply not only to situations where empty voting is undesirable, it is also likely to capture situations in which empty voting is a desirable practice. In formulating a ban on empty voting, it would be difficult to frame the rule in such a way as to capture the undesirable conduct without also targeting economically desirable activities. A prohibitive rule would curtail beneficial instances of vote buying as well as harmful ones. Secondly, there is not a unanimous view that empty voting is always, or generally, harmful. Even those who advocate regulation to counter the harmful effects of empty voting acknowledge that empty voting can be beneficial in individual cases, and so an outright prohibition or automatic deprivation of voting rights will often yield inappropriate results. It would seem desirable for there to be a consensus that the practice is harmful and ought to be prohibited prior to enacting such a regulation. Finally, implementing such a regulation may be impracticable and may be circumvented by financial product innovation.

181 Hermes Equity Ownership Services, Letter Responding to ESMA’s Call for Evidence on Empty Voting (25 November 2011).
184 Namely, one twentieth, one tenth, three twentieths, one fifth, one quarter, one third, one half, two thirds, eighteen twentieths or nineteen twentieths.
An alternative proposal would be to allow or encourage companies to take the lead by restricting voting rights through amendments to the corporate constitution. Hu and Black proposed that ‘corporate law should allow firms to adopt charter amendments to limit empty voting, subject to an array of limits designed to ensure that these amendments produce better voting’.192

C. Imposing Requirements on Lenders

A further regulatory strategy would be to impose various requirements on lenders of shares, for example requiring lenders to recall loaned shares prior to a shareholder meeting in order to vote them or requiring them to issue voting instructions to the borrower. A “classical proposal” to restrict empty voting would be to require shareholders who have lent their shares to recall them before a general meeting.193 Several objections have been raised to such a proposal: it would be burdensome, it may be overreaching because it would prevent securities lending around the time of general meetings whereas it is the use of borrowed shares to vote which is wrong and not the securities lending per se, and it would only address securities lending and not other forms of empty voting.194 More generally, Hu and Black proposed that regulators should encourage lenders to recall shares in order to vote them.195 Another option is to require funds to recall shares for “material” events or contentious resolutions.196 A further option would be to require lenders of securities to give voting instructions to borrowers. In some cases this occurs as a matter of course. A final option would be to encourage or require institutional shareholders to develop a policy relating to the lending of their securities.

While “encouragement” from regulators may be relatively harmless,197 requiring lenders of securities to recall their shares or issue instructions would be at odds with the approach adopted in relation to voting by institutional shareholders. As discussed above, regulators have not considered it desirable to impose a specific duty to vote on institutional shareholders. Indeed, such regulation may be unnecessary. Although it has been argued that lenders rarely recall their shares for the purpose of voting,198 more recent US evidence suggests that institutional share owners do indeed recall shares prior to shareholder meetings in order to vote, depending on the resolutions,199 and even where investors do not recall their shares, they may exercise influence in other ways, notwithstanding that their shares remain out on loan.

It should also be noted that AMSLA provides that the borrower must use its best endeavours to ensure
that any voting rights attached to borrowed securities are exercised in accordance with the instructions of
the lender;200 however, according to ASIC this clause is often deleted.201

D. Prohibition on Vote Buying

In the US, the buying of corporate votes is prohibited by common law in certain circumstances. The
leading decision is the Delaware case Schreiber v Carney,202 which relaxed the strictness of earlier
decisions which held that vote buying was illegal per se as a matter of public policy.203 The Delaware
Chancery Court held that although vote buying is not prohibited per se, the courts will intervene where
‘the object or purpose is to defraud or in some way disenfranchise the other stockholders’.204 The Court
held that an overriding fairness test will apply by which to test the legality of vote buying.205 One possible
response to empty voting or vote buying would be to extend these doctrines to prohibit vote buying in
situations where persons borrow shares pursuant to securities lending arrangements for the specific
purpose of voting. In one author’s view, this doctrine would already proscribe many of the more abusive
empty voting practices.206

Australia has no equivalent of the general vote buying prohibitions. The principle of fraud on a power or
fraud on the minority may apply to prevent abusive uses of voting power, depending on the
circumstances.207 However, there is no general prohibition on the buying of corporate votes and so it is
unlikely that Australian courts would develop the common law to prohibit empty voting without
legislative amendment. As the British Columbia Court of Appeal held in TELUS Corporation v Mason
Capital Management LLC, ‘[t]o the extent that cases of “empty voting” are subverting the goals of
shareholder democracy, the remedy must lie in legislative and regulatory change’.208

E. Self-Regulation

A regulatory response may be unnecessary to address the problem of empty voting. As documented
above, there is a widely held industry view that empty voting is inappropriate where a market participant
borrows shares in order to exercise the associated voting rights. It would be difficult to assess the specific
impact that these pronouncements have had on market practice. Nevertheless, it demonstrates that market
participants are alive to the concerns of empty voting. One author has argued that in the US context empty
voting may provide incentives for listed companies to implement strategies to detect and deter abusive
empty voting.209 Thus, ‘the alignment of the board’s incentives in empty voting contexts and their relative
ability to respond to the unaddressed problems suggest that the government’s best response may be to do
nothing’.210

200 Australian Securities Lending Association, Australian Master Securities Lending Agreement, clause 4.3.
201 Australian Securities and Investments Commission, Consultation Paper 107: Securities Lending and Substantial
Holding Disclosure (July 2009), 10.
202 Schreiber v Carney, 447 A2d 17 (Del Ch, 1982).
203 Macht v Merchants Mortgage & Credit Co, 194 A 19, 22 (Del Ch, 1937).
204 Schreiber v Carney, 447 A2d 17 (Del Ch, 1982), 25–6.
205 Schreiber v Carney, 447 A2d 17 (Del Ch, 1982), 26.
885, 897.
Journal of Corporate Law 96; B H McPherson, ‘Limits of Fraud on the Minority’ (1960) 77 South African Law
Journal 297.
208 TELUS Corporation v Mason Capital Management LLC, 2012 BCCA 403 at [81] (2012) (Justice Groberman,
Justice Levine and Justice Smith agreeing).
209 These strategies are: ‘establish disclosure regimes to help detect abusive empty voting, convey information to
shareholders in a clearer and more accurate manner, and adjust voting structures to better account for the
885, 911.
F. Other Options
This section briefly notes two other reform options advocated in the literature. Jonathan Cohen has proposed a private right of action whereby shareholders who are harmed by the negative voting perpetrated by another entity may sue that entity for loss suffered. The plaintiff would need to prove that the negative voting had an impact on the outcome of the shareholder vote and a negative impact on share price.

The Christoffersen study found that the median gap between record date and meeting date in relation to US listed companies was 54 calendar days. Eliminating or reducing the gap between record date and meeting would reduce the opportunity for shareholders to dispose of their shares after the record date but retain the right to vote at the meeting.

VI. ANALYSIS AND AUSTRALIAN CONSIDERATIONS
This Part considers whether regulatory intervention to address empty voting is warranted in Australia.

A. Evidence of a Problem
Several high profile cases have captured the minds of scholars and created a perception that there is a widespread problem requiring regulatory correction. These examples appear to have had a disproportionate impact in creating a perception of a problem. Aside from the often cited high-profile cases, it remains unclear to what extent abusive empty voting occurs in Australian markets (and worldwide). Securities lending only accounted for 10 of Hu and Black’s 80 examples of situations involving harmful vote buying from around the world between 1988 and 2007. No Australian example involving securities lending was provided by Hu and Black. The Christoffersen study was considered to have provided evidence that securities lending in the US is often used in an abusive way to capture corporate votes. This study has now been contradicted by a much more recent study, the Moser study, which suggested that there are legitimate reasons unrelated to voting for the market patterns observed in the Christoffersen study. Thus, it is unclear to what extent empty voting is a problem in Australia and elsewhere. A study in 2007 stated that apart from Solomon Lew’s unsuccessful attempt to be re-elected

to the Coles Myer board in 2002, ‘there have been no known high-profile examples of vote renting in Australia’. 219

As has been discussed above, there is far from a unanimous view that empty voting is always harmful; several scholars have argued that empty voting may be beneficial in certain cases, which has been acknowledged by those who would restrict empty voting. In light of the lack of evidence that there is a widespread problem of empty voting, recent examinations of empty voting by regulators have concluded that there is insufficient evidence to warrant regulatory intervention. As such, regulatory intervention in relation to empty voting in Australia would seem to be premature. Not every problem in the financial markets (or, for that matter, society as a whole) requires legislative correction. A legislative rule that banned empty voting or limited the voting rights of shareholders whose voting rights exceeded their economic exposure would likely be a rule of significant complexity; it would seem undesirable to introduce such an amendment into an already complex legislative regime without a convincing evidence base.

B. Disclosure

Australia’s substantial shareholding disclosure system is much clearer and more effective than that operating in a number of other jurisdictions. In some jurisdictions, disclosure requirements are based on the concepts of beneficial ownership and control, so that it is not difficult for sophisticated investors to amass a voting stake without corresponding beneficial ownership, thereby avoiding disclosure. 220 Other jurisdictions do not clearly require empty voting positions to be disclosed. 221 As a result, one of the key reform proposals that has been considered by commentators and regulators to address the problem of empty voting is to improve disclosure requirements so that empty voting positions are required to be disclosed.

Section 671B of the Corporations Act provides that a person must make disclosure upon acquiring or ceasing to have a “substantial holding” in a listed company. 222 A person has a substantial holding in a company if the person and their associates have “relevant interests” in 5% or more of the total number of votes attached to the voting shares in the company. 223 Disclosure is also required where a person has a substantial holding and there is a movement of at least 1% in their holding. 224 A loan of securities involves the transfer of legal title to those securities, including all voting and other rights attached to those securities 225 and thus confers a “relevant interest” in those securities on the borrower. The regime requires both borrowers and lenders of securities to make disclosure of substantial holdings. 226

The information required to be disclosed is set out in s 671B(3). Disclosure is made using forms prescribed by ASIC and released to the relevant financial market. 227 If the transaction does not take place on a prescribed financial market, the terms of any agreement that contributed to the situation giving rise to

219 RiskMetrics Group, Securities Lending and Voting Entitlements (December 2007), 28.
222 Corporations Act 2001 (Cth), s 671B(1)(a).
223 Corporations Act 2001 (Cth), s 9, definition of ‘substantial holding’.
224 Corporations Act 2001 (Cth), s 671B(1)(b).
227 Form 603 Notice of Initial Substantial Holder and form 604 Notice of Change of Interests of Substantial Holder.
the need to make disclosure must also be disclosed. Where a borrower acquires the voting rights to 5% of the total number of shares in a listed company under a securities lending arrangement, that borrower would be required to make disclosure of their holdings.

Accordingly, Australia already has a disclosure system that meets the requirements of the proposals made by commentators. Any empty voting position created by a borrower of securities would need to be disclosed that position to the market and the market would thus be fully informed in relation to the borrower’s position. As a result, it does not appear necessary to reform Australia’s disclosure rules to capture empty voting.

C. Prohibiting or Limiting Empty Voting

It was noted above that a blanket rule prohibiting empty voting is not likely to be an appropriate response to empty voting. It would also be at odds with the general approach to institutional investors and corporate governance outlined above. Some have therefore considered that regulators should allow or encourage companies to amend their constitutions to restrict voting rights. Rather than a regulatory response, this would be a market-driven approach, albeit encouraged by regulators.

Under this approach, company constitutions could provide that shareholders are not permitted to vote borrowed shares. There are two possible restrictions in principle upon such constitutional provisions. First, where such an amendment was made to a company’s constitution so as to take away the rights of existing shareholders, the High Court’s decision in *Gambotto v WCP Ltd* would need to be considered. If such an amendment were considered to be an expropriatory one, the amendment would need to satisfy the two-pronged fairness and proper purpose test. When adopting a constitution upon establishment of a company, these requirements would not apply. Secondly, the ASX Listing Rules provide that holders of ordinary shares are entitled to one vote per share at shareholder meetings and provide that these rights can only be taken away in specified situations, including where the ASX grants approval. Thus, ASX’s approval would be needed for any amendment to a listed company’s constitution which restricted empty voting or voting of borrowed shares.

VII. CONCLUSION

This paper has analysed the issue of empty voting and considered the implications in the Australian context. Some scholars have argued that empty voting is a harmful practice, especially where shares are borrowed in order to influence the outcomes of corporate votes in ways that are detrimental to the company. Many industry bodies and standards have condemned the practice. However, this paper has noted that there is far from a unanimous view that empty voting is always harmful. Vote buying may intensify the preferences of engaged shareholders and increase efficiency in the market where informed shareholders can purchase the votes of less informed shareholders. Further, contrary to an earlier US study which suggested that securities lending was frequently used to capture corporate proxy votes, a more recent and detailed US study has argued that there is no widespread practice of abusive proxy capture.

In light of the lack of evidence that there is a widespread problem of empty voting, there is insufficient evidence to warrant regulatory intervention. The Australia disclosure regime is adequate and already requires disclosure of substantial holdings of borrowed shares. Empty voting positions are already captured by Australia’s disclosure rules.

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228 *Corporations Act 2001 (Cth),* s 671B(4)&(5).