

WHAT WE TALK ABOUT WHEN WE TALK ABOUT VOTING: EFFICIENCY AND THE ERROR IN EMPTY VOTING

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Abstract

Under the shareholder primacy model, shareholders exercise voting power because their votes are wealth maximizing and efficient. The practice of decoupling, or the strategic separation of the right to vote on a share from the economic ownership of that share, undermines this efficiency. The decoupled investor's interests are not aligned with maximizing the value of the corporation and decoupled investors have, to the detriment of all other shareholders, used their voting power to dictate inefficient corporate decisions. This Note advocates for proxy card disclosure of decoupled shares and subsequent voiding of the decoupled votes. In this way, only those shares interested in wealth maximization are able to influence corporate outcome, restoring efficiency to shareholder voting.

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INTRODUCTION

In early 2001, Perry Corporation (“Perry”), a hedge fund, was a substantial shareholder of Rubicon Ltd. (“Rubicon”).¹ By June 2001, however, Perry publically announced that it had whittled down its sizeable investment to that below the threshold requiring disclosure.² Surprisingly, a year later, Perry disclosed a sizeable holding in Rubicon conveniently in time to vote at Rubicon’s annual meeting.³ Unbeknownst to Rubicon, Perry had previously engaged in derivatives transactions designed to decouple the economic interest of their shares from the attendant voting rights.⁴ Decoupled of its voting rights, Perry’s holding diminished in size albeit temporarily. Then, before the annual meeting, Perry easily unwound its derivative transactions, reuniting the shares with their voting rights and consolidating its once again sizeable holding in time to influence the vote.⁵ In short, Perry had engaged in “decoupling,” or the strategic separation of the right to vote from the economic ownership of shares.⁶

Decoupling has existed undocumented for an undetermined amount of time.⁷ Yet, in 2005, Shaun Martin and Frank Partnoy first identified situations in which investors used derivatives to vary their economic

1. See Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 836 (2006) (discussing the Perry-Rubicon situation).

2. Because Rubicon is a New Zealand company, it is required to disclose 5% ownership positions pursuant to New Zealand law, similar to that of Section 13(d) in the United States. See *id.*

3. *Id.*

4. *Id.* at 836-37.

5. *Id.* at 827.

6. See, e.g., *id.* at 815-16.

7. Because decoupling is “largely unregulated and often unseen,” determining its full extent and historical presence is difficult to measure. *Id.* at 818-19. Nevertheless, Hu and Black have been able to identify eighty-two decoupling examples from 1988 through 2008. See Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 661-81 (2008).

interests while retaining voting power, or engaged in decoupling practices.⁸ Next, Henry Hu and Bernard Black comprehensively discussed the phenomenon of decoupling in their seminal article, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*.⁹ Hu and Black referred to decoupling as the “new vote buying” because it consists of a combination of “conventional” transactions that are by themselves not suspect: the purchasing of shares and using derivatives for hedging purposes.¹⁰ The results, however, are anything but conventional.¹¹

For the decoupled investor who maintains voting rights but who has otherwise abrogated economic ownership, decoupling may have many benefits, chief among them personal profit.¹² Corporate law rewards an interest in profit maximization so long as it is aligned with maximizing firm value.¹³ Under the shareholder primacy model of corporate law, shareholders are given the ability to vote on corporate decisions precisely because they are more tied to the economic risk in the venture.¹⁴ As the “residual claimants,” they are interested in maximizing firm value more than any other corporate party.¹⁵ Shareholder votes are thus deemed efficient because their decisions will be directed at wealth maximization.¹⁶ The decoupled investor, on the other hand, has severed herself from the economic interest of her shares and is therefore not interested in maximizing the value of those shares.¹⁷ And despite her disinterest in wealth maximization, the decoupled investor still retains the right to vote on those shares—her votes are inefficient.¹⁸

8. Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 789-94 (2005) (describing seven situations where shareholders use derivatives to decouple their voting rights from economic interest).

9. Hu & Black, *supra* note 1, at 816.

10. *See id.* at 818.

11. *See infra* notes 72-91 and accompanying text.

12. *See infra* note 44.

13. *See infra* note 23.

14. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 68 (1991); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945-46 (1996) (“The case for the one share, one vote rule turns primarily on its ability to match economic incentives with voting power . . .”).

15. *See infra* note 26.

16. *See infra* notes 26-29 and accompanying text.

17. *See infra* note 39.

18. *See infra* note 39.

This Note argues that the votes associated with decoupled shares should be excluded from corporate voting. To accomplish this, federal disclosure rules should require that investors disclose the extent of their shares that are decoupled in the event of a vote.¹⁹ Aware of the decoupled votes, the corporation can therefore exclude those from the final vote tally, curing the inefficiency problem by only counting those votes that are interested in maximizing firm value.²⁰

This Note proceeds in three parts. Part I discusses the efficiency rationale underlying the shareholder primacy model, and how decoupling breaks the efficiency link in its various forms. Part II discusses the existing disclosure requirements, how decoupling evades those requirements, and critiques existing proposals to address decoupling. Part III describes the author's proposal to mandate the disclosure of decoupled shares on shareholder voting proxy cards and to exclude them from the vote.

I. SHAREHOLDER PRIMACY AS AN EFFICIENT MEANS OF WEALTH MAXIMIZATION

This part begins by exploring the shareholder primacy model and the crucial efficiency link between shareholders' interest in wealth maximization and their right to vote on corporate decisions. The remainder of this part then discusses decoupling, its forms and techniques, and how it breaks the efficiency link.

A. SHAREHOLDER PRIMACY

Corporations exist to generate wealth.²¹ Maximization of firm value in turn maximizes social welfare.²² Accordingly, corporate law achieves

19. See *infra* note 142 and accompanying text.

20. See *infra* notes 144-45 and accompanying text.

21. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

22. Jordan M. Barry, John William Hatfield & Scott Duke Kominers, *On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership*, 99 VA. L. REV. 1103, 1120 (2013) [hereinafter Barry et al.] (arguing that the "justification for giving shareholders control rights is that doing so maximizes the value of the corporation, which in turn maximizes social welfare"); see also Black & Kraakman, *supra* note 14, at 1945-46.

this goal most efficiently by allocating voting rights to those who are uniquely situated to pursue firm wealth maximization: the corporation's shareholders.²³ This is referred to as the shareholder primacy model.²⁴ A long line of legal and economic scholarship supports and reinforces the wisdom of shareholder primacy.²⁵

Shareholder primacy is efficient because shareholders are more invested, and therefore more interested, in wealth maximization than any other corporate party.²⁶ As both the true owners of the corporate property²⁷ and the "residual claimants" of the corporation, shareholders reap the benefit or bear the brunt of the loss in firm value.²⁸ They will vote to their benefit by maximizing firm value.²⁹ Yet, shareholders exercise virtually no control over the corporation's general business and affairs, which are instead managed "by or under the direction of a board of directors."³⁰ This "efficiency link," giving voting power to the corporate party who is most interested in maximizing firm value, ensures that the business and affairs are wealth-maximizing.³¹ For instance, major corporate transactions or "fundamental changes" (such as liquidations, large asset sales, and mergers) that are most likely to directly affect firm value are subject to approval by shareholder votes.³²

Under the default rule, a shareholder is entitled to vote in proportion to the size of her investment.³³ Shareholders vote either in

23. See EASTERBROOK & FISCHER, *supra* note 14, at 66-72; see also Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 136 (2009) (discussing how "regulation of voting behavior also occurs to ensure the correct alignment between voting and the common welfare").

24. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 408 (2002).

25. Barry et al., *supra* note 22, at 1112; see also Black & Kraakman, *supra* note 14, at 1945-46; Frank H. Easterbrook & Daniel Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983). While the shareholder primacy model is generally accepted, it is not undisputed. See, e.g., BAINBRIDGE, *supra* note 24, at 441-42.

26. See, e.g., EASTERBROOK & FISCHER, *supra* note 14, at 67-70.

27. BAINBRIDGE, *supra* note 24, at 408 ("[U]nder the traditional conception of shareholder primacy, shareholders are said to own the corporation.").

28. See EASTERBROOK & FISCHER, *supra* note 14, at 67-70.

29. See *id.*

30. DEL. CODE ANN. tit. 8, § 141.

31. See *supra* note 23.

32. See, e.g., DEL. CODE ANN. tit. 8, §§ 275(b), 271(a), 251(c).

33. BAINBRIDGE, *supra* note 24, at 450. Virtually all state corporate codes have adopted this one-share-one-vote standard as the default rule. *Id.* at 453.

person or by proxy, although most shareholders vote by proxy.³⁴ A proxy is a shareholder's grant of authority to another to vote her shares.³⁵ Under Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act"), the Securities and Exchange Commission ("SEC") has broad authority to regulate the issuance of proxies.³⁶

B. DECOUPLING OF VOTING RIGHTS FROM ECONOMIC OWNERSHIP

Decoupling refers to a variety of practices in which a shareholder may separate, or decouple, the voting rights attached to the economic ownership of her shares.³⁷ Decoupling consists of two conventional transactions: buying shares and hedging those shares.³⁸ The combination of those transactions results in breaking the efficiency link: those parties with voting power are not affected by an increase in firm value and therefore not interested in maximizing firm value.³⁹ Although it may not benefit the corporation, decoupling is attractive to an investor for a number of reasons.⁴⁰ Decoupling allows an investor to hedge her investment and minimize her exposure to market changes.⁴¹ Decoupling

34. See, e.g., *id.* at 443.

35. ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS 292 (4th ed. 2006). A shareholder may also sell the voting rights attached to her shares. Such "vote-buying" is permissible, but somewhat suspect as "easily susceptible of abuse," and is therefore subject to a test for "intrinsic fairness." *Schreiber v. Carney*, 447 A.2d 17, 26 (Del. Ch. 1982).

36. 15 U.S.C. § 78n. Issuers with a class of securities registered under Section 12 of the Exchange Act are required to comply with federal rules governing the solicitation of proxies. *Id.* Rules 14a-4 and 14a-5 deal with the formatting of the proxy cards (font type, box to check for approval, disapproval, or abstention for each matter voted upon). 17 C.F.R. §§ 240.14a-4, 5 (2014). In the case of fundamental changes, Rule 14a-3 requires disclosure of information mandated by Schedule 14 for specific transaction. 17 C.F.R. § 240.14a-3 (2014). Broadly, Rule 14a-6 requires that the preliminary proxy statement and ballot be filed with the Securities and Exchange Commission ten days before the final copies are expected to be delivered to shareholders. 17 C.F.R. § 240.14a-6 (2014).

37. See Hu & Black, *supra* note 1, at 816.

38. See *id.* at 818.

39. See *id.* at 815 (arguing that negative economic ownership "gives the investor an incentive to vote in ways that reduce the company's share price"); see also Martin & Partnoy, *supra* note 8, at 809-10 (referring to this situation as "voting arbitrage").

40. See, e.g., Barry et al., *supra* note 22, at 1120-29 (discussing the potential problems and benefits of decoupling).

41. JEFFREY J. HAAS, CORPORATE FINANCE 119 (2014).

also enables an investor to strategically evade disclosing her investment position.⁴² Unknown to her fellow shareholders, she is able to covertly influence major corporate decisions.⁴³ Finally, decoupling can yield investors a large personal profit.⁴⁴

The hedged position may be achieved through traditional securities or derivative instruments such as forward, future, and swap contracts.⁴⁵ A derivative is a security whose value depends on, or derives from, the value of another asset or financial or economic variable.⁴⁶ Through the use of derivative instruments, it has become cheaper and easier for an investor to engage in decoupling.⁴⁷

Perhaps the most straightforward way to engage in decoupling is by purchasing shares in the corporation while simultaneously hedging that investment by “shorting” those shares.⁴⁸ To short shares is to bet that the value of those shares will decrease.⁴⁹ For example, an investor may purchase equity or equity derivatives that increase in value as the corporation’s share price falls.⁵⁰ Her economic interest is decoupled from her right to vote because the hedge abrogates her investment in the value of those shares and she is left only with the right to vote.⁵¹ In such a situation, the efficiency link has been broken: the investor has the right to vote but is not interested in maximizing firm value.⁵² On the contrary,

42. See Barry et al., *supra* note 22, at 1126.

43. See HAAS, *supra* note 41, at 119-20; Barry et al., *supra* note 22, at 1121.

44. See Andrew Ross Sorkin, *A Loophole Lets a Foot in the Door*, N.Y. TIMES, Jan. 15, 2008, at C1 (“So why do investors go to such extremes to mask their trading? Money – lots of it.”).

45. See Hu & Black, *supra* note 1, at 816; Barry et al., *supra* note 22, at 1114-15.

46. See HAAS, *supra* note 41, at 119.

47. See Hu & Black, *supra* note 1, at 815 (explaining how derivatives have made it “cheaper and easier” to engage in decoupling).

48. See Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 484-85 (2008).

49. An investor who sells short borrows a security from a broker, sells it and buys an identical security to give back to the broker. The short is profitable if the price of the security drops after the investor sells it and before she buys another to give back to her broker. See IVO WELCH, CORPORATE FINANCE 167 (2d ed. 2011).

50. See Hayden & Bodie, *supra* note 48, at 484-85.

51. See Hu & Black, *supra* note 1, at 818 (describing how an investor buys shares in the open market and uses derivatives to offset the economic ownership of those shares, the investor “is left only with voting ownership”).

52. See *supra* note 39.

because she is betting that the firm value will decrease, she is interested in decreasing firm value.⁵³

Another way of decoupling involves futures and forward contracts.⁵⁴ Futures and forward contracts create an obligation under which the purchaser is obligated to buy, and the seller is obligated to sell, the underlying asset at a particular price (“forward price”) on a particular date in the future (“expiration date”).⁵⁵ In the period from when the parties enter into the contract until the expiration date, the seller has no real economic interest in the shares she is selling because she neither benefits nor suffers from any change in their value.⁵⁶ However, until the expiration date, she is still the legal owner of those shares and retains the right to vote on them.⁵⁷ If the seller enters into a forward or futures contract in which she agrees to sell more shares than she presently owns, in order to fulfill the contract she will need to purchase the shares-promised-yet-not-yet-owned on the market.⁵⁸ She therefore desires that the market price of those shares she will purchase to fulfill the contract be lower than the amount to be paid – she is interested in decreasing firm value.⁵⁹ Again, the efficiency link has been broken because she retains the right to vote those shares while she is incentivized to vote to decrease their value.⁶⁰

Hu and Black characterize such an investor’s position in different ways, depending on the degree of separation of the voting rights and economic interest.⁶¹ “Hidden ownership” refers to situations in which an

53. *See id.*

54. *See, e.g.,* Barry et al., *supra* note 22, at 1114-16.

55. *See* HAAS, *supra* note 41, at 131. Broadly speaking, the difference between forward and futures contract is that forward contracts are privately-negotiated agreements, while futures contracts are standardized and publicly-traded. *Id.* at 131, 133. Forward and futures contracts are designed to decrease the contracting parties’ exposure to price fluctuations of the underlying asset. *Id.* If the underlying asset is a security, then the contract is a derivative instrument. *See* Barry et al., *supra* note 22, at 1113. However, should the asset’s spot price rise above the forward price, the contract becomes valuable to the purchaser, who can sell the underlying asset for a profit immediately after executing the contract. *Id.*

56. *See* Barry et al., *supra* note 22, at 1113-14.

57. *See id.* at 1114.

58. *See id.*

59. *See id.*

60. *See supra* note 39.

61. *See* Hu & Black, *supra* note 1, at 815-16 (describing and classifying decoupling’s different forms).

investor's economic interest exceeds her voting rights.⁶² Similarly, "hidden (morphable) ownership" is a combination of hidden ownership with acquired control of voting rights.⁶³ "Empty voting," perhaps the most well known instance of decoupling, refers to situations in which an investor's voting rights exceed her economic interest.⁶⁴ Extreme cases of empty voting, in which an investor has voting rights despite having negative economic interest in the corporation, are referred to as "negative voting."⁶⁵ Negative voting is extreme not only because of its negative ownership but also because the position gives the investor the incentive to vote in ways that reduce the company's share price.⁶⁶ Though these types of ownership are dissimilar, they are alike in that they all break the efficiency link between a shareholder's interest in wealth maximization and voting power.⁶⁷ For example, if the hedged position the investor used to short her shares completely offsets her economic investment in the corporation, she will have become an empty voter.⁶⁸ Where the hedged position is strong enough, however, her hedged position may outweigh her investment in the corporation and she is a negative voter.⁶⁹ In this situation, the negative voter is not interested in maximizing firm value because it is more profitable for her to pursue the interests of her hedged position.⁷⁰

62. See Barry et al., *supra* note 22, at 1115; Hu & Black, *supra* note 1, at 825.

63. See Hu & Black, *supra* note 1, at 815-16. An example of morphable ownership is the following: A and B enter into a contract (a futures contract) in which B will buy A's shares for a particular price on a particular date and A informally agrees to vote the share as B wishes until that date. Barry et al., *supra* note 22, at 1116.

64. The votes are "empty" because the shares have been "emptied" of the economic risk normally inherent in those voting rights. See Hu & Black, *supra* note 1, at 815; Barry et al., *supra* note 22, at 1114; see also Martin & Partnoy, *supra* note 8, at 780 (referring to the situation as "encumbered shares" rather than empty voting).

65. See, e.g., Hu & Black, *supra* note 1, at 815.

66. *Id.* at 815. An example of negative ownership is the following: A and B enter into a futures contract in which A agrees to sell to B more shares than she presently owns. In order to fulfill the contract, B will have to purchase the shares promised-but-not-yet-owned. Therefore, B desires that the price at which she buys these shares is less than the price that she will be paid – she desires that the stock's value decreases. Barry et al., *supra* note 22, at 1114 ("[T]he empty voter actively wants the corporation to decrease in value.").

67. See *supra* note 39.

68. See Black & Hu, *supra* note 1, at 815; Barry et al., *supra* note 22, at 1114.

69. See Black & Hu, *supra* note 1, at 815; Barry et al., *supra* note 22, at 1114.

70. See Black & Hu, *supra* note 1, at 815; Barry et al., *supra* note 22, at 1114.

Examples of such anti-wealth maximization behavior exist and are well documented as cautionary market tales.⁷¹ Take, for example, the story of Henderson Land.⁷² In 2006, Henderson Land offered to buy all outstanding shares of its publicly-held affiliate, Henderson Investment, for a substantial premium.⁷³ Because Henderson Investment shareholders were in favor of the buyout, Henderson Investment's share price increased substantially and the buyout seemed highly likely.⁷⁴ Yet to the market's surprise, Henderson Investment's shareholders rejected Henderson Land's offer.⁷⁵ In response, Henderson Investment's share price dropped significantly after the vote was announced.⁷⁶ Reports later emerged that one or more hedge funds had borrowed enough Henderson Investment shares to vote against the buyout.⁷⁷ Confident that their votes would block the transaction, the hedge fund (or funds) had bet that the value of Henderson Investment's shares would drop and shorted their shares.⁷⁸ Thus the hedge fund (or funds), for its personal benefit, manipulated the vote to block a deal that would have benefited other shareholders.⁷⁹

Also consider the example of hedge fund Perry's⁸⁰ involvement in Mylan Laboratories' ("Mylan") acquisition of King Pharmaceuticals ("King").⁸¹ In 2004, Mylan announced an agreement to acquire King, but the merger was subject to approval of both companies' shareholders.⁸² Perry owned seven million shares in King and stood to

71. See, e.g., *infra* notes 72-91 and accompanying text.

72. See Hu & Black, *supra* note 1, at 834-35.

73. See *id.* at 834; Barry et al., *supra* note 22, at 1105.

74. See Hu & Black, *supra* note 1, at 834.

75. See *id.*; Barry et al., *supra* note 22, at 1106.

76. See Hu & Black, *supra* note 1, at 834.

77. See *id.* at 834-35.

78. See *id.*

79. See *id.* at 835.

80. See *id.* at 842-43. It is worth noting that Perry is somewhat of a repeat-player with decoupling. Perry was involved in both the Rubicon example, *supra* notes 1-6, and the King-Mylan acquisition, *infra* notes 80-89. In addition, the hedge fund Children's Investment Fund, while headed by a Perry alumnus, was involved in Deutsche Boerse's attempted acquisition of the London Stock Exchange. Hu & Black, *supra* note 1, at 842-43.

81. See Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 46 (2006) ("[T]he Perry deal has become a rallying cry for regulating hedge funds . . .").

82. See Hu & Black, *supra* note 1, at 828.

make a \$28 million profit if the merger went through.⁸³ Mylan shareholders still had to approve the deal, however, and Mylan's shares had dropped sharply when the deal was announced.⁸⁴ To ensure that Mylan voted in favor of the merger, Perry acquired a 9.9% voting stake in Mylan, but hedged its stake in Mylan through a series of equity swaps and "other undisclosed transactions."⁸⁵ Thereby, Perry had acquired voting power in Mylan to make sure Mylan voted the way it wanted, but had emptied its stake in Mylan of economic interest.⁸⁶ Absent any economic interest in Mylan, Perry desired to complete the deal even if Mylan's firm value would suffer.⁸⁷ Perry was voting against the wealth-maximizing interests of other Mylan shareholders.⁸⁸ Carl Icahn, a large Mylan shareholder who had opposed the acquisition, sued Perry for voting without any true economic ownership and for having a negative ownership.⁸⁹

The Henderson Land and Perry examples differ in their decoupling strategies but are similar examples of hedge funds surreptitiously dictating the outcome of major transactions for their personal benefit to the detriment of other shareholders.⁹⁰ Or, as one commentator described it, influencing the outcome of shareholder elections for one's own benefit at the expense of the corporation allowed hedge funds to "'hijack' shareholder elections for their own private gain."⁹¹

83. *Id.*

84. *Id.*

85. *Id.*

86. Hayden & Bodie, *supra* note 48, at 485.

87. Hu & Black, *supra* note 1, at 828-29.

88. *Id.*

89. *Id.* The lawsuit was well publicized. See, e.g., Jesse Eisinger, *Icahn Cries Foul at Perry's No-Risk Play in Takeover Fight*, WALL ST. J., Dec. 15, 2004, at C1; Andrew Ross Sorkin, *Icahn Accuses a Hedge Fund of Stock Manipulation*, N.Y. TIMES, Dec. 13, 2004, at C1; Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C1. But the lawsuit became moot when Mylan called off the acquisition. See Hu & Black, *supra* note 1, at 829.

90. See Hu & Black, *supra* note 1, at 835.

91. Jonathan Katz, Note, *Barbarians at the Ballot Box: The Use of Hedging to Acquire Low Cost Corporate Influence and Its Effect on Shareholder Apathy*, 28 CARDOZO L. REV. 1483, 1516 (2006).

II. FAILURE OF MANDATORY DISCLOSURE RULES TO CAPTURE DECOUPLING, AND PROPOSED SOLUTIONS

This part begins by describing the existing federal disclosure regime and how decoupling allows an investor to strategically evade disclosure obligations. It then considers existing proposals for reform—enhanced federal disclosure rules and bylaw amendments aimed at capturing decoupling—but finds that they fail to remedy decoupling’s inefficiency problem.

A. THE FEDERAL DISCLOSURE REGIME

Disclosure rules are the “cornerstone” of modern securities regulation.⁹² The disclosure regime is built on the strong belief that transparency leads to greater market efficiency.⁹³ The purpose of federally mandated disclosure is to “alert the marketplace” of other investors who may be able to exert control over corporate decisions.⁹⁴ When called upon to disclose information, an investor is largely required to reveal her investment portfolio.⁹⁵ A disclosure-based regime therefore enables more informed decisions and improves market

92. See Barry et al., *supra* note 22, at 1153; Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1023 (2000) (“Mandatory disclosure is a – if not the – defining characteristic of U.S. securities regulation.”). This is not to suggest that mandatory disclosure is not without its critics. See, e.g., Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2372-88 (1998) (arguing for the removal of mandatory disclosure requirements).

93. See, e.g., Barry et al., *supra* note 22, at 1156 (arguing that increased transparency of derivatives and financial markets generally could improve market outcomes).

94. See, e.g., *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971) (“[T]he purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a shift in corporate control . . .”).

95. Under Schedule 13D, a shareholder is required to disclose her identity and background (including any criminal convictions), the source of funds of her holding, and any plans or proposals she has for the company. 17 C.F.R. § 240.13d-101 (2014); see also, Barry et al., *supra* note 22, at 1154 (describing how federally mandated disclosure rules largely reveal the portfolios of “major market participants” and other participants are then “able to discern what each other’s ownership and control rights are”).

outcomes.⁹⁶ Generally, disclosure is not mandatory until the size of an investor's holding meets a threshold amount.⁹⁷ The size of an investor's holding is based on her "beneficial ownership" of shares.⁹⁸

However, beneficial ownership is determined in relation to voting interest, not economic interest, and does not include informal voting power such as hidden (morphable) ownership.⁹⁹ Consequently, decoupling, especially those relying on derivatives, often remains untouched by federal disclosure rules.¹⁰⁰ Despite the attempt to include contracts or other arrangements contributing to the size of a shareholder's position within the definition of beneficial ownership, the use of derivatives in structuring a holding often places that holding outside the scope of the disclosure rules.¹⁰¹ Short positions, for instance, whether they are in shares or derivatives, do not trigger disclosure under Schedule 13D.¹⁰² Similarly, the use of swaps likely does not trigger disclosure under either 13D or 13G.¹⁰³ Therefore, an investor who holds just under the 5% threshold as well as equity swaps conveying an additional 11% economic ownership, putting her actual holdings above

96. See, e.g., Barry et al., *supra* note 22, at 1156-59.

97. See *infra* note 98.

98. See Hu & Black, *supra* note 1, at 866-67. Such beneficial ownership is subject to mandatory disclosure in the following ways: institutional investors must disclose their positions in public companies on Form 13F, SEC Form 13F, Information Required of Institutional Investment Managers Pursuant to Section 13(f) of the Securities Exchange Act of 1934 and the Rules Thereunder, 17 C.F.R. § 249.325 [hereinafter Form 13F]; shareholders must disclose if they hold a position of 5% or more under Schedule 13D if active shareholders, Schedule 13D, § 240.13d-101 [hereinafter 13D], and under Schedule 13G if passive, Schedule 13G, § 240.13d-102 [hereinafter 13G]; insiders and shareholders with a 10% or larger position must disclose under section 16 of the Exchange Act ("Section 16"), Exchange Act § 16, 15 U.S.C. 78p (2012).

99. It does, however, cover sole or shared voting or investment power acquired directly or indirectly through a contract or less formal arrangement. See Exchange Act Rule 13d-3, 17 C.F.R. § 240.13d-3.

100. Disclosure obligations were "not crafted with derivatives in mind." Barry et al., *supra* note 22, at 1154.

101. See Hu & Black, *supra* note 1, at 864-65. Share-lending may trigger disclosure under 13D, but not under 13G. See *id.* at 868. Record date capture, by itself, is unlikely to trigger disclosure under Schedule 13G. See *id.* at 868. Disclosure is more likely under Section 16. See, e.g., *id.* at 872. Equity swaps and equity derivatives must be disclosed and therefore shares hedged with derivatives would be disclosed. See, e.g., *id.* at 873-74.

102. See *id.* at 867.

103. See *id.* at 868; see also *supra* note 98 (discussing 13D and 13G).

the disclosure threshold, will not be subject to the disclosure requirements.¹⁰⁴ Indeed, such hidden (morphable) ownership is often employed to shield ownership from public view.¹⁰⁵

Given the Henderson Land and Perry examples, it is clear that investors employ decoupling practices to strategically structure their holdings to circumvent disclosure obligations that would otherwise be applicable to holdings of that size.¹⁰⁶ Investors' reliance on the use of derivatives has only made decoupling cheaper and easier.¹⁰⁷ In addition, because decoupling evades disclosure obligations, it has historically been "largely unregulated and unseen."¹⁰⁸ Thus, decoupling also detracts from the efficiency benefits of a transparent market.¹⁰⁹

B. CURRENT PROPOSALS

1. *Expansion of Disclosure Rules to Capture Decoupling*

Hu and Black advocate for enhanced federally-mandated disclosure as a remedy for decoupling.¹¹⁰ They propose an "integrated ownership disclosure" solution that they feel both simplifies and builds upon the existing regulatory structure.¹¹¹ In addressing the use of derivatives, their proposal consists largely of including direct and synthetic holdings within economic ownership of shares, and extending Section 16

104. See Hu & Black, *supra* note 1 at 868.

105. See, e.g., *id.* at 872.

106. Barry et al., *supra* note 22, at 1121 ("Decoupling makes it easier for an investor to structure her holdings in a way that circumvents regulation . . . exploit any gaps in the regulatory net."); see also *supra* notes 1-6, 69-86 and accompanying text.

107. See Hu & Black, *supra* note 1, at 815.

108. *Id.* at 818.

109. See *supra* note 93 and accompanying text; see also, e.g., Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C.J. INT'L L. & COM. REG. 1 (Fall 2007) (arguing that empty voting is one area, of many, in which regulation can help achieve greater transparency and deter inappropriate practices). Even more troubling is the fact that decoupling is associated with hedge funds and extremely wealthy investors and insiders, suggesting that generally applicable disclosure costs are only borne by those who cannot afford to buy out of them. See Barry et al., *supra* note 22, at 1121-22; Hu & Black, *supra* note 1, at 815.

110. Hu & Black, *supra* note 1, at 864. At the same time, Hu and Black acknowledge that a more substantive response may be needed. *Id.*

111. See *id.* at 876.

disclosures to reach shareholders with derivative positions who would report on Form 13F and Schedules 13D and 13G.¹¹² The extent of the information disclosed would be assessed against a sort of “ordinary derivatives dealer” standard, or enough that a dealer with access to information on the volatility and “other pricing parameters” could assess the derivative’s value.¹¹³ Hu and Black would also require disclosure of share lending and borrowing practices, even if those practices are unaccompanied by economic ownership.¹¹⁴

Respectfully, while Hu and Black’s proposal would be more effective at capturing decoupling than the current system, it does not adequately deal with the fundamental flaw in allowing decoupled investors to vote and impact the outcome of major corporate decisions.¹¹⁵ In other words, the efficiency link is still missing.¹¹⁶ Even if federal disclosure rules were expanded to encompass decoupled holdings, investors who are not interested in wealth maximization would still be able to vote.¹¹⁷ Disclosure will not solve inefficient voting practices.¹¹⁸ In addition, Hu and Black’s proposal of enhanced disclosure obligations increases transaction costs.¹¹⁹ Given that individual shareholders already face significant transaction costs in acquiring and processing information, further costly disclosure requirements will reduce efficiency by discouraging investors from evaluating the available information.¹²⁰

Nevertheless, a disclosure-based solution such as Hu and Black’s is attractive for many reasons. One reason is that it furthers the longstanding commitment to transparency as the means to a fair and efficient market.¹²¹ Other commentators have shown support for Hu and

112. *Id.* at 878.

113. *Id.* at 879.

114. *Id.* at 878.

115. *See, e.g., supra* note 39 and accompanying text.

116. *See id.*

117. *See id.*

118. *See id.*

119. *See* Katz, *supra* note 91, at 1516-17 (rejecting enhanced disclosure as a solution for decoupling because “the rational response of shareholders that learn the intricacies of hedge fund involvement in their corporate elections [is] abstention from voting”). Even Hu and Black, in advocating for their “integrated ownership disclosure” proposal, acknowledge that enhanced ownership disclosure must be “crafted with sensitivity to the costs of disclosure.” Hu & Black, *supra* note 1, at 819.

120. Barry et al., *supra* note 22, at 1158.

121. *See supra* note 93.

Black's "integrated ownership disclosure" proposal in advocating for similar solutions.¹²² Ultimately, because decoupling is naturally "unseen," any solution will require some form of disclosure.¹²³ Indeed, disclosure would allow observers to identify the existence and frequency of decoupling.¹²⁴ Otherwise, it will continue to exist below the radar, undetected and untouchable.¹²⁵

2. Bylaw Amendments

In the absence of a satisfactory regulatory response, corporations are taking measures to protect themselves and their shareholders from empty and negative voters.¹²⁶ Some scholars have proposed that corporations force disclosure of synthetic positions as a requirement for eligibility to nominate directors.¹²⁷ For instance, in 2008, Sara Lee amended its bylaws to require a shareholder who nominates a board member or submits a proposal that could alter the path of the business to disclose if the shareholder has "hedged its ownership" or has "any short position in the stock."¹²⁸ Similarly, Coach amended its bylaws to require any shareholder's "hedging activities" to be divulged upon submitting a proposal.¹²⁹ This solution attempts to address empty voting by counting

122. See, e.g., Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10 U. PA. J. BUS. & EMP. L. 833 (2008) (arguing that the SEC can regulate by enforcing disclosure of voting and economic stakes in the form of 13D filings); Sean M. Donahue, *Lessons Learned from CSX Corp. v. Children's Investment Fund Management and Proposals for Reform*, 4 BROOK. J. CORP. FIN. & COM. L. 221 (2010) (arguing that the SEC should amend Rule 13d-3(a) to require disclosure of parties' holdings in equity swaps and sterilization of votes in 13(d) context).

123. See *supra* note 108 and accompanying text.

124. See, e.g., Barry et al., *supra* note 22, at 1156.

125. See *supra* note 108 and accompanying text.

126. See, e.g., Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, 33 SEATTLE L. U. REV. 931, 943-44 (2010).

127. See, e.g., Elina Khasina, Note, *Disclosure of "Beneficial Ownership" of Synthetic Positions in Takeover Campaigns*, 2009 COLUM. BUS. L. REV. 904, 905-06 (2009); Charles M. Nathan, *Developments in Takeover Defenses*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 23, 2008), <http://corpgov.law.harvard.edu/2008/10/23/developments-in-takeover-defenses/> [<http://perma.cc/NP6P-DDA7>].

128. Matt Andrejczak, *Sara Lee, Coach Set Rules to Spot Shareholder Actions*, MARKETWATCH (Apr. 2, 2008, 6:30 PM), <http://www.marketwatch.com/story/sara-lee-coach-set-rules-to-deter-devious-shareholders> [<http://perma.cc/6ZE2-JFNK>].

129. *Id.*

shares referenced in any sort of derivative transaction, rather than just shares actually owned, towards beneficial ownership.¹³⁰

These bylaw amendments have the benefit of being less costly than Hu & Black's "integrated ownership disclosure" proposal because the expense of gathering the required information and disclosing it to the corporation is lower.¹³¹ Unlike the obligations under federal disclosure rules, the information would not need to be disclosed periodically.¹³² The investor would not need to continuously monitor her beneficial ownership and promptly disclose any updates on any changes in the size of her holding.¹³³ Rather, a Coach or Sara Lee investor would only need to discern and disclose the number of shares hedged on a single, relevant date.¹³⁴

However, decoupling is only disclosed if management chooses to amend the corporation's bylaws.¹³⁵ Protection from decoupling would therefore vary from corporation to corporation.¹³⁶ Moreover, disclosure of synthetic positions does not directly prevent a decoupled investor from using her votes to covertly thwart a wealth-maximizing transaction.¹³⁷ The bylaw amendment solution is reactionary rather than prophylactic; it does not prevent the inefficient voting from happening but only renders those guilty voters more identifiable for blame.¹³⁸ Ultimately, the bylaw amendments suffer from the same shortcoming as

130. See William B. Chandler III, Symposium, *The Delaware Court of Chancery: An Insider's View of Change and Continuity*, 2012 COLUM. BUS. L. REV. 411, 415 (referring to these bylaw amendments as a "new wave" of pills).

131. See *supra* note 95 and accompanying text.

132. Upon reaching the threshold amount of shares beneficially owned. See, e.g., *supra* note 98.

133. A shareholder who is unprepared to disclose proprietary information, especially one with a holding just under the threshold amount, needs to monitor the extent of her beneficial ownership to ensure that it does not inadvertently rise above the threshold amount. See *supra* notes 97-98 and accompanying text. Should the shareholder discover that she has risen above the threshold amount and triggered disclosure obligations, she must disclose promptly. For instance, under Schedule 13D, a shareholder has ten days. 17 C.F.R. 240.13d-1(a) (2014).

134. As opposed to the substantive proprietary information required under federal disclosure obligations. See, e.g., *supra* note 95.

135. See *supra* notes 128-29 and accompanying text.

136. Protection from decoupling may also depend on legal counsel. See *supra* note 127.

137. See, e.g., *supra* note 91.

138. Eliminating the "unseen" nature problem. See *supra* note 108. But the inefficiency problem still remains. See *supra* note 39.

Hu & Black's enhanced disclosure solution: neither remedies the inefficiency problem in allowing decoupled investors, who are not interested in wealth maximization, to vote.¹³⁹

III. PROPOSAL FOR REFORM: RESTORING EFFICIENCY THROUGH PROXY CARD DISCLOSURE AND EXCLUSION OF DECOUPLED VOTES

Shareholders are empowered with the right to vote because their unique interest in corporate wealth maximization makes their votes efficient.¹⁴⁰ Absent that interest, it is no longer efficient to give shareholders the right to vote.¹⁴¹ Any proposal should bear directly on this inefficiency problem. Accordingly, pursuant to its authority under Section 14 of the Exchange Act, the SEC should mandate that shareholders disclose on proxy cards, under penalty of voiding their votes, the amount of shares for which they are entitled to vote that are hedged or decoupled on the day of the vote.¹⁴² Those decoupled votes would then be excluded from the vote.¹⁴³ This proxy card disclosure proposal directly cures the inefficiency problem by only allowing those votes that are tied to wealth maximizing shares to influence corporate outcome.¹⁴⁴ Those shares that are not wealth maximizing, such as those that are shorted, would thus not be able to dictate corporate outcome.¹⁴⁵

This proposal not only restores the efficiency link of shareholder voting and wealth maximization, but also imposes minimal costs.¹⁴⁶ The

139. See *supra* note 39.

140. See *supra* notes 23-29 and accompanying text.

141. This Note emphasizes that the hedging behavior associated with decoupling is not by itself inefficient. Rather, only when that behavior is contemporaneous with a vote, has the behavior rendered the voting inefficient. See *supra* note 39.

142. Under Section 14, the SEC has broad authority to issue rules governing the issuance of proxy cards. See *supra* note 36 and accompanying text. The proxy card disclosure proposed here is similar to that enforced by the Sarah Lee and Coach bylaw amendments, but is expanded beyond director nomination and shareholder proposals to include all opportunities subject to shareholder approval, including major corporate transactions. See *supra* notes 127-29.

143. Thus excluding those inefficient votes. See *supra* notes 52-53 and accompanying text.

144. *Id.*

145. Thus preventing the "hijacking" problem of corporate actions for inefficient purposes. See *supra* note 91.

146. See *infra* note 150. It is certainly less costly than federally mandated disclosure. See, e.g., *supra* notes 133-34.

proxy card disclosure is different from the disclosure currently mandated under federal disclosure rules.¹⁴⁷ Where the latter is designed to alert the marketplace of voting power, this proposal is designed to alert the shareholders of the corporation to those other shareholders whose voting interests are compromised.¹⁴⁸ As such, the proxy card disclosure is much more limited in scope, commands less effort, and demands less sensitive information from the investor.¹⁴⁹ Where federal disclosure rules reveal proprietary information across an investor's entire investment portfolio, this proposal only mandates disclosure of a fixed number of shares on a specific date.¹⁵⁰ Thus, the information disclosed is neither proprietary nor cumbersome.¹⁵¹

Moreover, the costs of obtaining this information are relatively low in comparison to federal disclosure rules that require monitoring and updating disclosure as the investor's positions change.¹⁵² In contrast to federal disclosure obligations, which apply at all times, this proposal's obligations are triggered only in the event of a shareholder vote.¹⁵³ In this way, this proposal burdens decoupled shareholders with disclosure obligations only when it is necessary.¹⁵⁴

The idea of excluding some shareholders' votes may seem radical. However, such behavior is not novel in corporate law.¹⁵⁵ Indeed,

147. See *supra* notes 94-98 and accompanying text.

148. See *supra* note 94 and accompanying text.

149. The proposed proxy card disclosure does not incur the monitoring costs inherent in federally mandated disclosure rules. See *infra* note 152 and accompanying text. Nor does this proposal call upon an investor to bear the costs of revealing sensitive and proprietary information. See, e.g., *supra* note 95.

150. See, e.g., *supra* note 95. The information disclosed of would only be the number of hedged or decoupled shares owned on the date of the vote. Similar to the bylaw amendments, because this number is fixed and static, it does not require constant updating. See *supra* notes 132-34 and accompanying text.

151. See *supra* note 95.

152. Information disclosed under federal securities laws needs to be updated. For example, an investor who beneficially owns more than 5% of a corporation needs to disclose certain information under 13D after meeting that 5% threshold. See *supra* notes 95, 98. Such an investor must also "promptly" file amendments to his 13D disclosures if there is any material change in the facts disclosed. 17 C.F.R. § 240.13d-2 (2014).

153. And therefore do not require updating. See *supra* note 152; see also *supra* notes 132-33 and accompanying text.

154. Disclosure obligations would be limited to events such as fundamental changes or major corporate transactions in which shareholders have a heightened interest in wealth maximization. See *supra* note 32 and accompanying text.

155. See, e.g., *supra* note 35 (discussing vote-buying).

Delaware courts are willing to exclude votes in similar situations in which they are concerned about shareholder abuse of the voting franchise.¹⁵⁶ Furthermore, excluding the compromised votes of decoupled investors would not take anything away from that class of shareholders.¹⁵⁷ Rather, viewed according to the shareholder primacy model, these empty or negative shareholders have not earned the right to vote because they do not possess the requisite interest in wealth maximization that forms the basis of efficient corporate voting.¹⁵⁸

CONCLUSION

Decoupled voting is inefficient. Corporate law should promote efficiency in the corporate form above all else. Shareholder voting rights are justified because when shareholders vote for decisions that are wealth maximizing, they are voting efficiently. The decoupled investor is not interested in maximizing firm value. In contrast, she acts to the detriment of the corporation and her fellow shareholders.

Enhanced disclosure through SEC rules or amendments to a corporation's bylaws may render decoupling less clandestine and underhanded. Indeed, either solution may make decoupling a less attractive strategy to some. Still, neither solution is able to cure the inefficiency problem inherent in allowing decoupled investors to vote on corporate decisions. By allowing only those wealth-maximizing votes to participate in deciding the corporation's future, efficiency is restored to the corporate form.

156. "Similar situations" referring to fundamental changes or major corporate transactions where the return of the shareholders' investment is most critical. *See id.*

157. Because they have "earned" the right to vote according to the underlying efficiency rationale of the shareholder primacy model; they do not possess the "efficiency link" empowering shareholders with the right to vote. *See supra* notes 24-31 and accompanying text.

158. *See supra* note 39.