



EMPTY VOTING

In November 2005, Henderson Land Development Co., Hong Kong's third largest property developer, offered a rich premium to purchase the remaining 27% of its subsidiary Henderson Investment that it did not already own. As discussed by Henry Hu and Bernard Black ("Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms," *The Business Lawyer*, May 2006, Vol. 61, No. 3), under Hong Kong law, the deal would go through unless 10% of the "free floating" shares – in this case 2.5% of the outstanding shares – opposed it. And, as reported by Kara Scannell, ("Outside Influence: How Borrowed Shares Swing Company Votes," *The Wall Street Journal*, January 26, 2007), because of the large stake held by the parent company and since large institutions supported the deal, "passage was considered a foregone conclusion."

When the vote was tabulated in early 2006, the acquisition was voted down. A surprising 2.7% (75.5 million shares) of the outstanding shares were voted against the buyout and Henderson Investment shares fell 17% the day after the voting outcome was announced.

What happened? According to Hu and Black, "It appears that one or more hedge funds borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, profiting from its private knowledge that the buyout would

be defeated. One hedge fund alone voted at least 72 million shares against the merger; that fund may have held enough shares by itself to defeat the buyout. Thus a shareholder with negative economic ownership blocked a deal that would benefit other shareholders."

This is an extreme example of what Professors Hu and Black refer to as "empty voting" – a decoupling of votes from economic ownership and a divergence from the modern corporate governance principle of one-share, one-vote.

What many commentators find especially troubling is that despite a myriad of disclosure rules designed to shed light on share ownership above certain threshold triggers, hedge funds or other investors are able to use various techniques, including derivative instruments, to aggregate voting power without triggering ownership disclosure requirements.

At a basic level, today's capital markets are designed such that the separation of votes and economic interest is the norm. Because of the use of central share depositories (CDS in Canada and DTC in the US) and nominee holders, more often than not, shares are not registered in the name of the beneficial holder. Then, there is the additional complication of exchange and over-the-counter derivatives to further blur the concept of "ownership". Layered on top of all this is the fact that the right to vote

at a shareholders' meeting is determined by ownership on a record date that is significantly prior to the meeting date (between 21 and 60 days prior under the CBCA).

The practical task of bridging the gulf between record holders and beneficial holders is not necessarily a simple one because of the layers of ownership between the ultimate beneficial owner and the top-tier depository, most frequently CDS. In describing the US system, Charles Nathan states ('Empty Voting' and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds," Latham & Watkins LLP M&A Deal Commentary, September 2006), "In practice the process is mediated through a combination of NYSE and NASD member firm rules and custom and is implemented by the various depositories which delegate voting authority through "master proxies" to underlying depositories and nominees, as well as by private providers, principally Broadridge (formerly ADP), which deliver proxy materials and voting instruction forms to ultimate beneficial holders and receive, tally and report voting instructions by ultimate beneficial holders to holders of "master proxies". Barring mistake and mischief, the process, while cumbersome, usually will produce a reasonably accurate tally of proxy votes attributable to the beneficial owners on the record date."

In addition to the separation of economic and voting interest and the gap between the record date and meeting date, the other facilitator of empty voting is the practice of share lending. Developed in the context of short selling, share lending now permeates the equity markets and according to Nathan, "has mushroomed in recent years and frequently represents a significant source of income for brokers and other custodians. By custom, the shares being lent are accompanied by full voting rights, so that the party borrowing the stock or its transferee can vote the shares which it holds on a record date. If, however, as frequently happens, the lending party is a custodian which does not allocate the lent shares to and notify specific beneficial account holders, it is possible that both the lending beneficial owner and the borrower will vote the shares and over-voting will occur."

The result of all this is an outcry from certain governance experts that the practice of empty voting must be stopped – and it appears that the regulators are listening. In a January 22, 2007 speech, SEC Commissioner Paul Atkins talked about the issue of "empty voting", quoting the work of Hu and Black. He concluded that, "[The Commission has] an obligation to create a learned, organized discussion on this subject. Is there a problem, given all that is occurring in the capital markets, and what solutions should we consider, given our power and authority?"

The issue has already caused certain institutions to reassess their policies regarding the facilitation of stock loans. An April 3, 2007 Globe and Mail article by Janet McFarland ("Why Teachers Halted Stock Loans to Short Sellers") discusses that the Ontario Teachers Pension Plan has halted the lending of shares to short sellers and plans to set up a new internal lending operation so that it can maintain tighter control over its voting rights as an investor.

It should be noted that not all commentators see "empty voting" in a negative light. In a January 2007 working paper for the European Corporate Governance Institute, titled "Vote Trading and Information Aggregation", Susan Christoffersen, Christopher Geczy et al, while acknowledging the potential harm discussed by other commentators, concluded that the trading of votes "cures the inefficiency arising from votes being distributed differently from information about how to vote them. Transactions in votes can move shares to investors more willing and able to vote them properly."

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