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Decoupling in the form of Empty Voting

A critical analysis of the phenomenon

Dissertation to obtain a Master Degree in Law, in the specialty of Law and Management

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ANTI-PLAGIARISM STATEMENT

I hereby declare that the work I present is my own work and that all my citations are correctly acknowledged. I am aware that the use of unacknowledged extraneous materials and sources constitutes a serious ethical and disciplinary offence.

The author,

Bruna Lima Delgado

To my family and friends,

without whom none of this would be possible

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To my mother, to whom I owe the person I am today.

To Rui, for being (and will be forever) the love of my life.

To all my family, for their unconditional support.

To my friends, for being the family I chose.

To Miguel de Azevedo Moura, for his constant availability and for all the knowledge transmitted.

NUMBER OF CHARACTERS DECLARATION

I declare that the body of this dissertation, including spaces and footnotes, occupies a total of 200.058 characters.

RESUMO

O crescente desenvolvimento dos mercados financeiros, em particular dos derivados, trouxe à luz novas preocupações para investidores e reguladores a nível internacional e criou novas questões de *corporate governance*.

Com efeito, embora seja pacífico que a titularidade de ações inclui um conjunto de direitos e obrigações, onde se inclui o direito de voto, já não é tão claro que essas posições sejam sempre indissociáveis do estatuto de acionista.

A verdade é que a revolução dos derivados, juntamente com o crescimento do mercado de empréstimo de ações, principalmente em consequência do papel cada vez mais ativo dos *hedge funds* permite agora que *outsiders* e *insiders* separem a titularidade económica inerente às suas participações sociais dos respetivos direitos de voto, dando origem ao fenómeno de *decoupling* sob a forma de *empty voting* (voto vazio), em que o poder de voto dos investidores excede a sua exposição económica às potenciais flutuações do valor das suas ações.

Este estudo tem como objetivo compreender os efeitos do fenómeno de *empty voting* e procurar possíveis soluções para o mesmo.

ABSTRACT

The increasing development of the financial markets, particularly derivatives, has brought to light new concerns for investors and regulators at the international level and has created new corporate governance issues.

In fact, although it is peaceful that ownership of shares includes a set of rights and obligations, where the right to vote is included, it is no longer so clear that these positions are always inseparable from the shareholder status.

The truth is that the derivatives revolution, along with the growth in the share lending market, mostly as a result of the increasingly active role of hedge funds now allow outsiders and insiders to separate the economic ownership inherent to their shareholdings from the respective voting rights, giving rise to the phenomenon of decoupling in the form

of empty voting, in which investors’ voting power exceeds their economic exposure to potential fluctuations in the value of their shares.

This study aims to understand the effects of the empty voting phenomenon and to seek possible solutions for it.

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Introduction

In the scope of Company Law, the right to vote is considered a fundamental instrument of the shareholders, as it allows them to participate actively in the life of the company and to control the managers' performance. There is a general consensus that the right to vote belongs to shareholders in detriment of other interested constituencies, since they are the ones who, by investing financially in the company, have a greater incentive to maximize its value. In this context, the attribution of voting power follows a proportionality criterion regarding the shareholder's investment – the "one share, one vote" rule –, from which derives a prohibition of detachment of the right to vote.

Longstanding legal and economic theories of stock corporations rest on the correspondence between shareholders' economic and voting interests, sustaining that these elements cannot readily be separated – in particular that voting rights cannot be disconnected from an economic interest in the corporation.

However, the derivatives revolution in finance, driven by continued improvements in financial technology, combined with the rapid growth in the share lending market, generated mostly by the rise of hedge funds, now permit that the link between voting rights and economic interest is not only severed, but reversed, easily and at low cost, giving rise to the "new vote buying" and consequently undermining the traditional assumptions as well as creating new corporate governance problems. This "new vote buying" includes empty voting – when an investor has greater voting power than economic exposure – and hidden ownership – when an investor has an economic interest greater than the voting right.

This study focuses on the empty voting phenomenon, which has assumed increasing importance throughout the corporate world. It starts from the traditional rule and works its way to the explanation of the new realities that now exist in the financial markets. Then, it aims to analyse the phenomenon itself, as well as the strategies used to accomplish it, providing with some real life examples of empty voting situations.

Some legal orders already have legislation that may help to address the empty voting phenomenon. Therefore, it is relevant to revisit some of the most important legal systems and their regulation approaches to empty voting, particularly the European Union and the United States of America. Finally, the ultimate goal is to understand the effects of empty voting and seek to find possible solutions for the phenomenon.

Chapter I – Some Notes on the Right to Vote in Stock Companies

1. The Traditional "One Share, One Vote" Rule

For those who adopt a contractual perspective, a corporation merely designates a set of contracts concluded between the various actors: shareholders, managers, employees, etc. However, it is impossible, in practice, to predict and regulate all the characteristics of these contracts. Neither legal rules nor loyalty duties can present solutions for all aspects of the legal relationships that are formed between the multiple players (Easterbrook & Fischel, 1983).

Voting serves the function of filling in the gaps of the abovementioned contracts. *"The right to vote is the right to make all decisions not otherwise provided by contract"* (Easterbrook & Fischel, 1983). In fact, the matters left unspecified by the contracts are often more important than the specified ones (Easterbrook & Fischel, 1983).

"Voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete" (Easterbrook & Fischel, 1983). Voting rights are universally allocated to shareholders, excluding other stakeholders (e.g. employees, creditors, customers, as well as society at large), because they are deemed the residual claimants to the corporation's income, by virtue of their share ownership and consequent economic interest in the company (Easterbrook & Fischel, 1983). "*As the residual claimants of the firm's assets, they are, in a sense, the economic "owners" of the firm (...)"* (Barry, Hatfield & Kominers, 2013).

The traditional and fundamental distinction between debt and equity, which gained importance in corporate law and governance, provides the economic justification for voting rights in favour of shareholders. As equity providers, shareholders have rights in the company, while creditors, as debt providers, are external parties who sign regular loan contracts with the company, consequently having rights against it (Ringe, 2012).

Each provider of capital bears a different level of risk. Equity investment is perceived as much riskier than debt financing. Indeed, shareholders are the ones who feel the (positive or negative) impact of the company's performance, being entitled to the profits that remain after the corporation fulfils its other obligations, while the other players have fixed claims (Barry *et al.*, 2013; Easterbrook & Fischel, 1983; Ringe, 2012). In addition, their claims are the last in line, in case of liquidation. Accordingly, they have the *"(...) appropriate incentives to make discretionary decisions because they receive* *most of the marginal gains and incur most of the marginal costs of these decisions*" (Martin & Partnoy, 2004).

Only shareholders, as equity investors, can influence the strategic direction of the company, whereas creditors have contractual claims arising out of their loan agreements. Thus, voting rights can be simultaneously understood as a control device given to shareholders as a type of compensation for the risk they enter into as equity holders, *i.e.,* a tool to allow them to at least partly influence the fate of the company and their own funds, as well as an incentive for them to invest in the company (Ringe, 2012).

Moreover, shareholders are vested with the power to oversee and possibly remove company managers, as the latter have fiduciary duties to the former, and only to them (Hu & Black, 2006a; 2007; 2008a). Also, they must directly approve major corporate actions, such as mergers (Barry *et al.*, 2013). Thus, "*the right to vote (that is, the right to exercise discretion) follows the residual claim*" (Easterbrook & Fischel, 1983).

The shareholder vote is the source of shareholder power and is at the core of corporate governance and capital structure (Hu & Black, 2006a; 2007). It is through voting that shareholders express their will and participate in the formation of the company's will, which allows it to exercise the ability to enjoy rights and to act that the law gives to legal entities in general, and companies in particular. Additionally, voting is one of the most suitable means to ensure the monitoring and control of the company's management and supervision (Cunha, 2012; Gião, 2005).

Pursuant to article 21 (1) (b) of the Portuguese Companies Code[1] (PCC), all shareholders are entitled to participate in the company's resolutions, without prejudice to the restrictions provided for by law[2]. This provision implies the right to vote, which presupposes, for its exercise, the existence of two other rights that are logically articulated and chronologically precede it: the right to attend general meetings, because, naturally, in order to vote, shareholders must be able to be present, and the right to participate in the discussion/formation of the company's resolutions. The right to vote can only be limited

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[1] Decree-Law n. º 262/86, of September 2nd.

[2] These restrictions include the legal regime of article 384 (2) of the PCC, along with cases of inhibition of the right to vote, as a sanction for certain irregular behaviours, such as the delay in making the capital contributions (article 384 (4) of the PCC), as well as impediments to voting, relating to situations of conflict of interests (article 384 (6) of the PCC, for stock companies). The PCC also provides for situations in which it is impossible to exercise the right to vote, such as the acquisition of treasury stock (article 324 (1) (a)) or non-voting preferred shares (article 341).

by law, being null and void all contractual clauses that go beyond legal limits (Cunha, 2012; Gião, 2005; Correia, 2012).

The legitimacy to participate and exercise the right to vote at general meetings is conceived as a fundamental and unwaivable right of shareholders to take part in the company's life, being indispensable for its good functioning[3]. In fact, the effective exercise of the voting right, by determining a direct influence of shareholders in the affairs of the company in relation to which the law or the articles of association attributed competence to the general meeting, allows a balance between the different interests that coexist within companies[4] (Cunha, 2012; Gião, 2005; Correia, 2012).

In modern company law, it is the main principle that ownership of equity is a complex legal reality characterized by generally conveying a set of rights and obligations towards the company, the shareholders, and third parties. The package of rights includes economic rights (*e.g.,* dividends and payments in liquidation), creating what is called "economic ownership"[5], and other not strictly monetary rights, such as voting rights[6]. As for obligations, the duty to contribute to the formation of share capital is emphasized, as well as the duty of loyalty, among others (Hu, 2015; Po, 2016; Estaca, 2008).

Corporate governance rests on the premise that shareholders are economically motivated to vote in a way that increases the company's value (Waddell, Nguyen, Epstein, Conti-Brown, Siciliano & Grundfest, 2010). Accordingly, they are better suited to use their voting rights to maximize that value, alongside with social welfare (Barry *et al.*,

[3] The G20/OECD Principles of Corporate Governance mention, in principle II, that *"[s]hareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings."*

[4] The right to vote includes the right to delegate, which means that shareholders elect managers and give them discretionary powers over matters that they otherwise could control. As stated by Hu & Black, *"(...) shareholder voting is a core ideological basis for managerial authority, legitimating managers' exercise of authority over property the managers do not own."* (Hu & Black, 2006a).

[5] Hu & Black define economic ownership as *"the economic returns associated with shares. This ownership can be achieved directly by holding shares, or indirectly by holding a "coupled asset" that conveys returns that relate directly to those on the shares. Economic ownership can be either positive – the same direction as the return on shares, or negative – the opposite direction from the return on shares."* For these scholars, coupled assets *"include derivatives (such as options, futures, and equity swaps) and other financial products, as well as contractual rights (such as rights under a share loan agreement). The coupled asset could either increase or decrease economic ownership."* (Hu & Black, 2006a; 2006b; 2007; 2008a; 2008b; Hu, 2015).

[6] In the terminology used by Hu & Black, voting rights or voting ownership of shares refer to "*either formal or informal rights to vote shares, including the de facto power to instruct someone else how to vote."* (Hu & Black, 2006a; 2006b; 2007; 2008a; 2008b; Hu, 2015). Po defines voting rights as *"either the formal right to vote (i.e., the legal right to vote under company laws or regulations) or the informal right to vote (i.e. not set forth under any company law or regulation principles), which is the power to instruct someone how to vote"* (Po, 2016).

2013). Indeed, *"[w]hen shareholders exercise their voting rights, they are directly taking part in the decision-making process and thereby indirectly influencing the market value of the company's shares"* (Čulinović-Herc & Zubović, 2015).

The connection between voting power and economic ownership underlies most business and contracting practices, as well as the majority of corporate governance rules, especially the ones about the rights and obligations of shareholders. It also facilitates the operation of the market for corporate control, since it provides shareholders with the option to sell their shares along with the associated voting rights to an acquirer (Hu & Black, 2006a; 2007; 2008a; Hu, 2015).

In this context, efforts have been made to ensure a minimum of proportionality in the relationship between the ownership of the company's capital and the respective influence of each shareholder in corporate life. This is possible through a "one share, one vote" rule, which is based on the foundational assumption that shareholders' voting rights are inextricably linked to their economic interest in the corporation[7] (Hu & Black, 2006a).

According to this rule, the number of votes must be attributed to shareholders in correspondence with the percentage of share capital held by each. Thus, the greater the shareholder's investment, the greater the weight that is given to his interest in making fundamental decisions for the corporation (Hu & Black, 2006a; 2008a). Consequently, the rule originates a *"(...) single class of voting common stock that has both a residual interest in corporate profits and one vote per share"* (Black & Kraakman, 1996).

"The one share, one vote principle is widely accepted across jurisdictions" (Black & Kraakman, 1996)[8]. In fact, under the corporate laws of all major jurisdictions, voting rights and economic ownership are intrinsically tied together in each share of stock. Portugal is no exception, as the "one share, one vote" rule is provided for in article 384

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[7] Initially, corporate voting practices mirrored those of the political process because corporations were formed to undertake governmental functions. Shareholders with larger amounts of share capital were typically entitled to greater control of the company. In the middle age, in both common law countries and Europe, the "one shareholder, one vote" practice – according to which each shareholder had one vote, regardless of the number of shares he owned – became widely perceived as fair and democratic. It was not until the nineteenth century that companies in Europe started to move towards the "one share, one vote" rule (Martin & Partnoy, 2004).

[8] In the U.S., even though it is not mandated by company law, the "one share, one vote" rule is dominant, being maintained by agreement in the prominent stock exchanges. In the U.K., the rule is essentially universal due to the support from institutional investors. For more information, see the survey of company law in emerging markets contained in the Appendix of Black & Kraakman, 1996.

(1) of the PCC, which states that, in the absence of a different contractual clause[9], each share corresponds to one vote[10] (Gião, 2005; Vasconcelos, 2006).

Article 385 (1) of the PCC refers to the voting unity principle, according to which shareholders with more than one vote cannot split their votes and exercise them in different directions on the same proposal or fail to vote with all their voting shares. The sense is that shareholders must vote *en* bloc, *i.e.,* in a unitary way, with the voting power that corresponds to the totality of their shares. Under article 385 (4), the violation of the rules established in this provision results in the nullity of all votes cast by the shareholder in question (Vasconcelos, 2006).

Accordingly, when paragraph 1 of this provision states that shareholders cannot split their vote or fail to vote with all their shares, the sense is that they must vote in a unitary way with the voting power that corresponds to the totality of their shares. Under article 385 (4), the violation of the rules established in this provision results in the nullity of all votes cast by the shareholder in question (Vasconcelos, 2006).

In the last century, the underlying assumption of a linked set of economic, voting, and other rights – full ownership – was mostly acceptable (Hu & Black, 2006a; 2006b; 2008a; 2008b). However, changes in financial markets started to make it plain and obvious that this paradigmatic position on corporate voting could no longer hold. In fact, economic ownership and voting rights may be initially fused, but they can later be separated, generating a phenomenon called "decoupling" (Barry *et al.*, 2013).

Regulators and scholars tend to argue that the "one share, one vote" rule properly aligns control and ownership and allows for the minimization of agency costs that would arise if there was a separation between shareholders' residual interests and control, therefore increasing the likelihood of maximization of corporate value. In fact, this rule remains generally the dominant practice throughout the world. On the other hand, market pressures and regulatory competition among states and exchanges push away from the

[9] This expression demonstrates that the Portuguese "one share, one vote" rule knows some deviations. In fact, article 384 (2) of the PCC states that, subject to certain conditions, the articles of association may match a single vote to a certain number of shares (a) and establish that votes are not counted above a certain number (b). Yet, article 384 (5) prohibits plural voting, meaning that each share cannot correspond to more than one vote.

[10] The ownership of the right to one vote is a condition for the shareholders' right to participate in general meetings, under article 379 (1) of the PCC. However, paragraph 2 of the same provision establishes that shareholders without voting rights and bondholders can attend and participate in general meetings if the articles of association do not determine otherwise.

rule, with private parties attempting to dissociate control from ownership (Martin & Partnoy, 2004; Black & Kraakman, 1996).

2. The Possibility of Detachment of Voting Rights

As seen, share ownership incorporates a complex legal position that delimits shareholders' position before the company, other shareholders, and third parties. Accordingly, shareholders have an inherent set of rights and obligations. There are several conceptions of share ownership in the doctrine, ranging from a legal relationship, a legal position – a *status* –[11], or a complex subjective right[12]. Therefore, the – not so peaceful – question arises as to whether share ownership should be understood as an atomistic multiplicity or as a structured globality (Cordeiro, 2017; Vasconcelos, 1999; 2006)

Scholars that advocate for the classic conceptions understand that shares are unitary legal assets, made of shareholders' rights and obligations, with a specific and distinct discipline from that of its various components. The consequence of the adoption of these conceptions is the acknowledgment of a principle of indivisibility of shares[13], leading to the impossibility of ownership of the rights inherent to shares without the ownership of the shares themselves. Share ownership is understood as a whole, hence the rights and obligations that make it up are not susceptible of being the subject of autonomous legal transactions (Estaca, 2008; Abreu, 2015).

It turns out that the classic theories and the principle of indivisibility of shares have lost relevance or, at least, been severely restricted, because of the possibility of separation of shares from their inherent rights, or at least some of them. From a securities perspective, this is fundamental for the purposes of autonomous trading, particularly on secondary markets. At issue is the possibility of shares being traded without certain inherent rights that are usually incorporated in them, as well as the detachment of those rights so that they can be separately object of disposal legal transactions. The goal is to ensure that rights that are already autonomous from a substantial point of view also correspond to representations that are different from those of the securities on which they are based (Estaca, 2008).

[11] For further information, see Cordeiro, 2017.
[12] For further information, see Vasconcelos, 1999; 2006.
[13] The PCC expressly states, in article 276 (6), that shares are indivisible.

For most of the doctrine, such reasoning is deemed inapplicable to rights of political or administrative content, particularly the voting right, which is generally considered *res extra commercium*, being inseparable from share ownership[14] (Câmara, 2016; Abreu, 2015). But the fact is that, nowadays, not all shareholders are positioned in the same way *vis-à-vis* the company, and they may each be driven by different interests. Most investors, especially small shareholders, do not acquire securities in order to participate in corporate life and exercise their voting rights; many do not even attend general meetings. So, it does not make sense to continue to vigorously defend the importance of voting rights for any and all shares (Estaca, 2008).

Certainly, there will be situations in which share ownership is fundamental, not only because of the value of the capital it represents but also because of the resulting voting rights that allow control and governance of the company. But there will also be many other situations in which the ownership of shares is only important as a pure investment, especially in companies whose capital is widely distributed to the public, and the acquisition of securities is made in large quantities (Estaca, 2008).

The doctrine usually points to the prohibition on the sale of votes as the main obstacle to the admissibility of negotiating voting rights[15]. However, there is a fundamental difference between the sale of the exercise of a right or the abstention from that exercise in exchange for certain special advantages and the sale of the ownership of that right. In the first scenario, the shareholder allows himself to be corrupted in the punctual or permanent exercise of the voting right by alienating, not the right itself, but the freedom to exercise it, while receiving something in return. Differently, in the second situation – which corresponds to the detachment and autonomous negotiability of the voting right –, the shareholder alienates, definitively but separately, the ownership of a right inherent to the share, so that the acquirer can exercise it according to his interests in the company, especially those of participating in its governance (Estaca, 2008).

Therefore, we believe that the best position is the one that advocates that the right to vote can constitute an autonomous legal asset susceptible to economic trafficking, since

[14] Vasconcelos supports the prohibition on the division of shares, stating that it expresses the need to keep the complex of active and passive legal positions that is share ownership together. Thus, since the detachment of the voting right would represent the division of the share, it should not be allowed (Vasconcelos, 1999; 2006).

[15] Article 17 (3) (c) of the PCC provides that agreements are null and void when, in exchange for something, shareholders undertake to vote in a certain way or only to vote or to abstain from voting.

a market or business opportunities exist between those who have a legal power that they do not intend to use and can alienate and those who do not have that power but want to use it (Estaca, 2008).

The Portuguese Securities Code (PSC)[16] establishes, in article 1 (1), a typology of securities, which includes, in subparagraph (f), the rights detached from the securities described in subparagraphs (a) to (d) – among which we have shares – provided that this detachment applies either to the entire issue/series or is duly described in the issue conditions. This provision opens the door to address the susceptibility of separating rights that, at first glance, do not have a direct patrimonial expression, such as the right to vote, but through them, other patrimonial interests of the respective holders, or third parties, end up being safeguarded (Estaca, 2008).

Thus, in Portugal, the conjunction of article 1 (1) (f) with article 55 (3) (b) of the PSC – which states that voting rights are inherent to securities – leads to the conclusion that voting rights are rights inherent to securities that can be detached from them and subject to autonomous negotiation[17] (Estaca, 2008).

3. The "New Vote Buying"

The globalization of financial markets, their progressive liberalization and deregulation, the fierce competition between financial intermediaries, and the extraordinary progress of information and communication technologies, have led financial institutions to a ceaseless dynamic of creating and perfecting new products or instruments designed to satisfy the increasingly diverse and complex needs of its customers and markets (Antunes, 2020).

The derivatives revolution in finance, especially the increase in equity swaps and other privately negotiated equity derivatives, and the substantial growth in the share lending market, related with the upsurge of lightly regulated hedge funds, whose trading strategies often include short selling, brought up a new possibility of separation between the economic return on shares and the related voting rights (Hu & Black, 2006a; 2006b;

[16] Decree-Law no. 486/99, of November 13th.

[17] The previously mentioned exceptions to article 21 (1) (b) demonstrate that the right to vote is not absolutely essential to the ownership of shares, in the sense that the various derogations to its exercise do not substantially affect share ownership (Estaca, 2008).

2007; 2008a; 2008b; Hu, 2015). These discrepancies between voting power and economic interests can be incidental, as unintended consequences of transactions, or intentional, particularly to obtain votes without the equivalent economic exposure[18] (Kahan & Rock, 2008). Here, we will focus on the latter.

Actually, the shareholders' residual claimant position described before is not always, or even commonly, so accurate. In fact, some of them – particularly large institutions and hedge funds – simultaneously hold shares of various companies. But, since these shareholdings affect their risk exposure, they prefer to avoid it whenever possible, typically by holding portfolios that include both "pure" residual claims and positions with financial derivatives, posing a challenge to the traditional approach of voting rights[19]. This is a widely known practice that allows shareholders to leave the investment risk that should be theirs for others (Čulinović-Herc & Zubović, 2015; Martin & Partnoy, 2004).

Albeit there is no universal definition of hedge funds, in the Portuguese doctrine, Antunes defines them as "legally atypical organised collective investment structures, which resort to a very diversified set of investment strategies aiming to obtain absolute return within a framework of great regulatory freedom"[20] (Antunes, 2009). Investors participating in hedge funds are usually institutional investors (e.g., banks, large commercial and industrial companies, etc), although, in certain situations, individual investors are also admitted. Certain is that, regardless of their nature, investors are always necessarily limited in number (Antunes, 2009).

Hedge funds seek to eliminate market risk[21] – the risk of exposure to uncertainty in the market value of an asset portfolio – using hedging techniques and creating

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[18] For example, a person may buy shares after the record date because she believes the stock price will increase or in order to sell them after that date so that she can vote those shares without having any economic exposure. In the first case, the discrepancy between voting power and economic ownership is incidental, since the person did not acquire the shares having that objective in mind. But in the second case, the shares are definitely acquired to exercise the voting rights underlying them without the corresponding economic exposure (Kahan & Rock, 2008).

[19] Conversely, other constituents frequently acquire through financial engineering positions that mimic those of "pure" residual claimants. Still, even though they have the same incentives as shareholders, they are not given the right to vote. As stated by Martin & Partnoy, *"[y]et neither market pressures nor regulatory initiatives have led to the shifting of voting rights from shareholders who do not have the proper incentives to non-shareholders who do."* (Martin & Partnoy, 2004).

[20] Our translation.

[21] Market risk is eliminated as far as possible, but exposure to other specific risks increases, namely resulting from the fact that the investment is fundamentally based on the personal assessments developed by the fund manager in relation to an expected return and in his ability to detect specific market inefficiencies and channel investment to those niches with the exact speed and intensity (Dias, 2008).

conditions for the investment made to remain impervious to market fluctuations and typical asset volatility. One of their main features is their absolute return objective: they always pursue positive and maximum returns for their investors, in any market context. The results they obtain are not measurable by comparison with any index and demonstrate an intentional and clear de-correlation with market movements, showing that hedge funds take advantage of the depreciation of some assets, achieving comfortably positive returns in contexts of market devaluation[22] (Antunes, 2009; Dias, 2008).

In modern financial markets, hedge funds, as sophisticated alternative investment funds that masterfully exploit the categories of company law, financial derivatives, and risk management, have quickly grown into critical players in both corporate governance and corporate control[23]. They are seen as *"(...) the prime corporate governance and control activists"* (Kahan & Rock, 2007). This is because they are increasingly trying to influence the business strategy and management of corporations and are particularly active in transactions involving potential changes in corporate control.

These activities, largely known as "shareholder activism", have become hedge funds' business model. In fact, they have turned into the most dynamic and prominent shareholders of the modern stock companies, getting deeply involved in the life, administration, and governance of these companies by pursuing activism as a profit-making strategy through the accrual of many economic positions in portfolio companies. This activism is characterised as "offensive" since it is included in hedge funds' investment plans (Kahan & Rock, 2007; Ringe, 2012).

Hedge fund activism is strategic and *ex ante*: firstly, they determine whether a company would benefit from activism and then take a position and become active (Kahan & Rock, 2007). They guide their investments according to the opportunities presented by the market, investing intensively in assets that, at each moment, appear likely to provide interesting returns, without a great deal of diversification (Dias, 2008).

The modern capital market offers a huge profusion of investment strategies and a multiplicity of financial techniques that hedge funds and other shareholders can use to the

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[22] It is not uncommon for hedge funds to operate against the market itself, resulting in the circumstance that some of their best performances have been recorded in times of sharp decline or even collapse of the international financial markets (Antunes, 2009).
[23] Traditionally, they used to trade predominantly in financial instruments. However, with the developments of computer technology and financial engineering, a growing number of hedge funds discovered the potential of equity markets (Ringe, 2012).

"(...) intentional exploitation of loopholes in the legal system to break up the connection between risk and influence in shares of their portfolio companies" (Ringe, 2012). Through hedging and other sophisticated trading and arbitrage strategies, with particular emphasis on financial leverage and short-selling, hedge funds can retain voting power and influence in their portfolio companies while eliminating or reducing the economic risk that is inherently attached to the shares they buy. They principally use financial derivatives or share lending to free the shares from their risk and still maintain their regular voting entitlement (Antunes, 2009; Ringe, 2012; Dias, 2008; Kahan & Rock, 2007).

Most hedge funds are independent, i.e., they are not affiliated with any other institution, such as a bank or insurance company (Kahan & Rock, 2007). Consequently, they are free from the most significant potential sources of conflicts of interest and from the concerns with adverse publicity that may dissuade other institutional investors from engaging in decoupling strategies. This means that they can pursue the new opportunities more aggressively. Therefore, with the emergence of more and more activist hedge funds, "(…) *decoupling may have found its muse*" (Hu & Black, 2006a; 2006b; 2007).

The new decoupling techniques have been called "new vote buying" because they make vote buying relatively easy and more frequent by overcoming the idea that it is only possible through an agreement between shareholders in which one decides to vote according to the instructions of the other, being generally deemed as illegal. On the contrary, in modern financial markets, votes can effectively be bought through a range of other strategies, which will be described in the next chapter (Schouten, 2010a).

"The new vote buying thus strikes directly at both the economic and legal logic behind shareholder voting rights" (Hu & Black, 2006a). It undermines the foundational assumptions underlying the abovementioned "one share, one vote" rule, making it no longer valid, reliable, and applicable, and threatens the integrity of decision-making in general meetings, especially in listed companies[24] (Po, 2016; Clottens, 2012). The traditional approach to voting rights is in contrast with the innovative structures used by corporations and, generally, in the financial markets (Martin & Partnoy, 2004).

[24] Listed companies need to access the capital market for financing, so they are more affected by a potential loss of shareholder confidence in voting integrity (Clottens, 2012).

Modern capital markets make it easier, quicker, and cheaper to dissociate formal share ownership, and the concomitant voting rights, from the economic interest of shareholders in the value of the firm (Waddell *et al*, 2010). Even though the possibility of decoupling votes from economic ownership is not new[25], by using financial innovation, investors are able to elevate decoupling to a larger scale and to do it often hidden from view (Hu & Black, 2006a; 2006b; 2007).

Chapter II – The Empty Voting Phenomenon

1. The Concept of Empty Voting

The "new vote buying", as described in the previous chapter, is at the origin of the growing relevance of the empty voting phenomenon. Empty voting is embedded in this new generical framework, in which innovations in the financial markets have created the possibility, and the reality, to divorce share ownership, and the associated voting rights, from the economic interest in the corporation's value (Ringe, 2012).

Decoupling, as an intentional deconstruction of equity investment, can take two forms: positive or negative decoupling. In fact, if a shareholder has an economic interest in a company, his voting rights are aligned with the firm's interests. However, if such interest does not exist, consequently there will be no investment risk, so the shareholder may vote freely as he pleases (Čulinović-Herc & Zubović, 2015; Ringe, 2012). Here, we will focus our analysis on negative decoupling[26].

[25] In the past, there were already certain commonly used techniques for decoupling, referred to as the old decoupling techniques, which were sometimes associated with potential benefits to the markets. These include dual-class common stock structures, involving two classes of shares in a single company. Typically, one class has higher voting power and is usually held by insiders. The other class has no or low voting power and is offered to the general public (outsiders). There are also pyramidal and circular ownership structures, which concentrate effective voting control in the hands of insiders at the top of the pyramid or the centre of the circular structure (Hu & Black, 2006a; 2007; 2008a; 2008b; Hu, 2015; Po, 2016).

[26] We will not address in detail positive decoupling, because it falls outside the scope of this work. For the sole purpose of distinguishing it from negative decoupling, it consists of a strategy where activist investors can limit their participation in a company by acquiring only an economic stake in the respective shares, without holding the corresponding voting rights. Positive decoupling leads to the "hidden ownership" phenomenon, where the economic risk of investors is higher than their voting power. Often, hidden ownership can be quickly transformed in order to include voting ownership, turning into "hidden (morphable) ownership". This is the situation where the holding of economic ownership, usually not covered by disclosure rules, exceeds the holding of formal voting rights, and is coupled with the possibility to obtain the possession of additional voting rights, both informally and formally, and/or acquire further shares when needed. For example, when an investor enters into an equity swap with a derivatives dealer on shares of a certain company, he will have economic-only ownership of those shares and no voting rights (hidden owner), whereas the dealer will have voting rights but no economic ownership (empty voter). If

Negative decoupling (or negative voting) is the situation where shareholders have a negative economic interest in the company, i.e., an *"(...) inverse economic risk profile and thus an inherent conflict of interest in all company decisions (...)"* (Clottens, 2012). In consequence, instead of having the incentives of optimal shareholders with perfect risk-alignment, on the contrary, they have no incentive at all to exercise their voting rights in the best interest of the company (Clottens, 2012; Ringe, 2012).

These shareholders will tend to pursue goals that can be quite different or even detrimental to the company as a whole and to vote in such a way that provokes a decline in its value, favouring projects that aggressively dissipate corporate resources. In fact, they will *"profit both directly from the decision itself (through the extraction of private benefits of control) as well as indirectly from the resulting drop in the share price."* (Clottens, 2012). This situation has a great potential for inefficiencies and welfare destruction (Barry *et al.*, 2013; Clottens, 2012; Ringe, 2012).

Negative decoupling may result in empty voting[27], a term firstly conceived by Professors Hu & Black to describe the situation in which a shareholder has a formal right to more votes than indicated by his net economic ownership[28] (Hu & Black, 2006a; 2006b; 2007; 2008a; Hu, 2015; Waddell *et al*, 2010). It derives from the idea that the shareholder's vote has been emptied of the economic consequences that shareholders typically face following their status (Čulinović-Herc & Zubović, 2015). *"In its widest sense, the notion of empty voting covers all situations where someone, whether or not a formal shareholder, can exercise voting rights or voting discretion without being subject to the economic risk of the underlying shares, or at least while being subject to a relatively (i.e., disproportionately) small risk"* (Clottens, 2012).

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later, the investor wants to vote the shares, he can acquire them (matched shares), consequently obtaining their voting rights to accompany economic ownership. These morphable voting rights will generally not be verifiable by outsiders and depend on market customs (Hu & Black, 2006a; 2006b; 2008b; Po, 2016).

[27] Martin & Partnoy had the merit of diagnosing this problem for the first time, using the term "*encumbered shares"* to describe the position of a shareholder who votes shares without full economic interest in them. They argued that shares could be encumbered in two ways. Firstly, we could have "*economically encumbered*" shares, which are *"those shares that are held by stockholders who may lack the otherwise homogeneous incentives generated by "pure" share ownership (e.g., who hold both a share and a short or other derivative position)."* Secondly, we may have "*legally encumbered"* shares, which are *"those shares that are held by stockholders who may have a legal impediment to voting such shares (e.g., who have loaned out such shares to a broker or short-seller (...))."* These scholars sustained that the "one share, one vote" rule was inefficient when applied to such shareholdings (Martin & Partnoy, 2004).

[28] Hu & Black define net economic ownership as *"(...) a person's combined economic ownership of host shares and coupled assets. This net ownership can be positive, zero, or negative."* (Hu & Black, 2006a; 2006b; 2007; 2008a; Hu, 2015).

Empty voting can be achieved by way of an overwhelming multitude of approaches, which will be described in the sections below, all of which touch the core of corporate governance and call into question the traditional approach to voting rights (Ringe, 2012; Schouten, 2010a). These strategies have the objective of reducing the risk exposure that is usually associated with equity investments while shareholders retain voting power and influence in the company, consequently being able to acquire or maintain control in it. They are used by investors for several purposes[29] and do not directly require market trading of shares. Thus, they can often be carried out rapidly and on a large scale, with little or no impact on share price[30] (Hu & Black, 2008a; 2008b).

Empty voting can be used in the context of mergers and acquisitions, affecting the market for corporate control through merger arbitrage, which involves purchasing and selling stock of two merging companies at the same time in order to create riskless profits. The shares will be bought by the merger arbitrageur before the transaction, considering the probability of it not being closed on time or at all, expecting to make a profit when it is completed. When the positive vote of the merging companies' shareholders is required to complete the deal, empty voters may try to influence it by acquiring shares of those companies in order to vote in its favour while simultaneously hedging their economic exposure to their performance. Hence, empty voting is not only an issue of corporate governance but also of market efficiency (Clottens, 2012; Po, 2016).

The key concern raised by empty voting is that it results in the possibility of shareholders with a negative net economic ownership having effective voting rights without bearing any economic risk linked to the performance of their shares, consequently acquiring a disproportionate influence in the company (Oliveira & Oliveira, 2012; Oliveira, 2013). This pathology seems to originate more votes for investors with bad incentives, which can be not only traditional corporate insiders, such as managers and controlling shareholders, aiming to consolidate their control but also outsiders, as empty voting strategies can be carried out by all market participants. Activist shareholders, typically hedge funds, are accused of using these strategies in the pursuit of quick profits,

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[29] For instance, to increase efficiency, since transactions with equity derivatives can include lower transaction costs, for tax purposes, to evade ownership disclosure obligations, to avoid being subject to certain legal provisions, to vote in conflict of interest situations, etc.

[30] For example, in stock lending, the empty voter borrows shares and votes simply move from the lender to him. No shares are bought or sold. This strategy will only affect share price if the borrowing is on a scale that influences the ability of hedgers to negotiate their trade (Hu & Black, 2008a; 2008b).

often at the expense of the long-term interest of their portfolio companies (Clottens, 2012; Kahan & Rock, 2008).

"It is today quite easy for investors to construct portfolios that increase in value as a corporation's stock price declines while retaining the right to cast large blocks of votes in shareholder elections" (Waddell *et al*, 2010). These shareholders cause their shareholdings to no longer be proportionally related to their economic exposure to the corporation's financial performance, not only severing but reversing the assumption of alignment between economic and voting interests. Additionally, they will often have incentives diametrically opposed to those of the company and may tend to vote and approve certain transactions that benefit themselves even if their decisions would harm the company's interest and value (Po, 2016; Waddell *et al*, 2010).

Furthermore, an artificial voting stake, namely a majority or blocking minority not backed by economic risk, can determine the outcome of the voting process in general meetings, in a way that will not maximise shareholder value. Empty voting can yield a voting outcome that is less reflective of the one that a majority of well-informed shareholders would have reached, consequently tending to result in systematically inferior voting outcomes (Clottens, 2012; Kahan & Rock, 2008; Waddell *et al*, 2010).

Empty voting *"(...) is an example of an old problem – conflicts of interests created by exploiting the separation of legal and beneficial ownership – aggravated by modern financial innovation"* (Kahan & Rock, 2007). It arises primarily in listed companies because stock lending and derivatives transactions are much easier and cheaper when the underlying shares are publicly traded, and the record date is only mandatory for this type of company. In reality, the more liquid the market for shares, and the larger the market for derivatives, the more often empty voting will occur (Kahan & Rock, 2007).

2. Empty Voting Strategies

2.1. Hedging through Financial Derivatives

In the modern financial markets, there are a number of instruments that shareholders can use to hedge their economic exposure and shift the risk to other market participants (Čulinović-Herc & Zubović, 2015; Ringe, 2012). Derivatives are a main pillar in the global financial system and the ultimate exponent of the financial innovation movement that has taken the centre stage in the capital markets of the last decades. Endowed with increasing complexity and sophistication, their economic relevance in the context of modern economies is undeniable, as they contribute to economic growth and increase the efficiency of markets (Antunes, 2020).

Derivatives are a category of financial instruments[31], generally provided for in article 2 (1) (c) to (f) of the PSC[32]. We will adopt the definition provided by Antunes: "financial instruments resulting from term contracts entered into and valued by reference to a specific underlying asset"[33] (Antunes, 2020). They have five main characteristics: their contractual origin[34]; they are always term financial instruments[35]; their designation stems from the fact that they are "second-degree" instruments, *i.e.*, built and valued by

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31 The main source of the financial instrument concept is Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments (Markets in Financial Instruments Directive II or MiFID II), which does not provide a definition, but, in article 4 (1) (15), refers to Section C of Annex 1, where a non-exhaustive list of financial instruments is found. The PSC also does not define the concept of financial instruments. The Portuguese legislator, following the European, limits itself to presenting a non-exhaustive case-by-case list in article 2 (1) of the PSC, leaving doctrine with the care to elaborate a unitary, general, and abstract concept, to which new analogous instruments that financial engineering may create can also be subsumed (Almeida, 2011; Antunes, 2020). Câmara states that it is not surprising that a closed demarcation of the financial instrument concept is avoided, both at the Portuguese and European level, as the term is merely a conceptual arrangement of circumstance that covers four juxtaposed realities – securities, money market instruments, derivatives, and emission licenses – having no intention of discerning the substantial characteristics that unite them (Câmara, 2016). Nevertheless, some definitions of this concept have already been advanced in the Portuguese doctrine. Antunes generally defines financial instruments as *"um conjunto de instrumentos juscomerciais heterogéneos suscetíveis de criação e/ou negociação no mercado de capitais, que têm por finalidades primordiais o financiamento, o investimento, e/ou a gestão de risco das empresas e demais agentes económicos."* (Antunes, 2020). Almeida defines them as *"documentos e contratos financeiros lato sensu, isto é destinados ao financiamento a qualquer prazo ou relacionados com o financiamento a qualquer prazo."* (Almeida, 2012).

32 The source of this provision is Annex I, Section C, points 4) to 10) of the MiFID II. This Directive was transposed into the Portuguese legal system by Decree-Law no. 357-A/2007, of October 31st. Also important are the provisions on derivatives contained in Regulation (EU) No. 600/2014 of the European Parliament and the Council of 15 May 2014 on markets in financial instruments (Markets in Financial Instruments Regulation or MiFIR) and in Regulation (EU) No. 648/2012 of the European Parliament and the Council of 4 July 2012 on OTC derivatives, central counterparties, and trade repositories (European Market Infrastructure Regulation or EMIR).

33 Our translation.

34 Derivatives are contracts, in the broad sense of abstract business models capable of generating legal bindings, which usually have a set of general characteristics: they are typically concluded by entrepreneurs in the exercise of their business activity; their formation results from the mere declaration of will of the contracting parties and gives rise to mere rights and obligations for both of them, the latter being linked together by a nexus of reciprocity; they are generally not subject to mandatory legal form; the person or qualities of the parties are irrelevant; they involve patrimonial allocations for both parties (Antunes, 2020).

35 Derivatives do not take shape in spot operations (object of immediate execution), but rather in term transactions, characterized by the existence of a more or less long period of time between the date of their execution and the date of execution of the rights and obligations arising from them, which may legally configure a term (*e.g.,* futures) or a condition (*e.g.,* options). The essentiality of the time factor is entirely consistent with the primary function of derivatives – hedging –, because risk consists on the fluctuation of economic variables in the future, so only a term transaction, executable in a future date, can cope with it (Antunes, 2020).

reference to a primary reality, which is a certain underlying asset[36], typically subject to financial fluctuations in its value; they are genetically based on risk[37]; and they are autonomous and abstract financial instruments[38] (Antunes, 2020; Ascensão, 2003).

Most derivatives are entered into "over-the-counter" (OTC), i.e., investors go to investment banks or similar entities and privately negotiate a contract. OTC derivatives are individual complex contracts – in the sense that they allow adaptation to the particular needs of specific investors –, typically bilateral in structure – since they only have investors as parties, without prejudice to the intervention of specialized financial intermediaries, which happens in the majority of cases – and negotiated and executed on a case-by-case basis outside an organized market (Antunes, 2020).

The execution of the contractual obligations of derivatives on the maturity date can be carried out according to two procedures: physical settlement, consisting on the delivery of the underlying asset against the payment of the respective price; or financial settlement, entailing the payment of the differential balance between the strike price (the price of the asset fixed at the conclusion of the contract) and the spot price (the price verified at the maturity)[39] (Antunes, 2020).

Derivatives perform two essential economic functions[40]: hedging and investing. On one hand, they are instruments for hedging or managing risk exposure, which economic agents use to protect themselves against the adverse consequences of unfavourable fluctuations on the financial performance of underlying assets, by investing

[36] The Portuguese legislator enshrined an extremely extensive but non-exhaustive list of relevant underlying assets in article 2.º (1) (e) and (f) of the PSC.

[37] Risk is the very *raison d'être* of derivatives transactions, in the sense that the contracting parties, more than simply entering them in a state of information deficit, because their pecuniary significance depends on a future event, only definitively determinable at the time of their execution, aim precisely to negotiate about such uncertainty, making it the true cause and basis of their agreement (Antunes, 2020).

[38] Autonomous, because once created, they become independent vis-à-vis the respective underlying assets. Even though, economically, derivatives constitute a kind of duplication of the underlying assets, since the value of the first derives from the value of the second, from a legal point of view, they are instruments whose existence and validity are totally independent of the legal vicissitudes of those assets. Abstract, in the very broad sense that they can perform a plurality of functions (Antunes, 2020).

[39] Po states that *"(...) cash settlement may increase market efficiency and liquidity given that, for example, (i) clearing and settlement risks are reduced to the timely payment of the price difference without any need to physically transfer the underlying shares, (ii) there are no minimum trading sizes, and (iii) preferential tax treatment applies to cash-settled instruments in certain jurisdictions."* (Po, 2016).

[40] Derivatives have other functions, such as arbitrage, which allows economic agents to make profitable applications that aim to obtain gains, without taking risks, exploiting inefficiencies or mispricing of markets or underlying assets, reciprocally benefiting from the most favourable conditions, or financial leverage, which permits economic agents to participate in a greater proportion in changes in the value of the underlying assets through the mobilization of reduced financial resources (maximization of gain or loss along with minimization of the initial investment) (Antunes, 2020).

in the opposite movement of the value of the assets, thus handling market risks (e.g. fluctuations in exchange or interest rates, inflation), regulatory risks (namely, prudential limits on the acquisition of shares), and other similar risks (Almeida, 2011; Antunes, 2020; Po, 2016).

On the other hand, derivatives are investment instruments that economic agents use to make profitable applications that aim to anticipate the direction of the evolution of the value of the underlying assets in the market[41]. This is a form of aggressive investment, where the investor takes substantial risks in exchange for higher profits, according to his previsions. The trading dimension is fundamental in the derivatives market: hedging and trading are two sides of the same coin. In fact, an entrepreneur will only be able to hedge a given risk of his economic activity if he finds an investor in the market willing to assume it (Almeida, 2011; Antunes, 2020).

Derivatives are a mass contracting mechanism for the transfer of risks inherent to the underlying assets between the parties. In all of them, one of the parties assumes the contractual position that will benefit from the increase in the price of the underlying asset and will record a loss with its decrease (the long position or “equity leg”) and the counterparty assumes the opposite position that benefits from the drop in that price and loses if it rises (the short position or “interest leg”) (Almeida, 2011; Antunes, 2020).

For corporate purposes, derivatives may be used as a mechanism for decoupling, creating economic exposure to the price of shares, either similar (long position) or inverse (short position) to their risk profile. When a derivative is built by reference to a set of shares of a certain company, the economic risk underlying the ownership of those shares is transferred, without, however, the shareholder losing their ownership and the voting rights associated with them. Derivatives enable investors to hedge the economic risk of shares by taking short positions in derivatives referenced to them, ending up with a greater number of votes than economic interest in the company, while their counterparts, assuming long positions, become subject to the economic risk underlying the shares,

[41] For example, an investor, believing in the potential for appreciation of the shares of a certain listed company but not wanting to directly assume the ownership of a shareholding in it, assumes a long position in an equity swap, reaping the benefits of any valuation and supporting the losses of any depreciation of the share price (Antunes, 2020).

having an economic interest in the company, even though they are not able to exercise voting rights[42] (Antunes, 2020; Po 2016).

Modern finance offers a multitude of ways for investors to hold divergent interests concerning the economics and control of a corporation, most of which arise through the use of derivatives. For many years, the derivatives market was rather small compared to the public market for stocks, making it impractical to use derivatives to acquire or sell significant economic or voting interests in a public company. However, over the past few decades, derivatives markets have grown explosively (Barry *et al.*, 2013).

Because all it takes to create a derivative is for two parties to agree to do it, and there is no need for either of them to own the underlying asset, derivatives markets can always become larger. In fact, their tremendous growth has enabled a surge in decoupling, given that financial derivatives make it far cheaper and easier. Since the expansion of derivatives markets shows few signs of slowing, decoupling seems likely to be an increasingly frequent occurrence (Barry *et al.*, 2013).

But one must not forget that the improper use of derivatives poses threats to corporate governance because they allow the complete hedging of certain risks. Even though a total elimination of the risk is an exceptional situation, and derivatives are more often used to produce, at the very least, a partial reduction of risk, there can be an adverse impact on shareholders incentives to exercise voting or other rights attached to shares (Ringe, 2012; Clottens, 2012). In addition, derivatives allow for a separation between formal and material ownership. Since most legal rules are based on formal ownership, derivatives can serve as a means to manipulate them[43] (Antunes, 2020; Po, 2016).

All in all, we can conclude that a core empty voting strategy is the acquisition shares of a company while simultaneously hedging the related economic exposure through a short position in an equity derivative (Po, 2016). Numerous derivative financial instruments can be created. With special relevance to our study, we will see below the

[42] This demonstrates that positive and negative decoupling are direct opposites: if one investor acquires more voting rights than economic ownership, then another investor must hold more economic ownership than voting rights (Hu & Black, 2006a; 2006b).

[43] This situation favours investors who are only interested in the price performance of securities and do not intend to own a physical equity position after the expiration date of the derivative (Antunes, 2020; Po, 2016).

main characteristics of swaps, options, futures, and forwards, and how they allow for the decoupling of economic ownership and voting rights.

2.1.1. (Equity) Swaps

Swaps are contracts by which the parties agree to exchange cash flows associated with financial assets at a future date. They are expressly provided for in article 2 (1) (e) of the PSC and are fundamentally hedging and trading instruments. In swap contracts, both parties undertake reciprocal and future obligations to pay monetary amounts, expressed in the same or different currencies, on one or more predetermined dates, calculated by reference to cash flows associated with a given underlying financial asset. The underlying assets are merely notional, that is, they are only reference values (notionals) and are not subject to transmission between the parties. They must have identical characteristics, being based on notionals of the same amount and with the same maturities, although with different rates (Almeida, 2011; Antunes, 2020).

Swaps are undoubtedly the most relevant OTC derivative. Their subjects are only the investors (usually companies, but also individuals or public entities), although, in the overwhelming majority of cases, their conclusion involves the intervention of financial intermediaries, namely banks, either in the role of *arrangeurs* of the swap operations (swap brokers), opening positions, looking for counterparties and receiving a commission for closing the deal, or, increasingly, in search of higher revenues, as professional "swappers" (swap dealers), intermediating financial flows or even directly intervening as a counterparty in these contracts[44] (Antunes, 2020).

The terms of swap contracts can be adjusted on a case-by-case basis. However, there has been an effort to standardize, in order to reduce transaction costs, while facilitating international transactions and speeding up operations. First, a preliminary contract (master agreement) is celebrated, containing a set of general clauses, which works as a framework or preliminary contract designed for future transactions between the parties[45]. The swap contract is only definitively closed when all the particular or

[44] As swaps are traded outside the organized market, there is no central counterparty that ensures the settlement/clearing of payments when one of the parties does not provide sufficient guarantees, so the intervention of third party guarantors may be required to ensure contract fulfilment (Antunes, 2020).

[45] These master agreements almost invariably correspond to adhesion contracts whose content investors simply adhere to or subscribe *en bloc*. They can either refer separately to each swap contract or establish a

special conditions (confirmation) are agreed upon, namely the definition of the underlying asset, its notional value, the duration of the contract, the payment terms, and the spread of the financial intermediary (Almeida, 2011; Antunes, 2020).

There are several types of swaps. For our study, the most relevant are equity swaps, in which the underlying assets are shares of a certain company. These contracts have several uses, such as risk management of instruments with variable yields, diversification of investments in portfolios without selling positions, indirect investment at low cost and without the need for ownership of shares, and access to emerging markets or with regulatory restrictions difficult to overcome. Through them, the risk of investing in a certain set of shares is replicated, without, however, having to make an effective investment in them. Thus, equity swaps can be used as financing mechanisms for the acquisition of the underlying securities. They may also have a purpose of parking shares, through their combination with the sale of those shares to the financial institution with whom the equity swap is concluded (Almeida, 2011; Antunes, 2020).

Total return equity swaps deserve particular relevance, as they most faithfully replicate financial returns of shares: the party with the short position (equity amount payer) undertakes to pay the counterparty any valuations registered by the shares – positive differential between the value of the shares at the time of completion and at the time of execution of the contract, as well as any dividends generated by them –, being the party with the long position (equity amount receiver) obliged to pay the former a sum calculated by reference to a fixed or variable interest rate applied to a notional amount equivalent to the value of the shares at the time of the conclusion of the contract, in addition to covering any devaluations – negative differential recorded by the value of the shares between the moments of contractual completion and execution (Antunes, 2020).

The equity amount receiver is interested in the increase of the value of the underlying shares, therefore benefiting from any appreciation in their market value and bearing losses in the opposite scenario. Consequently, this party is in a situation similar to the direct economic holding of those shares for the duration of the swap contract, assuming the associated risks and benefits, without, however, holding the right to vote.

long-term collaboration model between the parties, which can be modified through the special conditions of each contract. The contribution of the International Swaps and Derivatives Association (ISDA) through the disclosure of master agreements that are widely adopted internationally and influence most swap contracts should be noted. Currently, the 2002 ISDA Master Agreement is in force (Almeida, 2011; Antunes, 2020).

On the other hand, the equity amount payer, that may be a bank or another financial intermediary, is betting on the decrease in the price of the underlying stock, which makes him an empty voter, since he is no longer exposed to the economic risks of holding such shares, although maintaining the right to vote[46] (Po, 2016).

Total return equity swaps act like insurance contracts that cover the investor with the short position's losses if the company's stock price declines, but in return require that that investor sacrifices all his gains if the value of the company's shares increases. Therefore, the investor is indifferent to the share price movements but still gets to vote his shares normally, as if he had never entered into the swap contract. Hence, there is a greater risk that the investor could be motivated to cast a vote in a manner that causes economic harm to the company (Waddell *et al*, 2010).

As seen, equity swaps are suitable to transfer the risk of share price movements to another market participant. In fact, derivative dealers will tend to hedge their short positions against the risk of positive performance of the underlying shares which would give rise to their payment obligations under the swap. Such hedging strategy may be carried out either by investing in equity swaps referenced to the same underlying stock or by directly acquiring the shares (hedging or matched shares) so that losses or gains on the equity swap are offset by gains or losses on these shares[47] (Po, 2016).

[46] For example, A holds 100 shares of company X and enters into an equity swap with B for those shares, under which A is obliged to pay B the valuations of those shares, receiving, in return, from B, their devaluations, plus the 3-month Euribor interest rate over 2 years. As of the entry into force of that contract, B, who takes the long position, is exposed to the risk of a decline in the value of company X's shares: whenever there is a reduction in their value compared to the value they had on the date of the conclusion of the swap contract, B will have to deliver the amount of that devaluation, plus the 3-month Euribor interest rate. In turn, A, who has taken the short position, is subject to the risk of a rise in the value of those shares, since if their value increases in comparison with the value they had on the date of the conclusion of the swap contract, A will have to deliver to B the amount of that valuation, in addition to the dividends that were distributed in the meantime. In this situation, A is an empty voter because his voting power is greater than the economic risk that should be underlying it. This situation originates the danger that A may have a negative interest in the rising of share prices, as in that case, he will record a loss in the swap contract. Thus, A may be encouraged to vote at company X's general meeting in a sense that could be detrimental to the company itself (Antunes, 2020).

[47] When an investor enters into a derivative contract that mimics the economic effects of owning shares of a company's stock, the derivatives dealer pays the investor whenever that stock's value increases, and the investor pays the dealer whenever that stock's value decreases. Accordingly, the dealer's profits will depend on the value of the company's shares. However, the dealer can counteract this situation by purchasing the shares that constitute the underlying asset of the derivative contract. In this way, if the price of the company's shares rises, the dealer must still pay the investor, but the shares that he owns in the company will have increased in value. Conversely, if the company's share price falls, the dealer receives from the investor, but the shares that he owns in the company will have decreased in value. Hence, any fluctuations in the value of the company's shares will affect the value of the derivative contract and the value of the dealer's stock portfolio in ways that exactly offset each other. By design, the dealer has no economic interest in the company. Yet, as a shareholder, he gets to vote in its general meetings. Thus, the dealer is an empty

2.1.2. Options

Options are term contracts with an asymmetric risk profile, as they invest only one party in a potestative right to buy or sell a certain underlying asset at a predetermined price and (or until) a predetermined date, against the payment of a premium (option price). They are expressly provided for in article 2.º (1) (e) of the PSC and have the same economic functions as other derivatives, namely hedging and trading (Almeida, 2011; Antunes, 2020).

Essentially, options guarantee the beneficiary the possibility of an unlimited gain and the certainty of a limited loss, implying for the grantor the certainty of a limited gain and the risk of an unlimited loss. Their central element is the option right. It is a right – that constitutes on the legal sphere of the beneficiary, placing the grantor in a situation of subjection – and not a duty since the beneficiary is entirely free to exercise, reject or let his potestative right lapse. This means that options may cease by the timely exercise of the option right or by the expiration of the contractual term without such exercise. They are conditional operations whose execution and corresponding effects depend solely on the beneficiary's will. Still, the beneficiary is always obliged to pay the option price, which is a requirement of the formation of the contract and works as consideration of the advantage given to the beneficiary by the grantor, even when he does not, after all, exercise the option (Antunes, 2020).

Options have a huge variety of modalities. It is common to distinguish between call options and put options – whether they give the beneficiary a right to buy or sell the underlying asset - and European and American options – if they confer an exercisable option right only on the expiration date of the contract or at any time up to that date. In addition, there can be exchange-listed options and OTC options, depending on whether

voter and the investor is a hidden and morphable owner because the former will be willing to vote his shares according to the latter's wishes due to the interest that he maintains in their relationship (Barry *et al*, 2013). The hedging shares will be commonly locked into the equity swap structure and therefore taken out of the market. This is because a natural hedge (*i.e.,* direct purchase of the underlying shares) is often operationally and administratively the easiest way and the only commercially sound choice of hedging for the derivatives dealer, especially in cases where the equity swap involves a substantial amount of shares of a single company since alternative hedging strategies are likely to be limited and more expensive. The matched shares will be held by the dealer to cover its exposure until the maturity or early termination of the swap contract (Po, 2016).

they are constituted and traded in organized negotiation structures or directly between the contracting parties ("front to front") (Antunes, 2020).

Usually, the beneficiary of a call option on the shares of a company (stock option) assumes a long position because he expects a rise in their price, obtaining a gain if it is confirmed on the maturity date. If, on the contrary, the price falls, naturally he will not exercise the option and will only lose the amount of the option price. Conversely, the put option beneficiary assumes a short position, since he expects a reduction in the price of the shares. If that occurs, he controls the risk of devaluation, being able to sell the stock at the agreed price (Almeida, 2011; Antunes, 2020).

Options are particularly suitable for empty voting situations, to the extent that they make it possible to eliminate, albeit temporarily, exposure to the risk of impairment of the underlying assets[48]. In fact, they allow for the transfer of the risk of a fall in the price of shares from the beneficiary to the grantor, while the first one maintains the ownership of those shares, as well as the respective voting rights. In addition, the beneficiary still has the possibility of benefiting from a possible positive evolution of share price, since the potestative right he acquires creates within his legal sphere the unilateral choice of exercising or not the option.

In this context, it is particularly relevant to mention the zero-cost collar strategy, involving the combination of the purchase of a put option, to limit the risk of economic loss in case of a decrease in the price of the underlying asset, and the sale of a call option, reducing the profit potential. In this way, an investor can limit the potential appreciation or depreciation of his shares within a range between the two option prices: he forgoes certain gains in order to protect against losses. If both options have the same price and expire on the same date, this operation is economically equivalent to the sale of shares. The profit resulting from the sale of the call option is equivalent to the cost of the put option. This strategy preserves voting rights but sharply reduces economic ownership. It

[48] An example: A owns 100 shares of company X, and celebrates with B a put option relating to those shares for the value of € 100, paying, in return, the premium of € 5, on date Y. For the duration of the option contract, A's exposure to the risk of a decline in the value of company X's shares is covered by it, as A knows that if the price drops below € 100, he will be able to exercise the option, leaving B obliged to buy the shares. If between the date of conclusion of the option contract and date Y, A votes at a general meeting of company X, he will be considered an empty voter because his right to vote is expropriated from any economic risk underlying the shares, by force of the option contract (Antunes, 2020).

is mostly used by insiders to avoid or reduce exposure of their equity stakes[49] (Antunes, 2020; Hu & Black, 2006a; 2006b; 2007; Ringe, 2012; Oliveira, 2013).

2.1.3. Futures and Forwards

Futures and forwards are contracts that give investors long and short positions to respectively buy and sell certain underlying assets at a price and on a future date previously defined. Futures are expressly provided for in article 2 (1) (e) of the PSC. Even though forwards are not mentioned in that provision, they can be integrated generally in the figure of forward rate agreements (Antunes, 2020).

Futures and forwards show profound similarities, but also differences, particularly in their nature and trading. Whereas futures are traded in organized markets, forwards are OTC derivatives. Consequently, in futures, there is no counterparty risk, since the market management entity is the central and mandatory counterpart, but in forwards the parties are always subject to the risk of default by their counterparty. Additionally, while futures have their genesis in standardized contracts, whose terms are fully and previously determined through a set of general contractual clauses[50], forwards are subject to free negotiation on a case-by-case basis, allowing individualized hedging operations adapted to the particular needs of the contracting parties (Almeida, 2011; Antunes, 2020).

Futures have a plurilateral structure, involving the intervention of investors, financial intermediaries, and the market management entity. When the negotiation of each contract starts, investors make the respective offers to buy and sell. When these offers are met, they open contractual buy and sell positions for a certain price. This meeting is mediated by the market management entity who appears as a common counterparty of two final contracts with the same object but with an antagonistic sign with each of the investors: it assumes the status of the buyer before the investor with the seller position, and the status of the seller before the investor with the buyer position (Antunes, 2020).

[49] This strategy is deemed to be more problematic when carried out by managers because they can use their special insider knowledge to hedge their equity stakes to the detriment of shareholders (Ringe, 2012).
[50] In the Portuguese legal system, such general clauses are referred to in article 207 (2) of the PSC, which states that the object, the quantity, the term of the operation, the periodicity of losses and gains, and the settlement method are standardized in them and that they are elaborated by the market management entity (Almeida, 2011; Antunes, 2020).

This implies that in futures contracts there is no direct legal relationship between the investors themselves[51]. Also, it can be said that each futures contract, although constituting a unitary operation from an economic point of view, legally implies the existence of a plurality of autonomous and successive legal transactions (between investors and intermediaries, intermediaries and management entity, and management entity and investors) (Antunes, 2020).

Futures contracts have as their immediate object the underlying assets and as a mediate object the contractual provisions. The normal way of terminating a futures contract is to comply with it on the due date. However, this is not the most frequent method of termination. In fact, in most cases, futures are extinguished before the respective maturity thanks to the opening of new contractual positions of the opposite direction by the contracting investors, who close by compensation their previous positions in the market (closing-out)[52] (Almeida, 2011; Antunes, 2020).

Futures and forwards have the main objective of setting prices in the present that will have effects in the future[53]. Fundamentally, they were designed for hedging or managing risk exposure, by giving parties the right to buy or sell a certain asset on the market at a price known in advance (Antunes, 2020). Thus, these derivatives are also conducive to lead to the empty voting phenomenon[54].

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[51] In futures, real investor negotiation is minimal, being practically limited to price, which has minimum and maximum limits (ticks). Total standardization ensures greater efficiency and liquidity in the market, eliminating transaction costs and accelerating the speed of trading (Almeida, 2011; Antunes, 2020).

[52] As is typical of exchange-listed derivatives, futures contracts are born and die on the respective market, and are not susceptible to circulation in life: once a contractual buy or sell position is opened in relation to a given future, this position is not subject to transfer or assignment to third parties, but it is possible to obtain an equivalent economic result by opening a new position of the opposite direction (Antunes, 2020).

[53] One may think about the case where a company needs a certain raw material subject to enormous price volatility (e.g. lead or fuel) for its work during the year but does not intend to store it for that entire period, because that would imply financial costs, and, intending to safeguard itself against unexpected increases in production costs, enters into a futures contract that fixes the price today to pay tomorrow, thus stabilizing the acquisition price. If at the time of settlement, the market price is lower, the company will lose money, but, on the other hand, it manages the risk of a possible price increase (Almeida, 2011; Antunes, 2020).

[54] Suppose that A celebrates with B a forward contract related to the shares of company X, under which he is obliged to sell those shares for € 100, on date Y, and B has to buy them. As of the entry into force of that contract, B is exposed to the risk of a decrease in the value of company X's shares. If on date Y the share price is below € 100, B will register a loss corresponding to the difference between the market value on that date and the predetermined price between the parties. In turn, A is subject to the risk of rising of the value of company X's shares, because if they rise above the agreed value of € 100, he will be forced to sell the shares he holds for a price below market value. In this situation, A will be an empty voter because his voting power is greater than the economic risk that should be underlying it. This example is valid for both futures and forwards. In addition, these derivatives may assume additional dangers in terms of empty voting as they lead to A having a negative interest in the rise of the share price, as he will lose with that increase.

2.2. Share Lending

There is an active and huge market for the highly profitable business of borrowing and lending of securities. In fact, borrowed shares are usually cheap and the number of borrowable shares is often large. According to the International Corporate Governance Network (ICGN), share lending *"is an important business activity for investors which can improve market liquidity and efficiency, reduce trading costs as well as the risk of failed trades and counterparties, and add significantly to the incremental return of investors"* (ICGN, 2016; Kahan & Rock, 2007; Hu & Black, 2006a).

Generally, the lender lends a set of shares to the borrower, who, in return, pays a commission and offers a guarantee for the return of the shares. At the term of the contract or at any time, at the request of the lender (recall), a corresponding number of equivalent shares must be returned, though not necessarily the shares specifically borrowed, and dividends or other income generated by the shares during the loan period must be paid to the lender (Ali, Ramsay & Saunders, 2014; Clottens, 2012; Ringe, 2012; ICGN, 2016).

But the notion of share lending is slightly misleading because it describes a legal transaction where securities are not just lent, but rather, there is an absolute transfer, although temporary, of their full legal title between the lender and the borrower[55]. Therefore, the borrower becomes the owner of the shares and, consequently, acquires all inherent rights, including voting rights (Ali *et al*, 2014; Clottens, 2012; Čulinović-Herc & Zubović, 2015; Ringe, 2012).

Most commonly, the borrower uses the borrowed shares for short selling, which is a sale made on securities that the seller does not own at that time. The borrower believes the shares are overvalued and will soon decline in price, so he sells them, at a high price. Later, he will buy the same shares, hopefully at a lower price, and restore them to the lender. Thus, the borrower ends up with no votes and negative net economic ownership (Hu & Black, 2006a; 2006b; Ringe, 2012; Kahan & Rock, 2007; Oliveira, 2013).

Yet, although share lending transfers the legal title of the loaned shares to the borrower, the economic risk of those shares remains with the lender, because he will bear

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They may, therefore, have the perverse effect of influencing A to vote at company X's general meeting in a sense that is detrimental to the company itself (Antunes, 2020).

[55] In the Portuguese legal system, article 350 of the PSC establishes the rule of the transfer of ownership of the securities to the borrower, however, the parties may agree otherwise.

the consequences of the share price development and of the voting decisions that the borrower may take in general meetings while owning the shares, once they have been re-transferred to him. The lender continues to be the beneficial owner, i.e., the actor who is economically interested in the shares and the respective company, even though he no longer has the respective voting rights (Ali *et al*, 2014; Clottens, 2012; Čulinović-Herc & Zubović, 2015; Ringe, 2012).

Except for the cases in which the borrower uses the shares for short-selling – because, in this case, the borrower will have to purchase a set of equivalent shares to return to the lender, so he will generally be exposed to the fluctuation of their price – the borrower acquires temporary ownership of the shares but does not feel its economic consequences. Upon their redelivery, the borrower's interest in them ceases to exist (Ali *et* al, 2014; Clottens, 2012; Čulinović-Herc & Zubović, 2015; Ringe, 2012).

As a result, share lending makes it possible to separate the voting rights inherent to the borrowed shares, which are controlled by the borrower, from the economic interest in them, which is maintained by the lender. During the loan period, the borrower holds the right to vote, emptied of economic ownership, making him an empty voter. Therefore, this practice has been used to temporarily acquire voting influence in a company, or to cross a certain share threshold (Ali *et al*, 2014; Ringe, 2012).

The IGCN Securities Lending Code of Best Practice mentions the risks attached to the incorrect use of voting rights by borrowers, namely loss of shareholder votes in important situations, and the exercise of voting power by entities who have no equity capital at risk in the company in which they are voting, consequently having no long-term interest in that company's welfare. In fact, if a borrower with only temporary interest in the borrowed shares exercises voting rights at a general meeting, there is a substantial risk of distortion of that meeting's outcome. That circumstance could bring discredit to the governance process and ultimately destabilise participants' confidence in the market[56] (Ringe 2012; ICGN, 2016).

[56] The ICGN advocates that borrowers should only exercise voting rights with the express authorization of the lender and following his instructions (ICGN, 2016). On the other hand, the Global Master Securities Lending Agreement, a contract model of the International Securities Lending Association (ISLA), provides that the borrower is generally not obliged to vote according to the lender's instructions unless the parties agree differently. Thus, if the borrower votes contrary to the lender's instructions, such voting is considered valid, not affecting the legitimacy of the decision rendered based on that vote (Čulinović-Herc, 2015).

Given the potential abuse or misuse of voting rights by borrowers, the IGCN states that it is bad practice to borrow shares with the primary purpose of exercising influence or obtaining control of a company, without the respective exposure to the economic risks[57], as well as the use of share lending to deliberately reduce or suppress the right to vote at a general meeting. Thus, lenders and their agents should make best endeavours to discourage such practices (Ringe, 2012; ICGN, 2016).

In closing, share lending is one of the easiest and, therefore most widely used methods to effectuate risk-decoupling strategies, particularly empty voting, if a company's shares are lent to allow an investor to obtain a voting stake without corresponding economic risk in a short time frame, at low cost and anonymously, in order to vote in a way that does not reflect the company's long-term interest. Therefore, it may have adverse consequences relating to corporate governance practices (Ali *et* al, 2014; Clottens, 2012; Ringe, 2012; ICGN, 2016).

2.3. Record Date Capture

Most jurisdictions worldwide have introduced a record date system, where the legitimacy of shareholders to participate and vote in general meetings of listed companies is determined by reference to the number of voting shares they own on a given date – the record date, usually set some time before the shareholders' meeting takes place. The justification for this system is that it allows shareholders and the company sufficient time to make the appropriate preparations for the general meeting. Moreover, it is believed to alleviate concerns over conflicts in the voting process and to favour legal certainty over commercial reality (Ringe, 2012).

While the notion of record date is fundamentally similar in most countries – the date that determines, in advance, the shareholders entitled to validly exercise their right to vote at the general meeting –, the time span between that date and the actual date of the meeting varies significantly from country to country. Still, despite the differences in the rules for setting the record date, there is a universal and critical feature: the inherent shift in risk between that date and the day of the general meeting, which increases as that

[57] Clause 14 of the GMSLA provides the following: *"Each Party hereby warrants and undertakes to the other on a continuing basis to the intent that such warranties shall survive the completion of any transaction contemplated herein that, where acting as a Borrower: (e) it is not entering into a Loan for the primary purpose of obtaining or exercising voting rights in respect of the Loaned Securities."*

period gets larger. Hence, all legal orders experience similar effects. *"[T]he entitlement to vote necessarily follows the ownership of shares on the record date"* (Ringe, 2012).

In the U.K., the period between the record date and the general meeting is relatively short. It can be chosen by the companies' articles of association, but the record date shall be no more than 48 hours before the meeting[58]. In practice, most companies choose a date as late as 18 hours before the general meeting. At the other end of the spectrum, U.S. law, specifically in the state of Delaware, requires that the setting of the record date is within the limits of no more than 60 days and no less than 10 days before the general meeting[59]. On average, companies usually set a period of about 54 days (Ringe, 2012).

In the E.U., the record date system was adopted due to the European harmonization process carried out by the Shareholder Rights Directive[60], whose article 7 prohibits share blocking[61], imposes a mandatory record date system for all E.U. Member States and sets 30 days as the maximum period that can elapse between the record date and the date of the general meeting. This large window of time has produced very different results in practice, as the Member States have chosen a range of time periods from two days in Ireland and Cyprus to 30 days in Malta (European Commission, 2010a). The Directive does not give further details on how the record date operates (Ringe, 2012).

The introduction of this system was seen as a large step towards a more efficient European capital market. The objective was to combat the absenteeism and passivity of shareholders of listed companies, aiming to eliminate the obstacles to their participation

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[58] According to the Companies Act 2006, 360B(2): *"A traded company must determine the right to vote at a general meeting of the company by reference to the register of members as at a time (determined by the company) that is not more than 48 hours before the time for the holding of the meeting."*

[59] The Delaware General Corporation Law, § 213 states that *"In order that the corporation may determine the stockholders entitled to notice of any meeting of stockholders or any adjournment thereof, the board of directors may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is adopted by the board of directors, and which record date shall not be more than 60 nor less than 10 days before the date of such meeting."*

[60] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

[61] The legal systems of many E.U. Member States, such as Portugal, had previously subscribed to a share blocking regime, where a period of time was fixed prior to the general meeting during which shareholders could not transact their shares or they had to be deposited. Although it guaranteed the maintenance of shareholders' status on the date of the general meeting, preventing that someone other than them would claim voting rights, this system reduced considerably the liquidity of securities markets in the days before the meeting. Faced with the choice of either not being able to sell their shares or not vote at the meeting, institutional investors preferred to preserve the alienability of shares at all times (Ringe, 2012; Correia, 2012).

in the companies' decisions, as an increase in shareholder democracy would lead to more efficiency in the company's management (Correia, 2012; Ringe, 2012).

In Portugal, currently, article 23-C of the PSC enshrines the record date system, making article 72 of the same diploma, referring to the share blocking regime, no longer applicable to the exercise of voting rights. Accordingly, the determination of participation and voting rights in listed companies is now based only on the number of shares held on the record date: shareholders who wish to be present at the general meeting must declare it in writing to the Chair of the meeting and to the financial intermediary where the individual registration account is kept until the day prior to the 0 hours (GMT) of the 5th trading day prior to the meeting date (article 23-C (1) and (3) of the PSC).

Article 23-C (2) states that the exercise of voting rights is not affected by the transfer of shares after the record date, nor does it depend on their blocking between that date and the date of the general meeting. At first glance, it appears to result from this rule that a shareholder who transfers shares between the record date and the date of the general meeting can still vote at that meeting. However, article 23-C (7) provides that whoever, having declared the intention to participate in the general meeting, transfers the ownership of shares between the record date and the end of the general meeting, must communicate it immediately to the Chair of the meeting and the Portuguese regulator – Comissão do Mercado de Valores Mobiliários (CMVM).

The most appropriate solution for the articulation of article 23-C (2) and (7) appears to be the one advocated by authors like Câmara, who claim that the duty of communication contained in article 23-C (7) can only mean that the alienating shareholder loses the right to participate and vote at the general meeting, despite the apparently contrary connotation of article 23-C (2). In fact, the ratio of this duty must be to prevent someone without the ownership of shares from participating and exercising the right to vote at the meeting. The sole favourable argument of the opposite position is the letter of article 23-C (2). However, the participation of the alienating shareholder in the general meeting would conflict with article 384 (1) of the PCC and open the door to empty voting with legislative consent (Câmara, 2016; Correia, 2012).

The record date system – albeit necessary to make a voting system workable for public corporations – enhances the appearance of empty voting situations through record date capture, i.e., the technique of conducting legal transactions between the record date and the date of the general meeting. In practice, the delay that necessarily exists between these two dates allows for the circumstance that those voting at the general meeting – despite having guaranteed the legitimacy to exercise the right to vote on the record date – are possibly no longer the economically interested shareholders and may not be affected by the economic consequences of the decisions taken there, due to a subsequent transaction (Kahan & Rock, 2007; Ringe, 2012; Hu & Black, 2006a).

Generally, shareholders who hold shares on the record date do not lose their voting rights if they dispose of them before the general meeting[62]. Conversely, shareholders who purchase shares after the record date are not entitled to participate or vote in the general meeting[63]. The shareholding status quo is "frozen" on the record date for purposes of the general meeting, allowing investors to shed economic exposure while suffering no hostile effects from exercising their voting rights in ways that decrease the company's value. This is the main disadvantage pointed out to the record date system, by contrast, either with a share blocking system or with a regime in which the legitimacy to participate in general meetings is determined on the date of their holding[64] (Kahan & Rock, 2007; Ringe, 2012; Hu & Black, 2006a).

Record date capture can be combined with share lending. A shareholder may borrow shares before the record date, acquiring the right to vote them at the general meeting, and return or sell them short subsequently. This creates perverse incentives for the borrower to vote against the company's interests, particularly if he engages in short selling, as he will profit from a drop of the share price, being able to buy the shares later in the market at a discount and return them to the lender[65]. However, if he borrows shares after the record date, he will not be entitled to vote them at the general meeting. These

[62] In Portugal, even though the position that shareholders who sell shares after the record date lose their right to participate and vote in the general meeting is not unanimous, if it is adopted, record date capture strategies will not be a major problem regarding empty voting.
[63] Portuguese law does not answer the question of whether the shareholder that acquires shares after the record date can still participate in the general meeting. According to article 7 (2) of the Shareholder Rights Directive and article 23-C (1) of the PSC, the response appears to be negative (Correia, 2012).
[64] In this system, although the shareholder could acquire shares before the general meeting and dispose of them immediately thereafter, he would be subject to the negative impact that the result of the meeting could have on the share price unless he hedged the risk of his shares or the market had not fully absorbed the information and only reflected it on the share price after he sold his shares (Clottens, 2012).
[65] Lenders can, if they choose, decline to lend out their shares or recall them in advance of record dates for general meetings at which they intend to raise issues or want to vote. But doing so would sacrifice substantial revenue, because, if they do that very often, the entities handling securities lending programs will have higher transaction costs, and consequently will not lend their shares unless no other shares were available, giving preference to other lenders who do not impose such limitations. The effect of this situation would be to opt out of securities lending, which is a very expensive decision (Kahan & Rock, 2007).

two strategies are connected, as is demonstrated by the spike in borrowing on the record date, but record date capture can be individualized as a separate category. Nevertheless, buying is more expensive than borrowing shares, so this strategy alone will probably be less common (Clottens, 2012; Kahan & Rock, 2007; Ringe, 2012; Hu & Black, 2006a).

To sum up, a person can acquire or borrow shares before the record date (record date capture) and sell them, short or not, or return them between that date and the date of the general meeting (post record date trade). A post record date sale is suspicious because a shareholder, who is expected to contribute to an increase in the company's value, would normally prefer to hold his shares, unless the sale could be explained by other motives, such as a sudden need for liquidity[66] (Clottens, 2012).

Ultimately, any transaction of shares between the record date and the date of the general meeting is potentially capable of bringing about an empty voting situation. Every regular shareholder who sells or lends any of his shares after the record date, but before the general meeting, may vote as a risk-freed or risk-reduced shareholder (Čulinović-Herc & Zubović, 2015). *"While smaller, unintentional deviations are to be accepted as inherent features of the system, larger deviations can be deliberately exploited and manipulated by knowledgeable market actors for their own purposes"*[67] (Ringe, 2012).

3. Empirical Evidence of Empty Voting

There is already vast empirical evidence on empty voting. Professors Hu & Black identified more than 80 examples of decoupling worldwide by 2008[68]. We will now highlight some of them (Hu & Black, 2006a; 2006b; 2007; 2008a; 2008b).

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[66] In theory, the problem of post record date trade could easily be solved by a voting proxy from the seller to the buyer, but, in practice, this is impossible when shares are traded anonymously on the stock exchange (Clottens, 2012).

[67] Companies can trade shares in different stock markets. In such context, there is a possibility for investors to manipulate the different markets so that they can vote twice, provided that the markets have distinct record date procedures, as is the case of the European and the American stock exchanges. For instance, if an investor of a European company that is listed on both stock exchanges may obtain a voting entitlement under the American record date system, which provides that the record date is usually about 60 days before the general meeting and, subsequently, convert his American shares to European shares, intending to get a second voting entitlement at the same meeting under the European record date rules (Ringe, 2012).

[68] In Portugal, there are few known cases of empty voting, since, as shown before, the Portuguese legal system already contains some rules that may hinder or even prevent its realization. Hu & Black mention two Portuguese cases: the Portugal Telecom/Sonae and the Portugal Telecom/PT Multimédia. Both cases arose as part of a defence strategy carried out by Portugal Telecom (PT) against Sonaecom's takeover bid: in the first one, PT attempted to park treasury shares with Barclays Bank because the bank would vote against the bidder, so the company would be protected against loss; in the second case, PT offered to spin

The most notorious example of intentional empty voting arose in the Mylan-King case, which relates to a takeover battle in the U.S. between Mylan Laboratories and King Pharmaceuticals. In 2004, Mylan agreed to acquire King, in a stock-for-stock merger agreement, at a 61% premium over King's trading price. Perry Corporation, an American hedge fund, owned approximately 7 million shares of King and supported the merger because, if it closed, Perry would make a $28 million profit.

The proposed acquisition depended on the approval of both Mylan and King's shareholders. The market reaction to the deal was favourable for King but negative for Mylan: King's shares rose, but Mylan's shares dropped sharply. Therefore, the needed support from Mylan's shareholders was in doubt. To help Mylan obtain shareholder approval, Perry acquired 9,9% of the company's shares, becoming its largest shareholder, and intending to vote them in favour of the transaction. At the same time, Perry fully hedged its economic exposure to any potential drop in Mylan's share price by taking short positions in total return equity swaps with third parties, essentially banks, who probably also hedged their long positions, most likely by selling Mylan's shares short, planning to buy them later at a considerably lower price (Oliveira, 2013).

Perry took advantage of modern financial innovation to acquire votes and offset its economic ownership: the hedge fund had 9,9% of voting rights, but zero economic ownership. Moreover, Perry also held shares of King, which made its overall economic interest[69] in Mylan negative[70]. In fact, the divergence between Perry's interests and those of Mylan's shareholders was obvious. The more Mylan (over)paid for King; the more Perry would profit. Thus, in order to realise the value from the takeover, even if the deal was good for King but bad for Mylan, as many Mylan shareholders felt, Perry would still vote its Mylan shares in favour of the acquisition purely on the basis of its interest as a King shareholder, without fearing any potential economic downside.

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off its affiliate PT Multimédia and used equity swaps with Barclays to acquire another 10%, in addition to the 58% already held, of that company (Hu & Black, 2008a; 2008b).

[69] Hu & Black define the *"overall economic interest in taking actions that affect firm value"* as *"the combined return from host shares, coupled assets and related non-host assets. It can be positive, zero or negative."* (Hu & Black, 2006a).

[70] In the terminology used by Hu & Black, these shares are related non-host assets, i.e. *"assets, often securities of another company, whose value is related to the value of the host company's shares. For example, if the host company plans to acquire a target in a share-for-share merger with a fixed exchange ratio, the target's shares are a related non-host asset."* The host company, which in this case is Mylan, is *"[t]he company at which voting takes place*" (Hu & Black, 2006a; 2006b; 2007; 2008a; 2008b; Hu, 2015).

Carl Icahn, a major Mylan shareholder, sued Mylan and Perry under American federal securities law, claiming that Perry and other hedge funds had acquired 19% of Mylan votes with zero economic ownership and, consequently, had a negative overall economic interest in Mylan[71]. This meant that they would want Mylan to complete the deal even if the company's value suffered. The lawsuit became moot when Mylan abandoned the acquisition for unrelated reasons, specifically because of accounting problems at King. Thus, the success and legal validity of Perry's strategy were not tested[72] (Oliveira, 2013).

A paradigmatic example of the use of stock lending for the practice of empty voting is the Lindner case, where borrowed shares were used for a squeeze-out in a German partnership. The founder, the general partner, and another shareholder of a limited partnership transferred, through a securities lending agreement, their limited shares, totalling 33,5%, to a limited partner who already held 62,59% of the partnership. The conditions of the share lending agreement were the payment of an annual fee and the reimbursement to the lender of the equivalent of all dividends, during the term of the loan. The borrower, whose stake had thus grown to 95%, then demanded the implementation of a squeeze-out procedure under §§ 327a-327f of the German Stock Corporation Act (*Aktiengesetz*) (Čulinović-Herc & Zubović, 2015; Ringe, 2012).

Minority shareholders challenged the transaction on legal grounds but in the end were not successful, as the German Supreme Court did not recognise the accumulation of a 95% stake in borrowed securities for the purposes of a squeeze-out as an illegal or abusive practice, and therefore did not declare the squeeze-out resolution legally null or void. This court decision was based on a formal approach that focuses only on the legal ownership of shares, and not on deviating shareholder agreements (Čulinović-Herc & Zubović, 2015; Ringe, 2012).

[71] Carl Icahn was not completely free of conflicts of interest. He had a stake of about 10% in Mylan, both in terms of economic exposure and voting rights, but he had also shorted 5,3 million shares of King. Thus, he could have an economic incentive to oppose the takeover, even it was beneficial for Mylan, as long as the market thought that it would be significantly more favourable to King. Icahn would profit more from the defeat of the transaction if his profits from shorting were greater than the increase in the value of his Mylan stake from completing the deal.

[72] In 2009, the U.S. Securities and Exchange Commission announced a settlement agreement with Perry over the question of whether the hedge fund had correctly disclosed its accumulation of nearly 10% in Mylan shares. This, however, only concerned the question of disclosure and did not address the wider concern with risk decoupling. Pursuant to the settlement, Perry paid a $150,000 fine, without admitting any wrongdoing (Ringe, 2012).

Finally, we address the British Land case, where both strategies of securities lending and record date capture were combined to produce a short-term voting entitlement for risk-decoupling purposes. In 2002, between the record date and the day of British Land's general meeting, the hedge fund Laxey Partners revealed that it had more than tripled its equity stake in that company (from 2,9% to 9%), by borrowing 42 million shares, in order to support a proposal to break it up and to oppose to the re-election of its chairman (Čulinović-Herc & Zubović, 2015; Ringe, 2012; Hu & Black, 2006; Oliveira & Oliveira, 2012).

While British Land considered Laxey's strategy a violation of good corporate governance and an abuse of the voting system, Laxey's position was that it was acting as an advocate for all shareholders and calling weak management to account. Ultimately, Laxey's strategy failed but the case caused a stir and demonstrated the possible extent of voting manipulation by borrowed shares. The particular irony was that prominent institutional investors were among the lenders and knew nothing of their role in facilitating the rebellious action of Laxey. In fact, the three institutions that lent out shares – Hermes, Barclays Global Investors, and Scottish Widows – later apologised to British Land (Čulinović-Herc & Zubović, 2015; Ringe, 2012; Hu & Black, 2006).

Chapter III – The Regulation of Empty Voting

1. European Union

At the European level, the Transparency Directive[73] is the main legislative instrument on transparency, having been adopted with the primary objective of improving market efficiency and corporate governance. Articles 9 and 10 of this Directive impose on holders of voting rights the obligation to notify the issuer whenever the percentage of voting rights held by them reaches, exceeds, or falls below the thresholds set forth therein, which vary between 5% and 75% of the share capital of the company. These notifications are subsequently disclosed by issuers to the market[74] (ESMA, 2012; Schouten, 2010a;

[73] Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.
[74] Under article 3 of the Transparency Directive, Member States may impose lower disclosure thresholds. Indeed, the transposition of the Directive has resulted in a number of Member States establishing (or maintaining) lower (initial) thresholds for disclosure of major holdings than that of 5% provided for in the Directive. These lower thresholds have been set at either 2% or 3%. Additionally, in several Member States

European Commission, 2010b). *"This information should enable investors to acquire or dispose of shares in full knowledge of changes in the voting structure; it should also enhance effective control of share issuers and overall market transparency of important capital movements"*[75] (Schouten, 2010a).

However, the Transparency Directive hardly offered any disclosure regarding empty voting. One of its major gaps was the fact that it did not require the reporting of long positions and did not cover financial derivatives with purely financial settlement[76]. Also, its rules have been criticized because the thresholds are too high, and the notification periods are too long, making it easy to escape notification or at least suspension of voting rights for lack thereof (Clottens, 2012; European Commission, 2010b; Mazars, 2010).

Therefore, in 2007, the European Commission consulted interested parties on the need to deal with stock lending and empty voting. At the time, the majority of respondents considered that the E.U. should address these issues in order to prevent abuses. As for empty voting, although it was not possible to quantify precisely its use as the phenomenon was not disclosed, there was still significant evidence and a general feeling that its strategies were regularly used. Accordingly, market participants and supervisors agreed that a reform of the transparency regime was appropriate and even necessary. Yet, there was less agreement as to what the best way was to achieve more transparency and as to whether increased transparency alone could suffice to address empty voting (Clottens, 2012; European Commission, 2010b; Mazars, 2010).

At the Member State level, France was one of the first jurisdictions to respond to the perceived empty voting problem by modifying its disclosure law in 2010. The new

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issuers can set lower thresholds in their own articles of association, either based on an explicit authorisation in the law or in the absence of an express prohibition (in which case, freedom of contract applies) (European Commission, 2010b).

[75] Point (18) of the Transparency Directive.

[76] Article 9 of the Directive applies only to voting shares of the issuer. Article 10 extends the notification obligations to any person who has the right under an agreement or collateral arrangement to exercise the relevant voting rights or to direct the holder of the shares as to how to exercise such rights. However, most cash-settled equity derivatives do not give the counterparty to the transaction the right to vote or influence the voting rights of the shares subject to them. Article 13 widens disclosure obligations to "*financial instruments that result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market"*. This article also does not cover cash-settled equity derivatives, which do not grant a right to the holder to acquire or dispose of the underlying shares but are only settled in cash. Therefore, cash-settled equity derivatives fall outside the scope of the Transparency Directive (Clottens, 2012; European Commission, 2010b).

legislation[77] introduced a requirement for persons, who, alone or in concert, hold more than 0,5% of voting rights as a result of stock lending or an agreement with similar effect, to notify the French supervisor (Autorité des Marchés Financiers) and the company on the record date at the latest (3 days before the general meeting in France[78])[79]. The consequence for failure to comply with this obligation is suspension of the voting rights attached to the borrowed shares (Ringe, 2012; Clottens, 2012).

Although this French approach was a first step, several problems can be pointed out. First, even though it was intended to include all temporarily held shares on the record date and to disclose them to the market, the French system ended up dealing only with part of the problem – decoupling in the form of securities lending –, leaving empty voting by derivatives or record date capture out of its scope. In addition, the disenfranchisement sanction applies only where disclosure is omitted, making it unrelated to abuses of the voting right and suggesting that share lending over the record date is allowed, as long as it is disclosed. Furthermore, the potential for abuse of a risk-decoupled position is very unlikely to materialise with a borrowed stake of 0,5% of the voting rights, as this is a very low disclosure threshold. Finally, a one-off disclosure duty on the record date might not give market participants enough information to respond (Ringe, 2012).

Beyond this French advance, the European Commission increasingly saw a necessity for an E.U.-wide improved transparency system. A subsequently published E.U. working document on the reform of the Transparency Directive discussed various legislative options. The recommendation of the Transparency Directive Assessment Report, the external report from which the working document was built, to improve transparency was to require that the economic exposure of all shareholders above a certain threshold be notified on the record date, to the extent such exposure was not previously disclosed, avoiding double notification if it does not provide new information. This system was considered to be comprehensive and not too burdensome (Ringe, 2012; Clottens, 2012; European Commission, 2010b; Mazars, 2010).

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[77] Article L 225-116 was inserted into the Code de Commerce by Article 49 Loi no 2010-1249 du 22 octobre 2010 de régulation bancaire et financière.

[78] Article R225-85 of the Code de Commerce.

[79] Disclosure must include the number of shares acquired by way of such transaction, the identity of the lender, details about the expiry date of the agreement, its way of operation, and a voting agreement, if any. Finally, the company must publish the information (Ringe, 2012; Clottens, 2012).

The European Corporate Governance Forum, an advisory body to the European Commission, proposed the introduction in company law of a presumption that shareholders participating in a general meeting hold the corresponding economic interest in the shares they vote, along with the principle that shareholders who have retained legal title to the shares and exercise their inherent vote but have ceded all or part of their economic interest, should disclose this to the market when their participation exceeds a certain threshold (European Corporate Governance Forum, 2010; Ringe, 2012; European Commission, 2010b; Mazars, 2010).

Meanwhile, the centre of legal policy was transferred from the European Commission to the new European market supervisor: the European Securities and Markets Authority (ESMA). In September 2011, ESMA launched a "call for evidence" on empty voting, inviting market participants to present their opinions and suggestions on this phenomenon. The public consultation was essentially aimed at collecting information and evidence on the extent to which empty voting occurred in practice within the E.U., the effects of its strategies, particularly if they could influence the voting outcomes at general meetings, and the need for possible regulatory action (ESMA, 2011; 2012; Oliveira & Oliveira, 2012). "*Therefore, the call for evidence was not restricted to transparency or corporate governance issues, or a specific piece of European legislation. Rather, ESMA was seeking views in a broader context on the occurrence of empty voting and the possible market failures that could arise from such occurrence."* (ESMA, 2012).

ESMA specifically focused on the impact of empty voting on listed companies, although the phenomenon might affect any public company. Despite noting that derivative instruments and trading strategies in the securities markets were normally used for fully legitimate purposes, ESMA pointed out that they could potentially be used to exercise influence in a company without having any economic interest in it, generating potential conflicts of interest with shareholders with effective economic interests in that company (ESMA, 2011; Oliveira & Oliveira, 2012).

ESMA received 29 responses, mainly from the investment services, banking, and asset management sectors. Most respondents highlighted that the empty voting phenomenon was relevant, and it was occurring in the E.U., even though they found it very problematic to exactly identify its extent and to measure its frequency and scale[80]. The difficulty to recommend appropriate solutions for empty voting, if any were needed, was also mentioned by the respondents, which expressed very different understandings on this issue (ESMA, 2012).

In the feedback statement on the call for evidence, ESMA found that the most common empty voting strategies were share lending and record date capture[81], with the riskiest practice related to the phenomenon happening when an investor borrows shares (or puts in place similar operations using derivatives) in order to vote in a way that is perceived to be against the long-term interest of the company, and which may be to pursue a personal gain. ESMA also considered that the most significant negative consequences of empty voting are related to transparency, especially when investors vote the "wrong way" for pure trading reasons (either following their own strategy or submitting voting instructions proposed by a third party), thus allowing their personal interest to prevail against the interest of the company (ESMA, 2012).

Nevertheless, ESMA concluded 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, 2012). Therefore, the extreme difficulty in achieving a clear and unique definition of empty voting and the substantial lack of relevant data/evidence about the occurrence and relevance of the phenomenon led ESMA to determine that the feedback from the call for evidence was not sufficiently decisive to justify any regulatory action at European level (ESMA, 2012).

On the other hand, even though recognising that empty voting had not been addressed explicitly in the E.U., ESMA highlighted the existing European legislation that could already be able to address empty voting issues[82], pushing away the need for a

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[80] As stated by ESMA, *"[t]hat might be the direct consequence of many different reasons which have been mentioned in the responses, e.g.: as the privacy/secrecy of some of the transactions involved, the fact that hidden ownership cases are much more frequent and sometimes it is difficult to separate the two phenomena, or because of the possible link to other activity, e.g., proxy advising."* (ESMA, 2012).

[81] Respondents also mentioned national conditions and the use of derivative instruments as ways through which empty voting may take place in the market (ESMA, 2012).

[82] In addition to existing legislation, ESMA also mentioned the draft for a Securities Law Directive on legal certainty of securities holding and transactions, which was in preparation. This Directive should take into consideration, among other things, the harmonisation of the ownership concept in the Member States

specific piece of legislation or for additional specific work at that point. The first legislation mentioned was the Transparency Directive, which has been already described. ESMA also recognized the interest of empty voting situations for the Takeover Bids Directive[83]. In fact, in the context of a takeover offer, there are strong reasons for requiring persons who relate to bidders or target companies, or who have significant interests in company assets, to make public disclosures of their long and short holdings and positions. But the Directive mentions nothing in this regard[84] (ESMA, 2012).

Furthermore, ESMA stresses that the Short Selling Regulation[85] can help to address some cases of empty voting in which a person has a negative interest, through the introduction of a pan-European regulatory approach to short selling, consisting of a new two-tiered transparency system that encompasses all net short positions that can arise not only through short sales but also through the use of various derivatives[86]. The threshold values are 0,2% of the issued share capital of the company in question and each 0,1% above that amount for disclosure to the respective national supervisory authority (article 5), and 0,5% of the issued share capital and each 0,1% above that amount for public release (article 6)[87]. The net short position shall be determined on each trading day at midnight and to be reported by 3.30 pm on the next day (article 9 (2)) (ESMA, 2012; Clottens, 2012; Ringe, 2012).

Overall, the European Commission expected these new harmonised transparency requirements to ensure that information on short positions would be provided to regulators and that the market would be complete and accurate. However, even though the definition of short position, present in article 3 (1) of the Short Selling Regulation, is

concerning securities, lastly aiming at allowing the ultimate account holder to exercise the rights flowing from the securities. However, no proposal for a Directive has ever been published (ESMA, 2012).

[83] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.

[84] Article 3 (1) (d) of the Takeover Directive states the general principle that false markets must not be created in the securities of the offeree, of the offeror, or any other company concerned by the bid. To ensure compliance with this principle, the Takeover Directive allows the Member States to lay down additional conditions and provisions more stringent than those on the Directive for the regulation of bids (article 3 (2) (b)). In most of them, during the offer period, the offeror, the offeree, the members of the board of the offeror or the offeree, persons acting in concert with them, and persons holding at least 1% of the securities of the offeree, must disclose all acquisitions or disposals of securities issued by the offeree, the offeror or the company whose securities are offered by way of consideration (Clottens, 2012).

[85] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.

[86] Recital 10 of the Short Selling Regulation.

[87] The low initial thresholds have attracted criticism, as market participants are concerned with institutional investors who invest in small or medium-sized enterprises because they may often exceed them relatively quickly (Ringe, 2012).

an attempt to capture all positions which give their holder a negative interest in shares, it does not cover all situations of empty voting[88]. In fact, transparency of substantial net short positions in shares can contribute to the prevention of empty voting, but the phenomenon can be achieved by employing other strategies that do not involve net short positions. Also, the objective of the transparency regime set forth in the Short Selling Regulation is quite different. Whereas the Transparency Directive is concerned with the exercise of control over the company, in an intra-company governance perspective, the Regulation aims at preserving market integrity, securing investor confidence, and avoiding market abuse (ESMA, 2012; Ringe, 2012; Clottens, 2012).

Finally, it should be noted that the Market Abuse Regulation[89], which replaced the previous Market Abuse Directive[90], may as well contribute to greater transparency in empty voting positions. This Regulation extends the market abuse regime to (i) financial instruments admitted to trading, or for which a request for admission to trading has been made, not only in a regulated market but also in multilateral and in organized trading facilities, (ii) other financial instruments, such as derivatives, the price or value of which depends or has an effect on the previous financial instruments and (iii) behaviours or transactions that may have an impact on those financial instruments (article 2). Additionally, the scope of the reporting of transactions carried out by managers now covers situations such as the pledge and the lending of financial instruments (article 19).

Following up on these preparatory steps, the official European Commission proposal for the reform of the Transparency Directive was published in October 2011. Later, Directive 2013/50/EU was approved, amending Directive 2004/109/EC. This most recent Directive has the merit of extending the disclosure obligations to all financial instruments with an economic effect similar to holding shares[91] and potential long positions[92], hence capturing both financially settled derivatives and other similar financial

[88] Recital 17 of the Short Selling Regulation mentions that the definition of short sale does not include repurchase agreements, derivatives where it is agreed to sell securities at a specified price at a future date and share lending.

[89] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation).

[90] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).

[91] These instruments are defined in article 13 (1) (b) of the Transparency Directive. The scope of this provision includes securities, options, futures, swaps, forward contracts, interest rates, differential contracts, and other agreements with similar economic effects subject to physical or financial settlement.

[92] Potential long positions are defined in article 13 (1) (a) of the Transparency Directive as *"financial instruments that, on maturity, give the holder, under a formal agreement, either the unconditional right to*

instruments. Thus, derivatives on securities and other financial instruments that have a similar economic effect should be added to the potential long positions for the purpose of exceeding the thresholds (Schouten, 2010a; Ringe, 2012).

Yet, although this enlargement of the Transparency Directive's scope, particularly the extension of the reporting obligations to all instruments that attribute a long position on the underlying shares, improved market confidence and investor protection, seeking to combat hidden ownership, potential situations of empty voting remain excluded, as the Directive does not provide for any obligation to report short positions (Schouten, 2010a; Ringe, 2012).

Also, it remains unclear what treatment should be given to share lending under the Transparency Directive. In some Member States, stock lending is treated as a temporary transfer of voting rights, therefore subsumable to article 10 (b) of the Directive, but in the vast majority, it is covered by the general rule of article 9, since it involves a transfer of ownership of the shares from the lender to the borrower. Thus, in most Member States, share lending leads to a notification obligation imposed on both the lender – who would disclose his move from full owner to the holder of a right to re-acquire the shares – and the borrower – who would declare his status of owner and his obligation to return the shares (Mazars, 2010; Clottens, 2012; European Commission, 2010b).

This system allows to provide complete and consistent information to the market and eliminates the risk of double counting the shares – a first time for the lender and a second time for the borrower. However, there is a lack of transparency from the fact that the borrower, differently from a buyer, bears no economic risk. Also, in most Member States, if the lender reserves for himself the right to recall the shares at all times, only an update at the end of the year is needed to demonstrate the shift from actual to potential voting rights, which makes the circumstance of the lender having no actual voting rights not transparent as well. Furthermore, it is not certain if the borrower must notify the subsequent sale or loan of the shares to a third party (e.g., for short selling) (Mazars, 2010; Clottens, 2012; European Commission, 2010b).

But the Directive has not been implemented in the same way in all Member States. In some of them, only the borrower is required to notify, either because the lender is still

acquire or the discretion as to his right to acquire, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market.".

considered the legal owner of the shares or because the lent shares are still aggregated to the lender's holdings. The argument behind non-notification by the lender is that disclosure on both sides of the transaction, given the huge number of stock lending transactions, could swamp the market with useless information, consequently harming the process of identifying material information. There are also liquidity concerns that may arise from placing a disclosure obligation on all stock lenders (Mazars, 2010; Clottens, 2012; European Commission, 2010b).

2. United States of America

In the U.S., courts have historically expressed concern over decoupling situations through the doctrine of "vote buying"[93]. The most widely cited modern case on corporate vote buying is the 1982 Delaware decision in *Schreiber v. Carney*, which focused on a loan given by Texas International Airlines to a controlling shareholder in order to obtain his support for a restructuring (Hu & Black, 2006a 2006b; 2007; Thompson & Edelman, 2009; Schreiber v. Carney, 1982). In this case, the court found that the loan constituted vote buying, defined as *"a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror"* (Schreiber v. Carney, 1982). However, it explained that *"each arrangement must be examined in light of its object or purpose"* (Schreiber v. Carney, 1982).

In the *Schreiber* case, the court refused to find vote buying illegal *per se, "unless the object or purpose is to defraud or in some way disenfranchise the other stockholders"* (Schreiber v. Carney, 1982). In the specific case of the judgment, it ended up concluding that *"[t]he agreement in question was entered into primarily to further the interests of Texas International's other shareholders"*, the best evidence being their approval of the transaction. But the court recognised that vote buying is easily susceptible to abuse, so

[93] In the E.U., empty voting is not considered a violation of the prohibition of vote buying, and the financial transactions that result from the phenomenon are not prohibited as such. Even though an agreement entered into with the exclusive goal of creating an empty voting situation could be considered an attempt to circumvent this prohibition, any distinction that depends on a criterion as subjective as whether the transfer of voting rights is the principal object of the agreement or not is too difficult to use and offers almost no legal security (Clottens, 2012).

"it must be viewed as a voidable transaction subject to a test for intrinsic fairness" [94] (Schreiber v. Carney, 1982; Hu & Black, 2006a 2006b; 2007; Thompson & Edelman, 2009; Schouten, 2010b).

An analysis of *Schreiber* and similar cases indicates that courts would allow vote buying only when such a deal aligns the financial interests of shareholders with those of the corporation, which may not happen in empty voting situations. But even if it did, the views are split on the question of whether empty voting can be addressed by the common law doctrine of vote buying[95]. Indeed, *"[s]trictly speaking, no voting rights are bought, but actual shares, the economic risk of which is shifted back to the lender or subsequently hedged in a separate transaction with one or more third parties"* (Clottens, 2012). In fact, the "new vote buying" makes a difference because it is based on ordinary market transactions that can be undertaken as easily by outsiders (e.g., activist shareholders) and insiders[96] (Waddell et al, 2010; Clottens, 2012; Thompson & Edelman, 2009).

Regarding transparency, the American rules go much further than the European rules. In the U.S., there are five ownership disclosure systems. The first aims to inform shareholders of a public company about potential changes in corporate control: any person who directly or indirectly acquires beneficial ownership[97] of more than 5% of a public company's shares must file a Schedule 13D with the American market supervisor – the Securities and Exchange Commission (SEC) – within ten days after crossing that threshold to disclose said ownership[98]. The second is a more abbreviated Schedule 13G for "passive" institutional investors, who invest in the ordinary course of business and

[94] The intrinsic fairness test implies a shift of the burden of proof from the plaintiff to the defendant: when the former shows the presence of a conflict of interest in a decision or transaction, the latter has to prove that the decision or transaction was intrinsically fair, in spite of his personal interest (Clottens, 2012).

[95] In the Delaware decision of *Kurz v. Holbrook*, the Chancery Court held that the courts have to provide a remedy based on vote buying against the new forms of decoupling that result in a misalignment between the interest of the person concerned and the company. This decision supports the idea according to which the underlying rationale of vote buying is also present in empty voting situations (Clottens, 2012; Kurz v. Holbrook, 2010).

[96] An example of how an investor can become an empty voter solely by engaging in conventional transactions is through a two-step process. He starts by acquiring shares in the market and then enters into a derivatives transaction in order to offset their economic ownership, being left only with voting ownership. The purchase of votes may be replaced by share lending, which is also an ordinary and not individually suspect activity, as it is not exclusively related to vote buying, but also to other legitimate purposes (Hu & Black, 2006a).

[97] Disclosure is based on "beneficial ownership" of shares, as defined in 17 C.F.R. § 240.13d-3.

[98] 17 C.F.R. § 240.13d-1(a); 15 U.S.C. § 78m(d)(1).

have no intention of influencing control, who must report year-end positions[99] (Hu & Black, 2006a; 2006b; 2007; 2008a).

Schedules 13D and 13G filers must report the number and percentage of shares beneficially owned, as well as all purchases and sales made in the previous sixty days. Schedule 13D also requires disclosure of any contracts, arrangements, understandings, or relationships (legal or otherwise) relating to any securities of the issuer[100]. Yet, short positions, regardless of whether in shares or derivatives, do not activate a disclosure obligation. Also, although share lending would likely count toward triggering disclosure and be disclosable on both forms, it is unclear how it is treated. Most likely, share lending might be disclosable on Schedule 13D but will not be captured by Schedule 13G, as there won't be many record dates around the year-end reporting date. *"In sum, Schedules 13D and 13G provide only limited disclosure of the existence and nature of the new vote buying."* (Hu & Black, 2006a; 2006b; 2007; 2008a).

The third ownership disclosure regime is applicable to institutional investment managers[101] that exercise investment discretion concerning accounts holding equity securities described in Section 13(d)(1). They must disclose to the SEC, in Form 13F, their holdings at the end of each quarter, no later than forty-five days after it[102]. This Form requires disclosure of holdings of "section 13(f) securities"[103] by every institutional investment manager who holds $100 million or more in these securities[104] (Hu & Black, 2006a; 2006b; 2007; 2008a).

Form 13F only requires disclosure for securities that are publicly traded[105]. Long positions are reported, but short positions are not. Empty voting through share lending will never be seen, as lenders report owning the shares and borrowers report nothing: the direct ownership is reported, while its empty character is not. Furthermore, hiding a voting stake is often easy, e.g. if an investor exchanges his shares for economically

[99] 17 C.F.R. § 240.13d-1(b).
[100] Schedule 13D, 17 C.F.R. § 240.13d-101; Schedule 13G, 17 C.F.R. § 240.13d-102.
[101] The term "institutional investment manager" is defined broadly in 15 U.S.C § 78m(f)(6)(A) and captures hedge funds, whether located in the U.S. or abroad, but will not include high net worth individuals, unless they invest for others' accounts (Hu & Black, 2006a; 2006b; 2007; 2008a).
[102] Form 13F, 17 C.F.R. § 249.325.
[103] The SEC publishes an "Official List of Section 13(f) Securities", which are generally limited to common shares and exchange-traded options of U.S. public companies (17 C.F.R. § 240.13f-1(c)). Anything not on the list does not need to be disclosed (Hu & Black, 2006a; 2006b; 2007; 2008a).
[104] 17 C.F.R. § 240.13f-1.
[105] For instance, positions in exchange-traded options are disclosable, but substantively identical positions in OTC options are not (Hu & Black, 2006a; 2006b; 2007; 2008a).

equivalent swap positions before the quarter end, and then unwinds the swaps and reacquires the shares immediately (Hu & Black, 2006a; 2006b; 2007; 2008a).

The fourth source of disclosure is Section 16, covering officers, directors, and 10% shareholders of U.S. public companies[106]. The 10% ownership threshold is built on beneficial ownership in the sense of Section 13(d), which is centred on voting power[107]. But if disclosure is triggered, the positions to be disclosed are based on beneficial ownership in the Section 16 sense, which focuses on economic ownership[108] and is defined broadly to include any "pecuniary interest"[109] (Hu & Black, 2006a; 2006b; 2007; 2008a).

The relevant forms require disclosure of most economic interests[110], including *"any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security"*[111]. This is a very broad definition, encompassing the disclosure of equity derivatives, physically- or cash-settled, exchange-traded or OTC (Hu & Black, 2006a; 2006b; 2007; 2008a).

Even though share lending would clearly count towards triggering disclosure by 10% shareholders, it seems likely that most, if not all, Section 16 filers will not report share lending, as there is no explicit SEC requirement to do so. As said before, Section 16 reporting focuses on economic ownership, which share lending does not change significantly, and on "pecuniary interests", term in which the borrower's voting rights hardly fall within (Hu & Black, 2006a; 2006b; 2007; 2008a).

The final set of reporting obligations applies to mutual funds, whose activity is governed by the Investment Company Act of 1940. Mutual funds must report to the SEC quarterly on their portfolio holdings and provide a summary list semi-annually to investors[112]. Mutual fund disclosure is carried out on Forms N-1A, N-CSR, and N-Q. Disclosure focuses on economic ownership and covers both long and short positions,

[106] 17 C.F.R. § 240.16a-1(a), 16a-2.
[107] 17 C.F.R. § 240.16a-1(a).
[108] 17 C.F.R. § 240.16a-2.
[109] 17 C.F.R. §§ 240.16a-2, 16a-3 and 16a-4.
[110] An initial filing must be made on Form 3 (17 C.F.R. § 249.103) within ten days after the event which triggers coverage (17 C.F.R. § 240.16a-3(a)). Changes are reported on Form 4 (17 C.F.R. § 249.104). Form 5 (17 C.F.R. § 249.105) is an annual statement of changes.
[111] 17 C.F.R. § 240.16a-1(c).
[112] 17 C.F.R. §§ 270.30b1-5.

whether or not they convey voting rights, and exchange-traded and OTC derivative positions. There is no specific requirement to disclose share lending (Hu & Black, 2006a; 2006b; 2007; 2008a).

Both Section 16 and mutual fund reporting cover hidden (morphable) ownership reasonably well since they focus on economic ownership. But, for empty voting, Section 16 disclosure might depend on how the votes are acquired by the empty voter (e.g. hedging though derivatives is captured by Section 16 rules but share lending will most likely not be). As for mutual fund disclosure, it only captures quarter-end positions (Hu & Black, 2006a; 2006b; 2007; 2008a).

Some of the omissions and radical differences in focus between the American ownership disclosure systems may have once made sense. "*But in a world of easy decoupling of voting and economic ownership, plus a massive OTC derivatives market, greater uniformity and fewer omissions are called for"* (Hu & Black, 2006a; 2006b; 2007; 2008a).

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was enacted in July 2010, introducing some changes to the American legislation with potential benefits for an improvement in the transparency of empty voting. Before its enactment, derivatives trading was split into a regulated sector involving standardized contracts and the unregulated OTC market. As a result, OTC derivatives transactions and the phenomenon of empty voting largely escaped the scrutiny and regulation of the SEC (Waddell *et al*, 2010).

The Dodd-Frank Act included equity swaps within the definition of security[113]. Title VII of this legislation, the Wall Street Transparency and Accountability Act of 2010, promised to radically alter the derivatives market by, among other things, providing for the standardization, clearing, and exchange trading of certain swap contracts previously traded OTC. A comprehensive framework was created for regulating OTC derivatives as well as swap dealers and certain other designated participants in the derivatives markets, and broad authority was granted to the American market authorities to regulate OTC derivatives transactions, particularly involving swaps (Waddell *et al*, 2010).

[113] 15 U.S.C. § 77b-1(a)

The Act amended Sections 13(d), 13(f), and 13(g) of the Securities and Exchange Act of 1934 in order to specifically extend beneficial ownership reporting obligations to anyone who becomes or is deemed to have become a beneficial owner of securities after the purchase or sale of equity swaps. In addition, a new Subsection 13(o) was introduced in the Exchange Act, determining that, for the purposes of Sections 13 and 16, beneficial ownership of the securities underlying an equity swap may be deemed to have been acquired if the SEC determines that the equity swap provides incidents of ownership comparable to direct ownership and that the swap is necessary to achieve the purposes of Title VII of the Dodd-Frank Act (Waddell *et al*, 2010).

Chapter IV – Critical Analysis of the Empty Voting Phenomenon

In recent years, empty voting has been the subject of increasing attention from several regulators, companies, institutional investors, and lawmakers worldwide, who have sought to study the situations in which the phenomenon happens and what measures, if any, need to be adopted to prevent its occurrence. However, there remains a reasonable uncertainty as to whether empty voting constitutes a real problem in need of legislative intervention, as well as the impact it has on corporate governance, transparency, and the market of corporate control (Oliveira & Oliveira, 2012).

1. Consequences of Empty Voting

Bearing in mind the paradigm that generally underlies Company Law – according to which shareholders, as residual claimants, are the ultimate risk bearers, and, therefore, by placing their economic interests in the company, their votes will be in line with the company's interest, putting them in the best position to have the right to decide on matters essential to the life of the company – it is easy to understand the problems that empty voting can raise in the legal-corporate context, as the phenomenon creates a dissociation between the formal ownership of rights and the ownership of economic interests, thus disconnecting the risk underlying the holding of shares. As seen, when empty voting strategies are used, the shareholder's vote will not have any impact on his financial position and may even imply an interest contrary to that of the company and the other shareholders, thereby calling into question the dogma according to which shareholders have the greatest incentive to assume responsibility for the future of the company, thus causing new conflicts of interest (European Corporate Governance Forum, 2010).

One of the main – and probably the most serious – effects of empty voting is the potential distortion of economic incentives for voting. This poses a corporate governance problem of a qualified or aggravated type when compared to the traditional vertical agency costs – which are fundamentally related to the need to realign the interests of the managers with the interests of the shareholders, the owners of the company – or the classic difficulties inherent to the shareholder tendency to short-termism. Empty voting is a new and original problem of misalignment of the interests of shareholders themselves with the interest of the company. It is about ensuring that the vote in the general meeting is not conditioned by the intervention of subjects who, despite formally holding shares and votes, have an economic interest that is not corresponding or is even contrary to that of the company, leading to decisions susceptible of reducing its value. In short, we are faced with a new form of conflict of interest between the shareholder and the company, which is simultaneously a conflict between shareholders, mirroring horizontal agency costs (Oliveira & Oliveira, 2012).

One could argue that institutional investors may originate conflicts of interest similar to those caused by risk-decoupling structures through the holding of shares in a large number of different companies, some of which may be direct competitors or may be on both sides of a deal. In such situations, these investors will vote in the way that increases their net investment the most (Ringe, 2012; Thompson & Edelman, 2009).

Although powerful, this argument must be ultimately rejected, as this behaviour does not raise the same concerns as empty voting. First of all, if and when these conflicts of interest happen for institutional investors, there is a great probability that they are caused by fortune not deliberately, making them less worrisome. Thus, such potentially arising conflicts can be offset by market diversification. Given that individual investors are likely to have opposite alignments, the effects of such situations will end up cancelling each other out (Ringe, 2012; Thompson & Edelman, 2009; Kahan & Rock, 2007).

Second, the conflict situations at issue here show an entirely distinctive quality than the deliberately induced risk-decoupling structures. In fact, institutional investors are much less likely to manipulate the voting process because they always meet the full economic risk on both sides of the equation, *i.e.*, in both portfolio companies, while risk-decoupled shareholders do not, as their positions may be hedged by derivatives or based on temporary, borrowed shares. Therefore, the interests at stake in those situations are significantly different. While both empty voters and institutional investors can direct their votes toward value-increasing transactions, only the former might vote for an outcome with no economic benefits in an effort to make money just for himself (Ringe, 2012; Thompson & Edelman, 2009).

Third, potential conflicts of interest generated by institutional investors will produce significantly lower agency costs than risk-decoupling situations. Institutional investors will only be biased by possible private benefits of control – the advantages that some shareholders can obtain, while others cannot –, which may lead to conflicts that are most likely already addressed by traditional corporate law (*e.g.*, related party transactions). By contrast, empty voting creates new conflict situations and, consequently, brings about new agency costs, arising both from the distortion of voting incentives and from the motivations that empty voters have to pursue private benefits. In short, a new actor – the risk-decoupled shareholder, whose risk falls short of his voting influence – enters the stage and confronts other shareholders and investors with additional costs because he can profit from disproportionate benefits by virtue of his increased voting power (Ringe, 2012; Thompson & Edelman, 2009).

Due to the distortion on their voting incentives, risk-decoupled shareholders will exercise their voting rights in a way that is either more or less risk-averse than regular shareholders with proper risk-alignment[114]. The fact that they have a different risk profile than average shareholders means that an investment decision or a specific management strategy for the company as a whole may be both detrimental and beneficial for them (Ringe, 2012).

[114] For instance, if a hedge fund H holds 5% of company X's shares but temporarily acquires an additional 5% by means of share lending over the record date, there is the danger that H will vote in a more risk-friendly way than regular shareholders since H bears a reduced risk exposure compared with them. The regular shareholders will be affected by H's increased appetite for risk, while H does not fully feel the consequences of its decisions. An additional danger comes from private benefits: H may use its voting power in a way that the company enters into transactions that are advantageous only for him. The Mylan-Perry case is an extreme example: the hedge fund Perry became involved with Mylan without risk and enjoyed an additional benefit in the form of its involvement with the competitor King. Thus, the takeover benefited Perry in particular but did not bring the same benefits for all other shareholders (Ringe, 2012).

Risk-decoupling strategies also trigger additional information costs[115], which, in turn, can create higher costs of capital for companies and cause severe disruptions in their share trading. Indeed, the presence of risk-modified shares, or even just the merely abstract possibility of their existence among the usual shares of the company will unavoidably generate higher information costs for new investors, as it is an indication that the normal combination of influence and risk is no longer complied with (Ringe, 2012).

One of the ways through which corporate law attempts to reduce information costs is its property law side. In fact, when a shareholder acquires shares, he "(…) *does not merely acquire a contractual, personal claim against the corporation, but rather acquires a right in the corporation*" (Ringe, 2012). Because shares are fungible, acquirers do not need to investigate their particular characteristics in every purchase; instead, they can expect to obtain a more or less standardised security – consisting of the traditional unitary set of active and passive legal situations that accrue to shareholders according to the paradigm of corporate law –, which makes their purchasing decision easier and simpler (Waddell et al, 2010; Ringe, 2012).

According to the long tradition of property rights, *"[I]f you own something, you get to decide what to do with it"* (Waddell et al, 2010). However, decoupling transactions blur the lines of what "ownership" and "property" truly mean, as they raise the prospect of shareholders being able to control property that they do not, in the traditional sense, own, because they are not fully exposed to it (Waddell et al, 2010).

Another way to tackle information costs is through the *numerus clausus* principle, according to which firms have at their disposal a limited number of forms provided by corporate law that they can adopt for their organisation. Subsequently, companies also have to choose from the types of shares that corporate law allows to be created. This principle aims to use standardization as a means to reduce information costs for market participants. *"Firms that must choose from a catalogue of permissible corporate forms and share types are prevented from creating opaque and untransparent arrangements – which would be burdensome for third parties trying to evaluate them"* (Ringe, 2012).

[115] Whenever market participants consider the possibility of entering into a particular transaction, there is a process of information gathering and verifying that they must go through, and in which they incur costs (Ringe, 2012).

Risk-decoupling is an attempt to undermine the legislative option of bundling together influence and risk. It aims to split that standardised package of rights and obligations, where the right to vote and its associated economic exposure are contained within, by way of private autonomy. As a result, such strategies generate additional costs for market players, rather than striving to lessen them (Ringe, 2012).

Furthermore, from a corporate finance point of view, risk-decoupled shareholders aim to reduce the intrinsic risk that is associated with equity investment. They want the “best of both worlds”: to keep the ownership of shares and the associated voting rights, but to lessen the risk to which they are exposed, making their shareholdings more akin to debt than equity. However, the ideal situation for these shareholders is not only to reduce equity risk, but rather to eliminate it completely, becoming fully risk-decoupled and achieving the “best of three worlds”: to maintain the shareholder status, to have the risk profile of external debt investors and also to attract private benefits as a result of holding a stake in a competitor, as in the Mylan-Perry situation (Ringe, 2012).

Overall, risk-decoupling results in a contradiction: from an economic perspective, a risk-decoupled share is more similar to debt than equity, but if we switch to a legal point of view, a risk-decoupled shareholder intends to strip off the risk that characterises equity investment to nevertheless formally remain a shareholder, although of an empty shell (Ringe, 2012).

But the problem is that the rationale underlying the assignment of voting rights to shareholders is strictly related to their distinctive economic risk, which makes them in the best position to take the best possible decisions for the strategic direction of the company. To eliminate such risk also makes the justification for the granting of voting rights disappear. Therefore, risk-decoupled shareholders have lost the legitimacy to be entitled to voting rights, as they will most likely exercise their voting power in a selfish and potentially detrimental way, turning the right to vote into an instrument prone to abuse and self-benefit (Ringe, 2012).

Finally, an economic justification for empty voting is sometimes given by the fact that decoupling situations may still be economically efficient, even if they lose money for shareholders[116]. However, this argument is rejected by corporate law, as the purpose of the vote is not to facilitate transactions that are bad for shareholders, even if they are economically efficient. Thus, each corporation should focus on its own stock price, rather than overall social welfare. In fact, this is one of the reasons why voting rights are limited to shareholders in detriment of other constituencies[117]. Therefore, whenever a transaction is able to produce a cooperative surplus, directors should capture some of it for the shareholders. If, on the contrary, they worsen shareholders' positions because they have ceded all the surplus to the other party, then they should be disciplined by the company owners (Thompson & Edelman, 2009).

All that said, although many problems may be associated with empty voting, it is important to note that the phenomenon will not always have negative consequences. Some scholars point out that risk-decoupling structures may improve corporate voting and reduce agency costs, instead of exacerbating them. Their arguments build up on the rational apathy of small shareholders, who generally are not interested in exercising their voting rights. In this context, apathetic shareholders could transfer such rights to other shareholders who are actively interested in the strategic direction of the company (Ringe, 2012; Waddell *et al*, 2010; Christoffersen, Geczy, 2007; Brav & Matthews, 2010).

As a result, those informed investors could use their higher voting power to effectively control management, consequently reducing managerial agency costs, and cast more informed votes, therefore contributing to shareholder value (Ringe, 2012; SEC, 2010; Waddell *et al*, 2010; Christoffersen, Geczy, 2007; Brav & Matthews, 2010). *"If these transactions could dominate the marketplace, then modern capital market transactions that facilitate the separation of formal stock ownership from the allocation of voting rights could improve the efficiency of the corporate voting process"* (Waddell *et al*, 2010).

Obviously, the nature of the empty voting phenomenon in these circumstances will be qualitatively different from the most frequent situations where empty voters have a negative economic interest in the company. Here, instead, shareholders hold voting

[116] Using the Mylan-King case as an example, if the takeover produced net gains on the whole, apart from the distributional consequences for the shareholders of the two companies, even though empty voting was practiced to facilitate the result, it could be seen as positive for the economy (Thompson & Edelman, 2009).
[117] If companies were to prioritize social welfare over share price, that would almost surely entail giving votes to employees, bondholders, suppliers and/or local government officials (Thompson & Edelman, 2009).

rights that derive from shares owned by other shareholders but still have a positive economic interest, as their voting rights are aligned with the economic interest of the company. This is an example where empty voting could be beneficial, especially in an environment that is characterised by high dispersion of shares (Ringe, 2012; SEC, 2010).

Some authors state that this is an *"old argument in disguise"*, which had already been made regarding takeovers and acquisitions in favour of allowing the bidder to substitute the target company's management through the attainment of further voting rights. This argument was built on two conditions: both the acquisition and the use of the additional voting rights acquired had to be in the interests of the target company and all shareholders. In the context of risk-decoupling, these conditions will hardly be fulfilled, especially the second, as an empty voter will usually use his risk-decoupled position to consciously undermine or manipulate the voting process in order to achieve his own benefits, to the detriment of third parties, including the wider community of shareholders. Therefore, an effective control of management to the benefit of all shareholders seems quite implausible (Ringe, 2012).

Even though these authors' general objection lingers – there is no way to certify that empty voters will not prioritise their own private benefits over the interests of other shareholders and the company as a whole and use their voting rights accordingly – they recognise that risk-decoupling strategies may be beneficial in individual situations[118] (Ringe, 2012).

To conclude, while a certain uneasiness from risk-decoupling strategies is immediately conceivable, given the difficult trade-off between the possible advantages of a system that allows empty voting and the associated inconveniences, any legislative intervention should always be backed up by a thorough analysis of its pros and cons (Ringe, 2012).

2. Possible Solutions for Empty Voting

Regardless of whether empty voting is viewed as a welcome innovation or a threat to the established system, the truth is that the current legal regime is only prepared to

[118] For instance, in the previously described British Land case, hedge fund Laxey claimed that his use of share lending to obtain greater voting power was meant to be a way of monitoring management more efficiently in the interest of all shareholders (Ringe, 2012).

respond to a more primitive form of vote buying, meaning that it has not kept pace with the developments of the financial market. In this context, there are already several regulatory solutions pointed out by the doctrine to readjust the law to the modern financial reality, which go from the extension of the transparency rules to the proposal of substantive measures leading to the absolute ban on empty voting (Waddell *et al*, 2010).

2.1. Transparency

The first of the proposed solutions involves acknowledging that lack of transparency is the main problem underlying risk-decoupling structures. Some scholars advocate that empty voting situations weaken the ways through which transparency rules promote market efficiency and corporate governance. Thus, it is necessary to ensure greater transparency in the mechanisms that enhance them, extending the obligations to disclose the ownership of shareholdings (Schouten, 2010a; Ringe, 2012).

Disclosure of the disproportionality between voting power and economic ownership signals that shareholders whose control rights exceed their economic exposure have their incentives distorted, enabling investors to better anticipate agency costs and to assess the implications of this distortion on share value, creating transparency of the economic interests of shareholders (Schouten, 2010a; Ringe, 2012).

Regarding empty voting, ownership disclosure will be the most important source of information to the market, as the traditional ones, such as company's articles of association or initial and periodic disclosure requirements, which inform the market on conventional deviations from the "one share, one vote" rule (*e.g.* non-voting preference shares or shares with multiple voting rights) will not be able to capture situations where *"(...) a wedge between voting rights and economic ownership is created through market instruments instead of institutional instruments, not for the long term but for the short term, and not by insiders but by outside investors whose voting behaviour may nonetheless determine the outcome of the voting process"* (Schouten, 2010a). In fact, in such circumstances, *ad hoc* disclosure by shareholders will be preferable (Schouten, 2010a).

In terms of corporate governance, disclosure of empty voting strategies would most likely make hedge funds and other savvy investors less willing to engage in them.

As a matter of fact, *"the private benefits that are pursued and the agency costs that are produced are only seen as an attractive business model for some market actors for the very reason that they can be pursued unnoticed by the market"* (Ringe, 2012). Investors may fear reputational consequences if the market becomes aware of their risk-decoupling activities[119]. Moreover, transparency of the potential for empty voting could allow for companies, shareholders and regulators to better respond to, or prevent, abusive instances of empty voting, through litigation or otherwise (Ringe, 2012; Schouten, 2010a; Thompson & Edelman, 2009; Clottens, 2012).

Authors often favour transparency-based solutions that aim for an expansion of the information and disclosure obligations over prohibition laws, as they represent a less restrictive type of regulatory intervention and therefore are preferable under proportionality considerations. They believe that disclosure will reduce the uncertainty about the extent and importance of risk-decoupling structures by providing regulators with more information about them in order to measure their pervasiveness in practice and to consider potential follow-up actions (Ringe, 2012; Schouten, 2010a).

Hu & Black present an *"integrated ownership disclosure"* proposal for a reform and simplification of the current U.S. transparency. Their goals are the following: *"(1) moving toward common standards for triggering disclosure and for disclosing positions once disclosure is required; (2) providing a single set of rules for which ownership positions to disclose and how to disclose them; (3) requiring disclosure of all positions conveying voting or economic ownership, arising from shares or coupled assets; and (4) requiring symmetric disclosure of positive and negative economic ownership"* (Hu & Black, 2006a; 2006b; 2007; 2008a).

In large part, Hu & Black's proposed disclosure reforms are built largely on the basis of insiders and mutual funds transparency rules and practices, aiming to extend them to the subjects who fall under the disclosure obligations of Form 13F and Schedules 13D and 13G. The rules of Section 16 are the most appropriate to address derivative positions[120], particularly because they require disclosure of both long and short positions.

[119] Disclosure may also discourage the required counterparties from participating in risk-decoupling transactions. For instance, derivatives dealers might take reputational risk into account in deciding whether to facilitate a client's empty voting strategy. However, this effect is less likely to be seen (Ringe, 2012; Schouten, 2010a; Thompson & Edelman, 2009; Clottens, 2012).

[120] There will also be the need for regulators to develop guidelines for derivative positions whose reporting is not included in Section 16 and mutual funds disclosure rules. Scholars advocate that the information to be disclosed should be sufficient to allow derivatives dealers to estimate the derivative's value and delta,

Regarding Form 13F, these authors propose that all kinds of economic ownership of shares, either directly or by means of derivatives, should be counted toward the $100 million threshold. To sum up, all long and short positions would count toward the disclosure triggering thresholds for Schedules 13D and 13G and Form 13F (Hu & Black, 2006a, 2006b; 2007; 2008a).

In addition, given that some risk-decoupling mechanisms can be used only for a short period of time around the record date[121], which makes them not likely to be caught by periodic disclosure, Hu & Black propose that periodic filers – Form 13F, Schedule 13G and mutual fund disclosure – are required to report all the occasions where their voting power substantially exceeded their economic ownership by at least 0,5%. Such a threshold allows for reporting to be applicable only to a hopefully small fraction of filers which are the ones who engage in large-scale empty voting[122], consequently reducing implementation costs and the reporting burden for institutions who participate in ordinary hedging activities (Hu & Black, 2006a, 2006b; 2007; 2008a).

Finally, scholars would also require disclosure of share lending, both by the lender and the borrower[123], as well as voting ownership, regardless of whether it is accompanied by economic ownership (Hu & Black, 2006a, 2006b; 2007; 2008a).

Although Hu & Black's proposal for the reform of the American disclosure rules was meant to provide improved disclosure of both hidden ownership and empty voting, the reality is that it should only capture reasonably well the first mentioned phenomenon. And even that will only be true for Schedule 13D and Section 16 filers because they must disclose ownership and changes therein instantly. Disclosure for Schedule 13G and Form 13F filers, along with mutual funds, would be more erratic, as they only report end-of-period positions (Hu & Black, 2006a, 2006b; 2007; 2008a).

i.e., the ratio comparing the change in price of the underlying asset (in our context, shares) and the corresponding change in the price of its derivative (*e.g.*, if the delta value of a stock option is 0,65, it means that if the value of the underlying shares increases by € 1, then the option will rise by € 0,65 per share, *mutatis mutandis*) (Hu & Black, 2006a, 2006b; 2007; 2008a).

121 For instance, an investor could borrow 5% of a company's shares, vote them at a general meeting, terminate the share lending agreement before the quarter ends, and report nothing (Hu & Black, 2006a, 2006b; 2007; 2008a).

122 If empty voting is widespread, the filing burden would be higher, but so will the need for information (Hu & Black, 2006a, 2006b; 2007; 2008a).

123 The borrower would have to report if he retained the borrowed shares or rather sold them short (Hu & Black, 2006a, 2006b; 2007; 2008a).

When considering a transparency-based solution, it is fundamental to be aware of its potential costs and unintended consequences. Compliance costs are the most obvious[124], but they are not the only ones. There will also be additional firm-level costs, such as information costs, as efforts will need to be made in order to get information about the new disclosure rules, as well as costs of divulgence and implementation of those same rules within the company. Other costs will arise from legislative activity, particularly from resource expenditure and employment of people for the development and monitoring of the new rules. An emphasis should be given to opportunity costs, *i.e.*, the cost of the potential benefits of the alternatives that are forgone when you choose an option. Finally, a new system will also give rise to indirect costs, such as, for instance, avoidance costs, whose quantification will be very difficult to perform (*e.g.*, if market participants stopped entering into share lending transactions because of new disclosure, that would create costs from the decline in market liquidity) (Hu & Black, 2006a, 2006b; 2007; 2008a; Ringe, 2012).

In order for a disclosure regime to be successful, the first certification that needs to be made is that it captures all presently known empty voting strategies, as well as the potentially future cases that might be created by investors in the future. This will require a very wide general clause that encompasses both the risk-decoupling constellations that are already identified and those who are yet undiscovered. A non-exhaustive list of examples could be a more concrete option (Ringe, 2012).

In the second instance, the moment at which disclosure is set to occur is very important to ensure that shareholders are able to respond properly to disclosed information. The preferred option is a steady and continuous disclosure obligation throughout the entire business year (Ringe, 2012).

One could consider a disclosure obligation triggered upon the occurrence of a specific and relevant event, such as a general meeting, since it would place a minimal burden on investors. Yet, shareholders are expected to react to the information that is disclosed in a short timeframe, which may not be possible if a disclosure obligation is set right before the general meeting or the record date. On the other hand, if such obligation

[124] Hu & Black expect that additional compliance costs of their proposal should be limited and will most likely be offset for many filers because of the introduction of a single set of rules that determine what must be reported. They even expect that overall disclosure costs will decline (Hu & Black, 2006a, 2006b; 2007; 2008a).

is set after the record date, shareholders will be prevented from acquiring more voting rights, which could lead to a "dramatic exit" of shareholders and, ultimately, to a massive decrease in share price. Instead of mitigating the problems that can arise from the use of risk-decoupling strategies, a big-scale sale of shares would even exacerbate it by creating fresh disparities between voting entitlements and share ownership (Ringe, 2012).

Furthermore, it could be argued that it is around the general meeting that information on the risk exposure of shareholders and possible distortion on their voting incentives becomes most relevant and material. Although that is true, it should also be recognised that risk-decoupling strategies can occur at any time, and that their effects are not only relevant to the process of voting at general meetings. In fact, there are some ways of which particularly institutional investors and hedge funds can take advantage in order to put pressure informally and even unofficially on the management of the company that can be much more important than voting. Along with the threat of exercising their voting power, for example, to call a meeting, these investors manage to compel directors to act in the ways that are most profitable to them at any time of the business year. Additionally, there are some situations where shareholders can replace formal resolutions through written consent[125] (Ringe, 2012).

The need for a continuous disclosure obligation should be complemented with the choice of a relatively high disclosure threshold, such as 5% or more, as a filter to single out meaningful disclosure information (*e.g.*, everyday transactions below the threshold). It could be one way to keep the costs at a minimum by ensuring that disclosure of trading activities with no intention whatsoever to influence corporate governance arrangements within companies is not required[126]. Thus, only situations that could potentially lead to governance problems would be targeted. Indeed, *"[o]nly such a stake accumulated in the first instance will give a shareholder the necessary voting power to influence the target company – and only a sufficiently high risk elimination will distort her incentives in a meaningful way"* (Ringe, 2012).

Moreover, if short positions are disclosed too frequently, some investors may respond to that by selling their shares, which may exacerbate market declines. Also, there

[125] In the U.S., under Delaware law, if there is a written consent by the majority of shareholders, the need for a general meeting to take action disappears (DGCL § 228) (Ringe, 2012).
[126] Institutional investors' normal trading positions may easily surpass lower disclosure thresholds (Ringe, 2012).

is a possibility of reduction of market liquidity because investors are not fond of revealing their short positions to companies. Thus, they prefer to avoid taking short positions altogether (Ringe, 2012).

In conclusion, disclosure by itself will most likely reduce the frequency of empty voting and allow for other market participants to properly react to the actions of empty voters, thus making the phenomenon's strategies less productive. But even though disclosure will be valuable, for empty voting it may only be the first step, as shareholders will still be able to exercise the voting rights associated with their shares without bearing the underlying economic risk. In fact, disclosure should help gathering the information necessary to determine if further empty voting reforms will be required (Hu & Black, 2006a, 2006b; 2007; 2008a; Thompson & Edelman, 2009; Clottens, 2012).

2.2. Ban and Restrictions on Empty Voting

Another solution to deal with empty voting is the introduction of a comprehensive and mandatory rule for the distribution of voting rights based on the "one share, one vote" standard, accompanied by a general ban on instruments that would circumvent this rule, ultimately favouring an explicit restriction on vote buying. Scholars who propose this solution are true defenders of the "one share, one vote" rule, as they believe that, if shares generate multiple votes, the consequence will be the distortion of shareholders' incentives and their disconnection from the economic performance of the company (Thompson & Edelman, 2009).

Empty voting totally undermines these authors' justification for corporate voting, which they believe is meant to *"(...) correct errors of directors that lead to a decrease in the stock value of the corporation"* (Thompson & Edelman, 2009). In theory, shareholders are in the best position to perform this task, but if they eliminate the financial interest in the company from their voting rights, they will no longer be able to comply with the error-correcting rationale. For them, *"[t]o argue that "empty voting" is not a concern is to argue that there is no need for shareholder voting at all"* (Thompson & Edelman, 2009; Ringe, 2012).

This solution for empty voting is a modern adaptation of the law's traditional concern about the connection between economic and voting interests, as well as an extension to the empty voting arena of the traditional corporate law bans on agreements that break such attachment and on vote buying. Indeed, it would provide certainty that shareholders were not voting more shares than the ones in which they have an economic interest. The suggestion to proceed with the banning of risk-decoupling strategies altogether was considered by the Transparency Directive Assessment Report the most consistent decision bearing in mind the principles at stake (Thompson & Edelman, 2009; Mazars, 2010).

In general, any rule that prohibits the exercise of the right to vote in the event of empty voting will only be effective if it considers the various ways in which voting can be dissociated from economic ownership. Though, a general ban on mechanisms that enhance empty voting situations is not desirable, as stock lending, short selling, and financial derivatives perform a vital role in the financial markets (Hu & Black, 2006a; 2006b; 2007; Clottens, 2012).

Additionally, as seen, empty voting is not always, or even as a rule, a harmful practice. In fact, it creates the possibility of transfer of votes from passive to informed shareholders, allowing the latter to have higher voting power and to use it in the interests of the company as a whole. Also, voting can be partially or fully empty. Partial empty voting is less problematic because shareholders will still have an interest in the company, although small or neutral, and, consequently, some incentives, even though suboptimal, to act in its best interest. However, a general prohibition on empty voting would cover both the situations in which the phenomenon is objectionable and also those in which it may be beneficial, making it (Hu & Black, 2006a; 2006b; 2007; 2008a; Clottens, 2012).

Therefore, we can conclude that this solution would be highly impractical and would lead to inadequate results. Moreover, there is a great probability that investors would use financial innovation to circumvent it (Hu & Black, 2006a; 2006b; 2007; 2008a; Clottens, 2012).

A less restrictive solution in this area would be to prohibit stock lending and short selling at least around general meetings. But since banning these practices would be impracticable, as they are well-established, some measures have already been proposed to restrict or even proscribe them under exceptional circumstances. Share lending, in general, is only subject to soft law, such as standard contracts (*e.g.*, ISLA's Global Master Securities Lending Agreement) and best practice codes (*e.g.*, IGCN Securities Lending

Code of Best Practice). As seen, to use share lending with the primary purpose of obtaining control and influence without the risks of ownership constitutes a violation of best practices (Clottens, 2012).

In order to prevent this situation, although lenders are not allowed to retain the voting rights for themselves, unless the share lending agreement is entered into after the record date, they should exercise their right to recall the lent shares, particularly in case of controversial resolutions, except if there are sound economic reasons against it. But this does not mean that they should have an obligation to recall. In fact, such an obligation could ultimately lead to an adverse impact on market liquidity and share price, as it would generate a temporary shortage of shares available for share lending around general meetings. Thus, institutional investors should at least establish clear lending and voting policies (Clottens, 2012).

This solution also raises problems when the lent shares have been sold to a *bona fide* third party. In fact, share lending and short selling create some uncertainty and raise questions about the attachment of voting rights to shares that have been loaned out, particularly if the lenders retain such rights, and shorted shares, regarding the acquisition of the right to vote by the purchaser (Martin & Partnoy, 2004; Clottens, 2012).

The tension between lending and shorting arrangements on one hand, and voting rights on the other, arises from the fact that the majority of shares in publicly traded companies is not registered in the name of their beneficial owners, but rather in "street name", *i.e.*, they are held by brokers on behalf of shareholders, and these entities are deemed as the legal owners of the shares, even though they are only custodians. This practice is governed by the various stock exchanges, which give brokers discretion to vote "street name" stock in routine proposals, if the beneficial owners do not vote, abstain from it or give specific instructions to the contrary. However, regarding non-routine proposals in which the vote is important, brokers are not allowed to vote "street name" shares (*e.g.*, a merger is considered an important event and brokers are not permitted to vote at their discretion for or against it) (Martin & Partnoy, 2004; Hu & Black, 2006a; 2006b; 2008a; Kahan & Rock, 2007; Clottens, 2012; Karmel, 2009).

But broker voting practices are easily subject to manipulation, particularly through the use of lending and shorting, and cannot be completely faithful to shareholder preferences. Additionally, because brokers have the right to lend out shares and to keep the fees for doing so without notifying the client, the beneficial owners typically are not aware if their shares have been loaned or shorted. In fact, they assume that as long as they own shares – and hence will obtain profits or incur in losses depending on the development in share price – they are entitled to vote them. However, that might not be the case[127] (Martin & Partnoy, 2004; Hu & Black, 2006a; 2006b; 2008a; Kahan & Rock, 2007; Clottens, 2012; Karmel, 2009).

"Share lending thereby creates the illusion that there are more shares owned beneficially than are actually registered" (Martin & Partnoy, 2004). Yet, according to the "one share, one vote" rule, a single share must result only in a single vote. Thus, when a shareholder allows for his shares to be borrowed for shorting, and they are effectively sold, a new shareholder is created. That shareholder is the final shareholder of record, provided that he is the last buyer of the shares in the lending and shorting chain, who obtained through the stock exchange full title to the shares, including voting and economic rights. So, technically, given that the number of votes is finite, only the latter should have the right to vote, and not the previous beneficial owners of the shares, as they are no longer final shareholders of record (Martin & Partnoy, 2004; Hu & Black, 2006a; 2006b; 2008a; Kahan & Rock, 2007; Clottens, 2012; Karmel, 2009).

This situation could lead shareholders not to lend their shares or to withdraw them for fear of losing voting rights, which would be harmful to brokers, who receive often substantial compensations from share lending, as well as for the market, exacerbating any reduction in short-term liquidity. To evade this context, brokers perform a reallocation of votes among shares in the following manner: in the event that two parties each submit proxies associated with the same share, the broker allocates the vote of one of them to a non-voting share, granting both of them a voting right (Martin & Partnoy, 2004; Hu & Black, 2006a; 2006b; 2008a; Kahan & Rock, 2007; Clottens, 2012; Karmel, 2009).

Shareholders are not aware of this fictional reallocation of votes, which is nothing more than a bizarre solution of giving shareholders a "phantom" vote while consenting

[127] Shareholders and brokers, especially institutional investors, as major lenders of shares, should be aware of the consequences of stock lending as regards the exercise of voting rights and the dangers that it entails. However, few of them understand the potential limitations on voting that come from lending and shorting arrangements. For example, the lack of effort made to distinguish between loaned shares and shares that have not been loaned either demonstrates that shareholders do not understand share lending or that they are not interested in comprehending it at all. This is because, if the opposite were true, shareholders would want a market practice to detect which shares have been loaned out and are being held by someone else (e.g. loaned shares could carry a specific label). But there is no such practice (Martin & Partnoy, 2004).

that a single share is able to generate multiple votes. This method only works because not all shareholders vote or else the total number of votes would exceed the actual number of shares (Martin & Partnoy, 2004; Hu & Black, 2006a; 2006b; 2008a; Kahan & Rock, 2007; Clottens, 2012; Karmel, 2009). Therefore, *[o]nly voter apathy and manipulation of the voting process prevent pervasive overvoting."* (Martin & Partnoy, 2004).

These lending and shorting practices are more likely to occur in companies with less stock trading than in large publicly held corporations. As a matter of fact, they can lead to inefficiencies of the market and to a higher cost of capital overall, as their presence will cause shareholders to be less willing to acquire shares affected by them. Such problems would not emerge if only the final shareholder of record would be allowed to vote (Martin & Partnoy, 2004).

2.3. Suspension, Limitation or Prohibition of Voting Rights

Another way to address empty voting is by means of a direct intervention in shareholders' voting rights via a suspension, limitation or prohibition of their exercise whenever they surpass the level of economic ownership, provided that they are connected with borrowed or risk-hedged shares. This solution represents a middle ground between the overly radical general ban on empty voting and the insufficient improvement of transparency rules (Clottens, 2012).

Some scholars that suggest this solution find the "one share, one vote" rule inefficient, as it can be easily circumvented by sophisticated investors through various strategies created by financial innovation, to the detriment of pure residual shareholders. They also reject the assumptions underlying that rule, according to which all shareholders are homogeneous in their preferences. In fact, they believe that certain shareholders do not face the same incentives as pure residual claimants. That is precisely the case of empty voters, who, in these authors' point of view, should not be entitled to voting rights. Their logic is based on the circumstance of other constituencies with an economic interest in the company identical to that of pure residual claimants not being granted the right to vote, because of the traditional arguments in favour of the attribution of voting rights to shareholders (Martin & Partnoy, 2004).

It turns out that, according to those same arguments, which we have been presenting throughout this study, risk-decoupled shareholders should not be entitled to voting rights either, precisely because of their lack of economic exposure. Scholars conclude that permitting them to vote, leaving aside the discrepancy between their economic incentives and those of pure residual shareholders, will lead to inefficient decisions, as they favour suboptimal proposals that do not maximize the corporation's value, and could even destroy it (Martin & Partnoy, 2004).

Despite maintaining their criticism toward the "one share, one vote" rule, authors recognise that the perpetuation of its application is due to the circumstance that the process of deciding which shareholders should receive voting rights is too expensive most of the times. Therefore, they adapt their line of reasoning to this situation by still advocating that some shareholders should be deprived of their voting rights but depending on the costs that will result from it[128]. For them, at minimum, that is the case of shareholders who hold substantial short positions, whose divestment could be implemented at a relatively low cost (Martin & Partnoy, 2004).

But to proscribe investors that hedged their positions against possible fluctuations in the share price through derivatives from exercising their voting rights is not a piece of cake. Practically speaking, disclosure of empty voting positions would be necessary, followed by the intervention of courts for the application of sanctions (*e.g.*, damages or declaration of nullity of the company's resolutions), as an enforcement of the prohibition. All of this would imply substantial costs arising, for instance, from the legal insecurity about the validity of the general meeting's resolutions that would emerge. Additionally, it is extremely difficult to determine exactly whether, in derivative positions, voting power exceeds economic ownership because their effective economic exposure varies depending on share price, making its calculation not so straightforward (Clottens, 2012).

On the other hand, regarding share lending, it should be considered that the solution of suspending voting rights linked to borrowed shares can be potentially as damaging as abusive voting. In fact, if the votes that are lost as a result of such suspension are not considered for the purposes of calculating the threshold for a quorum or a majority,

[128] For instance, in the case of shareholders that are simultaneously managers, employees, suppliers, or others with relationships with the firm, to decide which of them should be granted voting rights as a result of their appropriate economic incentives would be very costly. Hence, the cost-effective solution is to disregard the disparity between their interests and those of pure residual claimants and give them the right to vote (Martin & Partnoy, 2004).

especially qualified, that could strengthen the position of some shareholders. Nevertheless, stock lending is not the only empty voting mechanism, so the outcome that the suspension of voting rights attached to borrowed shares is intended to prevent can also be reached through derivative-hedging or record date capture (Clottens, 2012).

Scholars also question whether, in the opposite situation, voting rights should be attributed to other constituencies besides shareholders who have acquired an economic interest in the corporation identical to that of a pure residual claimant, without acquiring the respective shares. The first argument against it is that non-shareholders did not purchase a stake in the company, consequently having no direct relationship with it, and therefore should not be involved in its governance. The question that arises is whether a formal link with the firm should have a greater weightiness than investors' economic incentives (Martin & Partnoy, 2004).

In fact, sometimes, non-shareholders fit better in the role of "shareholders" than the company owners themselves. In other words, *"the economic residual interest of a corporation might not reside with shareholders"* (Martin & Partnoy, 2004). Thus, scholars are not convinced with the attribution of votes to shareholders, and not to other constituencies with equivalent positions, merely because of form. They believe that *"the assigning of votes should be invariant to capital structure"* (Martin & Partnoy, 2004).

One of the consequences of allocating votes to anyone who bears a similar economic risk as shareholders, regardless of the formal title to shares, would be that the voting rule could not be "one share, one vote". The way to assign votes would have to be the following: each net share receives one vote. In other words, all investors holding a "share-like" claim on the company are residual interest holders and therefore receive a vote, whether or not they are real shareholder of that firm. Financial engineering is zero-sum, as it does not create new prerogatives on the cash flows of the company, but rather reallocates its already existing finite set of claims. Thus, *"the number of net shares will equal the number of shares issued and outstanding"* (Martin & Partnoy, 2004).

An argument that is sometimes made against assigning voting rights to non-shareholders, notwithstanding the fact that they hold residual interests in the company, is that the total number of voting rights would become unmanageably large and possibly infinite, causing the corporation to lose control of the voting process and increasing the likelihood of manipulation. However, there may be a solution for this undesired complication, which is restricting the exercise of voting rights only to those non-shareholders who hold positions that can be traced directly to a voting share (*e.g.*, the counterparty to a short position assumed by a real shareholder with the legal right to vote) (Martin & Partnoy, 2004; Clottens, 2012).

Scholars conclude that the real reason why non-shareholders with an economic residual interest do not receive a vote is related to the cost of matching individual positions with individual votes, which is too high. Thus, it is more efficient to assign voting rights to shareholders, regardless of their economic incentives. Authors point out that the "one share, one vote" rule is inconsistent with marrying voting rights to economic residual interests, which demonstrates that the rationale underlying it is after all based on transaction costs, instead of economic incentives (Martin & Partnoy, 2004).

To sum up, as the financial contracting costs keep declining, scholars believe that we are moving more and more towards the moment when it will be cost-effective to give voting rights to all economic residual interests, regardless of whether they have a formal connection with the company, the only condition being that voting rights can always be traced to such interests, which, in turn, will be linked to shares, even if their holder is not a shareholder. This will allow for the number of votes not to exceed the number of shares (Martin & Partnoy, 2004).

Conclusion

As a first conclusion, we can state that the development of market practices, alongside with the new wave of financial innovation, have transformed corporate voting. In fact, empty voting destabilizes the corporate voting process, as it gives voting power to subjects that do not hold the economic ownership of their shareholdings.

However, the real question that needs to be answered is whether the phenomenon aims to increase the value of the companies or, on the contrary, it distorts the incentives to exercise voting rights and, consequently, constitutes a source of value destruction. This is an issue that is far from being considered simple or consensual, because, as described, empty voting may be considered beneficial for the creation of value in a company and for its shareholders. Yet, the phenomenon may also have the effect, or even the objective, of defrauding securities and corporate rules for the allocation of voting rights.

The truth is that the law must be prepared to be adapted according to the needs of our society and business life that are constantly changing due to the countless new challenges that come with the world's evolution. That said, whatever the virtues or vices of empty voting, it is decidedly uncontroversial that the law has not yet responded to the new financial realities that the phenomenon represents. Part of the reason is precisely the fact that there still is a considerable amount of uncertainty about when and how the "new vote buying" occurs and how often it is beneficial or harmful.

So, in order to decide on the best solution to regulate empty voting, the first step needs to be to understand whether the situation in question is effectively harmful to the company and if the empty voter, shareholder or not, is exercising the right to vote for his benefit and to the detriment of the company and/or the shareholders and in breach of the duty of loyalty to the company and the other shareholders.

To finalize, it should be noted that what is relevant in empty voting is not the concrete underlying mechanism, but rather the situation created by it. For that reason, any solution aimed at regulating empty voting to be considered under positive law must be abstracted from the underlying cause of the phenomenon or else will be doomed to failure.

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