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THE DECONSTRUCTION OF EQUITY

Activist Shareholders, Decoupled Risk,
and Corporate Governance

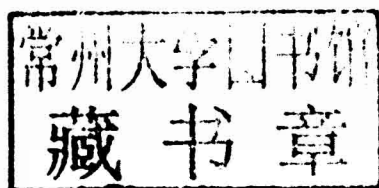
WOLF-GEORG RINGE



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*Activist Shareholders, Decoupled Risk,
and Corporate Governance*

WOLF-GEORG RINGE



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Preface

This book is the fruit of several years of research. It brings together several aspects of legal and economic scholarship, as it is the attempt to develop solutions to equity risk-decoupling, a problem that is present in capital markets around the world. Corresponding to these challenges, my approach is both comparative and interdisciplinary, and seeks to put economic problems at the centre of the discussion. Legislative responses from different jurisdictions are provided and discussed as examples. The book differs from other studies on the subject in that it develops a concrete regulatory proposal to address the problem in an EU context. However, the concepts developed in the study may hopefully also serve as inspiration for regulators in other jurisdictions.

I presented aspects of this work in research seminars in various universities and research centres around the world, and I am very grateful for the many fruitful discussions, and the feedback and suggestions that I received. I benefited from discussions with staff at the European Securities and Markets Authority, who gave me valuable insights into the political implications and hands-on practicalities of EU lawmaking.

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The book builds on, and draws on, some of my previous research. Parts of the text extend and further develop articles that I have published over the past few years,¹ and the topic should be seen in the context of my broader interest in shareholder engagement and activism and my forthcoming work in this field.²

¹ For example, Maiju Kettunen and Wolf-Georg Ringe, 'Disclosure Regulation of Cash-Settled Equity Derivatives—An Intentions-Based Approach' [2012] *Lloyd's Maritime and Commercial Law Quarterly* 227; Wolf-Georg Ringe, 'Hedge Funds and Risk-Decoupling—The Empty Voting Problem in the European Union' (2013) 36 *Seattle University Law Review* 1027; Wolf-Georg Ringe, 'Empty Voting Revisited: The *Telus* Saga' (2013) 28 *Butterworths Journal of International Banking and Financial Law* 154.

² Wolf-Georg Ringe, 'Shareholder Activism: A Renaissance' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (forthcoming, Oxford University Press 2016).

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Georg Ringe

Copenhagen
October 2015

Table of Cases

AUSTRALIA

<i>Shears v Phosphate Co-operative Company of Australia Ltd</i> (1988) 14 ACLR 747	83
<i>Amalgamated Pest Control Property Ltd v McCarron</i> (1994) 31 ACSR 42	83

CANADA

<i>In re TELUS Corporation</i> [2012] BCSC 1919.....	35, 152–153, 154
<i>TELUS Corporation v Mason Capital Management LLC</i> [2012] BCCA 403.....	34, 35, 152–154, 155
<i>TELUS Corporation v CDS Clearing and Depository Services Inc</i> [2012] BCCA 403, [2012] BCJ No 2083 (QL).....	34

EUROPEAN UNION

Case C-84/94 <i>United Kingdom v Council of the European Union</i> [1996] ECR I-5755, ECLI:EU:C:1996:431.....	226
Case C-270/12 <i>United Kingdom v European Parliament and Council</i> ECLI:EU:C:2014:18.....	182, 225

GERMANY

Bundesgerichtshof (Federal Supreme Court)	
1 February 1988 (II ZR 75/ 87), BGHZ 103, 184 = NJW 1988, 1579 (<i>Linotype</i>)	207
21 April 1997 (II ZR 175/ 95), NJW 1997, 1926 (<i>ARAG/ Garmenbeck</i>)	97
5 July 1999 (II ZR 126/ 98), BGHZ 142, 167 = NJW 1999, 3197 (<i>Hilgers</i>).....	207
16 March 2009 (II ZR 302/06), BGHZ 180, 154 (<i>Lindner</i>)	39, 153, 154, 195, 203, 211, 212
OLG Frankfurt (Frankfurt Court of Appeal)	
17 August 2011 (13 U 100/ 10), ZIP 2011, 2008.....	97
OLG München (Munich Court of Appeal)	
23 November 2006 (23 U 2306/ 06), NZG 2007, 192 (<i>Lindner</i>)	39

NEW ZEALAND

<i>Perry Corporation v Ithaca (Custodians) Ltd</i> [2004] 1 NZLR 731	64, 65, 67, 126, 127, 128, 217
---	--------------------------------

UNITED KINGDOM

7722656 <i>Canada Inc (formerly carrying on business as Swift Trade Inc) and</i> <i>Peter Beck v Financial Conduct Authority</i> [2013] EWCA Civ 1662	59
<i>Bond v Barrow Haematite Steel Co</i> [1902] 1 Ch 353	112
<i>Borland's Trustee v Steel Bros & Co</i> [1901] 1 Ch 279	105
<i>In re Tea Corporation Ltd</i> [1904] Ch 12.....	117, 201

<i>Northern Counties Securities Ltd v Jackson & Steeple Ltd</i> [1974] 1 WLR 1133.....	208
<i>Re Abbey National plc</i> [2004] EWHC 2776	117
<i>Re Bluebrook Ltd</i> [2009] EWHC 2114	117, 201
<i>Salomon v Salomon</i> [1897] AC 22	78
<i>Trevor v Whitworth</i> (1887) 12 App Cas 409	43

UNITED STATES

<i>Alabama By-Products Corporation v Cede & Co</i> , 657 A.2d 254 (Del. 1995).....	116, 154
<i>Chew v Inverness Mgmt. Corp.</i> , 352 A.2d 426 (Del. Ch. 1976).....	82
<i>Crawford v Cincinnati Bell, Inc. (In re IXC Communications, Inc. Shareholders Litigation)</i> No. C.A. 17324, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999).....	83
<i>Crown EMAC Partners, LLC v Kurz</i> , 992 A.2d 377 (Del. 2010)	83, 154
<i>CSX Corporation v the Children's Investment Fund Management (UK) LLP</i> , 562 F Supp 2d 511 (SDNY 2008), 12 June 2008, 08 CV 02764	61–65, 66, 121, 126–127, 129, 130, 135, 136, 217
<i>CSX Corporation v The Children's Investment Fund Management</i> , No. 08-2899-cv, slip op. (2d Cir. July 18, 2011)	66
<i>Deephaven Risk Arb. Trading Ltd. v UnitedGlobalCom, Inc.</i> , No. Civ.A. 379-N, 2005 WL 1713067 (Del. Ch. July 13, 2005).....	30, 35, 153, 154, 212
<i>Hewlett v Hewlett Packard Co.</i> , No. Civ.A. 19513-NC, 2002 WL 549137 (Del. Ch. 2002).....	83
<i>In re Atmel Corporation Shareholders Litigation</i> (Del. Ch. May 22, 2009)	148
<i>In re Save Our Springs (S.O.S.) Alliance, Inc.</i> , 388 B.R. 202 (Bankr. W.D. Tex. 2008).....	201
<i>In the Matter of Perry Corp. Respondent</i> , Exchange Act Release Nos. 2907 & 60351, 2009 WL 2163550 (July 21, 2009).....	32
<i>Jones v HF Ahmanson & Co</i> , 460 P.2d 464.	207
<i>Kahn v Lynch Communications Systems, Inc.</i> , 638 A.2d 1110 (Del. 1994)	207
<i>Macht v Merchs. Mortgage & Credit Co.</i> , 194 A.19 (Del. Ch. 1937).....	82
<i>Parfi Holding AB v Mirror Image Internet, Inc.</i> , 954 A.2d 911 (Del. Ch. 2008)	116, 117, 153, 154, 212
<i>Parkcentral Global Hub Limited v Porsche Automobile Holdings, SE</i> , 11-397-CV (2d Cir. N.Y., Aug. 15, 2014)	120
<i>Schilling v Belcher</i> 582 F.2d 995	116, 154
<i>Schreiber v Carney</i> , 447 A.2d 17 (Del. Ch. 1982).....	83
<i>Sinclair Oil Corporation v Levien</i> , 280 A.2d 717 (Del. 1971)	207
<i>Stott v Stott</i> , 242 N.W. 747 (Mich. 1932)	82
<i>Weinberger v Bankston</i> , No. Civ.A. 6336, 1987 WL 20182 (Del. Ch. Nov. 19, 1987).....	83

Table of Legislation

EUROPEAN UNION

Treaty of Lisbon 2009	226
Treaty on European Union (TEU)	
Art. 5.....	225–226
Art. 5(3)	164, 226
Art. 5(4)	164, 227
Treaty on the Functioning of the European Union (TFEU)	
Art. 50(2) lit. g.	225, 226
Art. 53(1)	225
Art. 101(3)	139
Art. 114.....	225, 226
Alternative Investment Fund Managers	
Directive 2011/61/EU	85, 86, 150
Art. 4.....	85
Art. 12.....	85
Council Regulation (EC) No 1/2003.....	139
Art. 2.....	219
Directive 2013/50/EU, [2013]	
OJ L294/13	61, 122, 173, 197, 204, 226, 230
EMIR Regulation (EU) No 648/2012.....	72
First Company Law Directive	
2009/101/EC, art. 2	108
MiFID 2 (Directive 2014/65/EU).....	190
Rome II Regulation (EC)	
No 864/2007, art. 30	229
Second Company Law Directive	
2012/30/EU.....	200–201, 229
Art. 21.....	44
Art. 22.....	44
Art. 24(1)	43, 201
Shareholder Rights Directive	
2007/36/EC.....	20, 22, 38, 42, 54 f, 57, 77, 81
Short Selling Regulation (EU)	
No 236/2012.....	131, 182, 184–190, 225, 227
Recital 2	228
Recital 10	184
Recital 17	185, 190
Art. 2(1)(b).....	185, 190
Art. 3(1)	185, 190
Art. 3(4)	188, 190
Art. 5(1)	184, 188, 189
Art. 5(2)	184

Art. 5(3)-(4)	186
Art. 6(1)	184, 189
Art. 6(2)	184
Art. 6(3)-(4)	186
Art. 9(2)	184
Art. 12.....	34
Takeover Directive 2004/25/EC	
Art. 5.....	84
Art. 5(1)	132, 215
Art. 6(3)(g)	222
Art. 9.....	135, 141
Transparency Directive 2004/109/EC	23, 60–61, 122, 124, 136, 143, 156, 169, 170, 172–173, 176, 177, 179, 188–189, 193, 196, 204–205, 212, 216, 225, 226, 230, 233
Recital 37	197
Art. 5(4)	214
Art. 9(1)	60, 84, 129, 172, 180, 181, 188–189, 193–196
Arts. 9 ff.....	166, 196
Art. 10(a)	69
Art. 10(g)	68
Art. 12(2)	196
Art. 12(6)	180, 196
Art. 12(8)	196
Art. 13.....	172
Art. 13(1)	68, 125, 230
Art. 13(1b)(f).....	125
Art. 16.....	180
Art. 19(3)	180, 196
Art. 28.....	197
Art. 28a.....	197–198
Art. 28b.....	197–198
Art. 28a(b)	198
Art. 28b.....	200, 204
Art. 28b(2)	198, 204
Art. 28c.....	204

FRANCE

Code de Commerce	
Art. L. 225-126	167–168
Art. L. 225-126(I)	168
Art. L. 225-126(II)	168
Art. R. 225-85	168

Loi 2010-1249 du 22 Octobre 2010 de Régulation Bancaire et Financière, JORF, 23 October 2010, p. 18984	51–52, 167
Loi Florange	72

GERMANY

Aktien-gesetz (AktG) (Stock Corporation Act)	
§ 67(2)	53
§ 71b	43
§ 123(2), (3)	53
§ 136	201
§§ 327a ff.	39, 153
§ 405	201
Anlegerschutz- und Funktionsverbesserungsgesetz 2011 (AnsFuG)	122, 195
Gesetz zur Kontrolle und Transparenz im Unternehmensbereich 1998 (KonTraG)	75
Wertpapiererwerbs- und Übernahmegesetz (WpÜG) (Takeover Act)	
§ 30(1) no 2	68
§ 30(1) no 5	68
§ 30(2)	69
Wertpapierhandelsgesetz (WpHG) (Securities Trading Act)	
§ 21	67
§ 22(1) no 2	68
§ 22(1) no 5	68
§ 22(2)	69
§ 25	195
§ 25(1)	69
§ 25a	122, 124
§ 27a	139
§ 28	198
Corporate Governance Code, section 4.1.1.	97

HONG KONG

Securities and Futures Ordinance (SFR)	190–91
Part XV	191
Section 308	191
Section 309	191

ISRAEL

Companies Law 5759-1999, sections 192, 193	207–208
---	---------

NEW ZEALAND

Securities Markets Act 1988 No 234, sections 20–36	67
---	----

PORTUGAL

Código dos Valores Mobiliários, artigo 23.º-C(7)	57
Decreto-Lei n.º 49/ 2010, of 19 May 2010	57

UNITED KINGDOM

Companies Act 2006 (CA 2006)	
ss 168–169	81
s 172	97, 133
s 173	133
s 260	81
s 360B	53, 81
ss 629 ff.	81
s 829	81
ss 895 ff.	117
s 899	117
Competition Act 1998, s 9	139
Finance Act 1986, ss 66 ff.	59
Financial Services and Markets Act 2000 (FSMA 2000)	
s 118	214
s 397	214
The Companies (Model Articles) Regulations 2008 (SI 2008/3229)	81
The Uncertificated Securities Regulations 2001 (SI 2001/ 3755), reg. 41	53, 82
Combined Code on Corporate Governance	19
Disclosure and Transparency Rules (DTR)	
Rule 2	119
Rule 5	119
Rule 5.1.1R (5)	195
Rule 5.1.2	123
Rule 5.3	61, 123
Rule 5.3.1(3)(c)	139
Rule 5.8	126
Rule 5.8.1	134
Rule 5.8.2	126, 137
Stewardship Code	11, 19, 22
Takeover Code	
Definitions—Interests in securities. . .	61, 132
Rule 8.3	61, 122–123
Rule 9.1	61, 122–123, 132

Rule 9.5.....	61
Rule 24.3(a)	222
UK Corporate Governance Code.....	19

UNITED STATES

Bankruptcy Code, section 1126(e).....	201
Delaware General Corporation Law (DGCL)	
§ 213 (a)	57, 161
§ 219	53
§ 220	35, 153
§ 228	180
Dodd–Frank Act 2010.....	62, 127
Section 766(e)	62, 127
Hart–Scott–Rodino Act 1976.....	139
New York Business Corporation Law, § 609(e)	82
Securities Exchange Act 1934	
Rule 13d-1	126, 130, 137, 138

Rule 13d-3	66, 125, 129, 137, 217
Rule 13d-101	126, 137
Rule 13d-102	126, 137, 138
Rule 14c-7(a)(3).....	53
Section 13.....	62
Section 13(d)	61, 62, 125, 127, 189
Section 13(g)	127
Section 13(o)	62
Williams Act	125, 139–140
<i>See also</i> Securities Exchange Act 1934	
Federal Reserve Board	
Regulation T	159–160, 212

INTERNATIONAL

European Convention on Human Rights	202, 205
--	----------

Table of Contents

<i>Preface</i>	v
<i>Table of Cases</i>	xi
<i>Table of Legislation</i>	xiii
I. Introduction	1
A. Context	3
B. Structure	5
II. Shareholders in Corporate Governance	7
A. Costs of Voting and Apathy	8
B. Blockholders	11
C. Activist Shareholders and Hedge Funds	14
D. The Financial Crisis and Recent Developments	18
E. Shareholders and Risk-decoupling	22
F. Conclusion	25
III. Risk-Decoupling Strategies	27
A. Negative versus Positive Risk-decoupling	27
B. Negative Risk-decoupling: More Influence than Risk	28
1. Category 1: Financial derivatives	28
2. Category 2: Share lending	36
3. Category 3: Record-date capture	52
C. Positive Risk-decoupling: More Risk than Influence	58
1. Contracts for Difference	59
2. CfD investments and their abuse	62
3. Case studies	66
4. Conclusion	69
D. Empirical Evidence	70
E. Related Situations Not Covered in This Book	74
1. Related risk-decoupling strategies	74
2. 'One share, one vote'	75
3. Proxy advisors	76
4. Limited liability	78
F. Summary	79
IV. The Failure of Traditional Categories of Law	81
A. Corporate and Securities Law	81
B. Hedge Fund Regulation	85

V. Problem Perspectives	87
A. Outline and Relevance of the Problem	87
B. Principal-agent Perspective	90
1. Risk-decoupling and agency costs	91
2. Possible reduction of agency costs?	98
3. Objection	101
4. Implications	103
C. Information Costs	103
1. Information and transaction cost theory	103
2. Risk-decoupling and information costs	107
3. Summary and implications	110
D. Corporate Finance	111
1. Debt versus equity	112
2. Risk-decoupling between debt and equity	114
3. Shareholders as residual risk-bearers	115
4. Implications	116
E. The Market for Corporate Control	118
1. Harmful market impacts of CfD dealings	118
2. What is wrong with a general CfD disclosure obligation?	127
3. CfDs and the market for corporate control	140
VI. Solutions	143
A. Doing Nothing	144
1. Persisting decoupling of voting rights	145
2. Self-regulation	147
3. Self-regulation of the hedge fund industry	149
4. Self-help in securities lending cases	151
5. Risk-decoupling in existing legal frameworks	152
6. Conclusion	155
B. Ban and Restriction	156
1. Ban on decoupling	156
2. Difficulties with the record-date problem	160
3. Conclusion	161
C. Transparency	162
1. Transparency as a response to decoupling problems	162
2. Legislative activity and reactions	167
3. Costs and critique	173
4. Key issues of a transparency regime	177
5. Co-ordination with transparency of short selling	182
6. A concrete proposal: An integrated disclosure system	192
7. Summary	199
D. Disenfranchisement	199
1. A general prohibition to vote?	200
2. Case-by-case regulator's decision	202
3. Limitations of the approach	205
4. Summary	206

E. Fiduciary Duties	207
1. Fiduciary duties as an established legal instrument	207
2. Individual disadvantages	208
3. Conclusion	210
F. Results, Overview, and Assessment	211
G. Positive Risk-Decoupling—An Alternative Regulatory Model	
Targeting CfD Abuse	213
1. Proposed regulatory structure	213
2. Reply to criticism	218
3. Efficiency of enforcement	220
4. Conclusion	223
VII. The Federal Dimension	225
A. Admissibility	225
B. Substantive Desirability	227
C. Practicability	230
D. Summary	231
VIII. Conclusion	233
<i>Bibliography</i>	235
<i>Index</i>	265

I

Introduction

What is the risk of artificially distorted incentives in shareholder voting? That is, in a nutshell, the central question of this book. This question matters because many players in today's equity markets can manipulate their incentives by modifying their risk exposure in investment targets. Sophisticated players, such as hedge funds, have found ways to invest without carrying the corresponding economic risk, with the help of financial derivatives and other instruments.

To make this more concrete, the subject matter of this book is best explained by providing an example.¹

Consider a hypothetical shareholder A who holds 100 shares in company C. Under regular circumstances, A's voting power in the company's general meeting corresponds to the number of his shares—100. At the same time, A's economic risk exposure in the business corresponds to the same economic value: he is interested in 100 shares, which stand to gain in value if the company does well, and which will depreciate if the company is run poorly. The assumption, therefore, is that A will use the voting influence he has by virtue of his 100 shares to make decisions that contribute to the company's optimal performance, since he stands to win or lose depending on the choices he makes. This is the traditional understanding of how shareholders are motivated and how their role as the corporation's residual risk-bearers allow them to exercise control rights.²

Now consider two alternative scenarios. The first is a scenario where the risk is eliminated or reduced. Let us assume that A as before holds 100 shares, but that he concludes a financial derivative contract with a bank, referencing the same number of shares, which makes him immune against any share price development in these shares. In other words, the derivatives put him in a position where he does not care whether the share price goes up or down. A is still the official owner of the shares, and he remains entitled to vote as before. But he will not feel the economic consequences of his actions as in the first example. This creates the possibility that A will use his voting influence for motives other than wealth maximization, which the existing shareholders will not be happy about.

¹ The problem will be discussed in more technical detail in Chapter III.

² Frank H Easterbrook and Daniel R Fischel, 'Voting in Corporate Law' (1983) 26 *Journal of Law and Economics* 395, 401.

In the second scenario, the relationship between risk and influence is reversed. Assume that A does not hold any shares, but that he intends to invest in company C. In order to avoid appearing publicly as a shareholder in C, he acquires indirect economic interest in the 100 shares, again using derivatives, options, or other instruments through entering into corresponding transactions with a bank. This allows A to be risk-exposed in the business like any other shareholder, but avoids triggering public disclosure laws by not appearing as a regular shareholder. The public, and in particular fellow shareholders, are unaware of A's exposure in C, and complain that his actions are a circumvention of block disclosure laws.

This book is concerned with such strategies to uncouple risk from influence in equity ownership. The traditional assumption in law and economic scholarship is that power should match accountability, and it is one of the unwritten assumptions of corporate law that the voting power should correspond to the economic risk exposure. More than thirty years ago, Easterbrook and Fischel put it like this:

Voting flows with the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management. Those with disproportionate voting power will not receive shares of the residual gains or losses from new endeavours and arrangements commensurate with their control; as a result they will not make optimal decisions.³

As we shall see, however, nowadays a number of techniques make it possible to decouple risk and equity ownership. Using a range of different strategies, sophisticated players for example attempt to eliminate or reduce the economic risk that is normally inherently attached to the shares they buy.⁴ The brief examples given above are based on the use of derivatives, but there are also alternative techniques, like share lending, where shares are simply borrowed over a certain time frame, or record date capture, where the registration date for a general meeting is exploited. They are all used to overcome the assumption that shareholders are risk-exposed participants in the firms, and they all deconstruct and dismember equity ownership and shift the risk to others.

One newspaper article describes the phenomenon as follows:

[I]nnovations in the financial markets over the last 30 years have created the possibility, and, in fact, the reality, that the link can be severed between share ownership and one's economic interest, which leads to an incentive to maximize the value of a corporation and its shares. Indeed, capital markets today make it easy to divorce share ownership, and the associated voting rights, from any proportionate economic interest in the value of the corporation's shares. This separation can be caused by a multitude of transactions, in the form of equity swaps, forwards, futures, puts or calls, all of which call into question the fundamental assumption of 'one share, one vote'.⁵

³ *ibid.* 409.

⁴ See Katayun I Jaffari and Whitney W Deeney, 'One Share, One Vote? Not Necessarily: Manipulation of the SEC Proxy System to Effect Empty Voting' *Legal Intelligencer* (25 February 2011) 7.

⁵ *ibid.*

These strategies touch the core of corporate governance and the traditional assumptions of share ownership and voting rights. Under the corporate laws of all major jurisdictions, risk and voting rights are necessarily tied together in a bundle of different rights and obligations, which together make up the essential elements of an equity share. This ‘deconstruction’ of the legal elements of a share into different parts is accompanied by several economic problems. For instance, if it is possible to separate the risk from the share—or, put differently, if the share and its voting right remain an empty shell without ‘skin in the game’—the shareholder pursuing such a strategy will no longer necessarily exercise the voting right in the way exercised by an optimal shareholder with perfect risk alignment. Quite the contrary, they might ultimately be able to pursue goals that are quite opposed or even detrimental to the company’s interests. The shareholder might misuse his control rights to further his own private benefits to the detriment of other shareholders and potential investors. This may be a contributing factor in what others have dubbed the ‘waning power of equity ownership’.⁶

Against this background, the present study examines this phenomenon from two sides. First, we explore implications that the decoupling of risk exposure may have on share ownership in general, and on the nature of equity. Second, the investigation discusses the risks that other shareholders and investors encounter when investing in companies in which the risk is decoupled.

Risk-decoupling raises a number of broader issues, which affect the most fundamental elements of corporate organization.

1. In particular, the occurrence of risk-decoupling strategies touches on the proper role of shareholders in corporate governance and capital markets. As we shall see, the traditional hypothesis of shareholders as the righteous owners of corporations—who have an optimal risk exposure as the residual owners—will be seriously tested.
2. Risk-decoupling techniques further jeopardize the effectiveness of capital markets. The information circulated on these markets is typically based on the distribution of voting rights, as a proxy for equity allocation. If, however, the voting right is an empty shell, and the risk behind it has disappeared, the voting rights disclosure is not worth much. Conversely, voting right disclosure may not be helpful where economic influence can be acquired without formally appearing as a shareholder.

A. Context

The phenomenon of risk-decoupling and equity-unbundling first caught the interest of scholars several years ago. Among the pioneers to describe the

⁶ John Plender, ‘The Waning Power of Equity Ownership’ *Financial Times* (London, 23 April 2012) FTFm 24.

phenomenon and to develop early regulatory concerns were Shaun Martin and Frank Partnoy, as well as Henry Hu and Bernard Black.⁷ In a series of subsequent articles, the latter duo further developed the analysis of risk-decoupling in its various facets.⁸ Several other legal scholars have built on this seminal work over the past few years.⁹

It took some time from the problem's first description until the topic also caught the interest of the economics literature. But over the past few years, economists have studied the extent and the pervasiveness of risk-decoupling in its various shades.¹⁰ In particular, these scholars have measured the frequency of such risk-decoupling strategies in real life. These empirical realities are further discussed later.¹¹

Finally, the issue has also interested legal practice, as several court decisions have had to deal with risk-decoupling situations, and law-makers and regulators have started to develop responses in some parts of the field. As we know from political economy, regulation is frequently scandal-driven. It is therefore not surprising that policy-makers have responded mostly in those jurisdictions that were affected by a high-profile case of risk-decoupling, and mostly addressing those substantive parts of the risk-decoupling problem that was at stake in their territory. Thus, for example, the occurrence of a large decoupling transaction in Telus, the Canadian

⁷ The early literature is Shaun Martin and Frank Partnoy, 'Encumbered Shares' [2005] *University of Illinois Law Review* 775, and Henry T C Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811.

⁸ Henry T C Hu and Bernard S Black, 'Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms' (2006) 61 *Business Lawyer* 1011; Henry T C Hu and Bernard S Black, 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership' (2007) 13 *Journal of Corporate Finance* 343; Henry T C Hu and Bernard S Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 *University of Pennsylvania Law Review* 625. More recently, Henry T C Hu, 'Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency' (2015) 70 *The Business Lawyer* 347.

⁹ See, for example, Dirk Zetzsche, 'Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental' (2009) 10 *European Business Organization Law Review* 115; Roberta S Karmel, 'Voting Power without Responsibility or Risk: How Should Proxy Reform Address the Decoupling of Economic and Voting Rights' (2010) 55 *Villanova Law Review* 93; Maiju Kettunen and Wolf-Georg Ringe, 'Disclosure Regulation of Cash-Settled Equity Derivatives—An Intentions-Based Approach' [2012] *Lloyd's Maritime and Commercial Law Quarterly* 227; Michael C Schouten, *The Decoupling of Voting and Economic Ownership* (Kluwer 2012); Jordan M Barry, John William Hatfield, and Scott Duke Kominers, 'On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership' (2013) 99 *Virginia Law Review* 1103; Wolf-Georg Ringe, 'Hedge Funds and Risk-Decoupling—The Empty Voting Problem in the European Union' (2013) 36 *Seattle University Law Review* 1027; Paul Ali, Ian Ramsay, and Benjamin Saunders, 'Securities Lending, Empty Voting and Corporate Governance' [2014] *Law and Financial Markets Review* 326; David Marais, 'Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting' (2015) 18 *Trinity College Law Review* 180.

¹⁰ See, among others, Susan E K Christoffersen and others, 'Vote Trading and Information Aggregation' (2007) 62 *The Journal of Finance* 2897; Avner Kalay, Oğuzhan Karakaş, and Shagun Pant, 'The Market Value of Corporate Votes: Theory and Evidence from Option Prices' (2014) 69 *The Journal of Finance* 1235; Reena Aggarwal, Pedro A C Saffi, and Jason Sturgess, 'The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market' (2015) 70 *Journal of Finance* 2309.

¹¹ See Chapter III.D.