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THE DECONSTRUCTION OF EQUITY

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

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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.