FIN536 CORPORATE GOVERNANCE

Lecture 11 Controlling Shareholders (3)

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TODAY'S AGENDA

- Decoupling of Economic and Voting Ownership
- Empty Voting
- Hidden Ownership
- Implications for New Vote Buying

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Voting right
  - The legal right to vote shares under company law (supplemented by rules on voting shares held in street name), regardless of who decides how to vote.

- Economic ownership
  - The economic return on shares, which can be achieved directly by holding shares or indirectly by holding a coupled asset.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Most U.S. public firms employ a one common share, one vote structure
  - It links economic interest to voting rights.
  - It places the power to oversee company managers in the hands of residual owners, who have an incentive to increase firm value
  - Linking shares to votes also facilitates the market for corporate control.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- The derivatives revolution in finance
  - The growth in equity swaps and other privately negotiated ("OTC") equity derivatives, and related growth in the stock lending market

  - It offers new ways to decouple economic ownership from voting power in public companies.
    - At low-cost, often low-transparency
    - for both outside investors and insiders

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Example 1
  - Perry Corp., a hedge fund, owned seven million shares of King Pharmaceuticals. Mylan Laboratories agreed in late 2004 to buy King in a stock-for-stock merger. When the deal was announced, King's shares rose but Mylan's shares dropped.

  - To help Mylan receive shareholder approval for the merger, Perry bought 9.9% of Mylan but fully hedged its risk on the Mylan shares, ending up with 9.9% voting ownership but zero economic ownership.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Example 1
  - A second hedge fund, Citadel, acquired 4.4% of Mylan's shares and was rumored to have followed a similar strategy.
  - Perry and kindred investors had a *negative* overall economic interest in Mylan's completion of the merger.
  - The more Mylan (over)paid for King, the more they would profit

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Example 2:
  - In 2002, Laxey Partners, a hedge fund, held about 1% of the shares of British Land, a major U.K. property company.
  - At British Land's shareholder meeting, Laxey emerged with over 9% of the votes and supported a proposal to break up British Land.
  - Just before the record date, <u>Laxey had borrowed 8% of British Land's shares</u>.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Example 3:
  - In May 2001, Perry shed its voting rights but not its economic interest.
  - It sold 31 million shares to two derivatives dealers and simultaneously acquired from them an equivalent long equity swap position, which it treated as **not requiring disclosure**.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Example 3:
  - When Perry needed voting rights, it terminated the swaps and reacquired the shares from the dealers.

  - Another shareholder challenged Perry's right to vote, based on its failure to disclose its ownership, but the New Zealand courts upheld Perry's nondisclosure.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Even if a firm has a one share, one vote capital structure, there are multiple ways to decouple votes from economic ownership.
  - Empty Voting
    - Often, this economic ownership is combined with de facto ability to acquire voting rights at any time.
    - The votes have been emptied of economic interest.
    - Share lending & Short equity swap position
  - Hidden Ownership

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Share lending
  - Under standard share loan agreements, the borrower acquires voting rights but no economic ownership, while the lender has economic ownership without voting rights.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Short equity swap position
  - The combined position (long shares, short equity swaps) conveys **voting rights** without economic ownership.

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Hidden (morphable) ownership:
  - Undisclosed economic ownership plus informal voting rights
  - "the new vote buying" or simply "decoupling"

1. DECOUPLING OF ECONOMIC AND VOTING OWNERSHIP

- Supply and demand factors have changed
  - Supply side
    - Financial innovations: equity swaps and other OTC derivatives
    - Massive growth in the share lending market, now permit large scale, low-cost decoupling
  - Demand side:
    - Hedge funds: a trillion dollar-plus pool of sophisticated, lightly regulated HFs
    - They are largely free from the conflicts of interest and concerns with adverse publicity that may deter other institutional investors from using decoupling strategies.

2. EMPTY VOTING

- Empty Voting By Outside Investors
- Record Date Capture

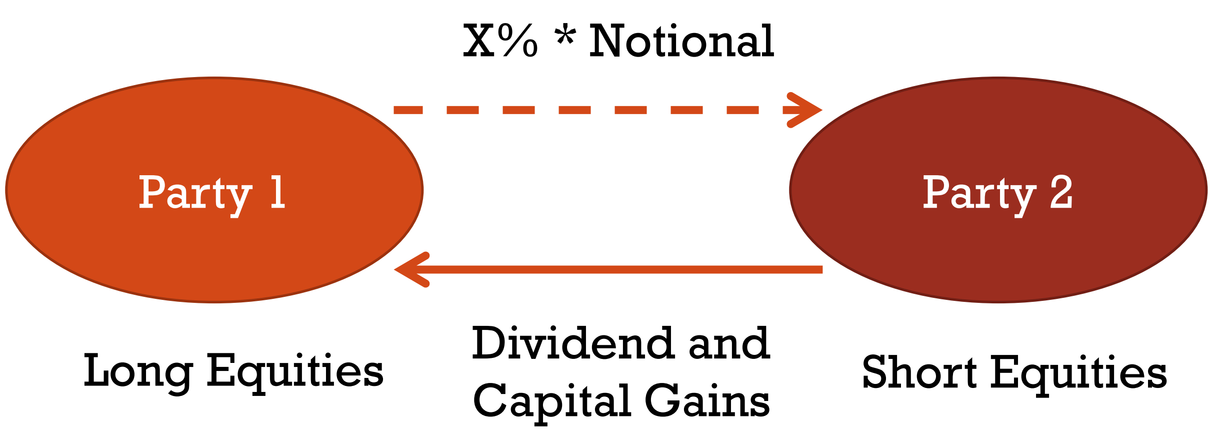
2.1. EMPTY VOTING BY OUTSIDE INVESTORS

- One core strategy for empty voting is to hold shares but hedge the economic return on the shares

- The simpler hedging strategies include:
  - a short equity swap position
  - a short position in a single stock future
  - a (short call, long put) position
  - Partial hedges, producing partly empty voting, are also possible.

2.1. EMPTY VOTING BY OUTSIDE INVESTORS

- Short equity swap position
  - In a typical cash-settled equity swap, the long equity side acquires the economic return on shares (but not voting rights) from the short side.



2.1. EMPTY VOTING BY OUTSIDE INVESTORS

- Example (M-Flex)
  - In March 2006, Multi-Fineline Electronix (M-Flex), a Delaware company, made an offer to acquire a Singapore company, MFS Technologies (MFS).
  - Another Singapore company, WBL, owns a majority stake in both M-Flex and MFS.
  - Stark, a hedge fund, holds at least 48% of the minority Mflex shares and has an incentive to vote for the offer even if it is bad for M-Flex
  - Stark owns a large stake in the target, MFS, and has hedged most or all of its interest in M-Flex.

2.1. EMPTY VOTING BY OUTSIDE INVESTORS

- Example (M-Flex)
  - M-Flex then sued WBL, seeking to compel WBL to vote against the transaction based on WBL's fiduciary obligations as a controlling shareholder.
  - M-Flex believes Stark, by its hedging activity, has effectively separated its voting power from its economic interest
  - Therefore, its incentives are directly opposed to the best interests of M-Flex and its true stockholders.
  - In short, the more that M-Flex is forced to overpay for MFS, the more Stark stands to profit.

2.1. EMPTY VOTING BY OUTSIDE INVESTORS

- Example (HP)
  - During Hewlett Packard's 2002 acquisition of Compaq, some holders of Compaq shares, who would profit if the merger were completed, were rumored to have engaged in empty voting of H-P shares to support the merger.
  - The merger announcement led to a sharp drop in H-P's price and to a proxy contest by Walter Hewlett opposing the merger.
  - Empty voting might have affected this very close vote.

2.2. RECORD DATE CAPTURE

- Borrowing shares in the stock loan market
  - "Record date capture" involves borrowing shares shortly before the record date for a shareholder meeting (the date on which the shareholders eligible to vote are determined), and returning them soon afterward

2.2. RECORD DATE CAPTURE

- Borrowing shares in the stock loan market
  - The borrower contracts with the stock lender to convey to the lender any dividends or other distributions on the shares during the loan period
    - Typically callable at any time by the lender, and repayable at any time by the borrower

  - The **lender** retains **economic ownership**, without voting rights, while the **borrower** obtains **voting rights**, without economic ownership.

2.2. RECORD DATE CAPTURE

- The cost of short-term borrowing is trivial
  - less than 1% per year to borrow

- Borrowing costs can be significant for a company with limited "free float" (shares not held by insiders) or with substantial short selling interest.
  - Yet at present, the share lending market operates oddly, with substantial excess supply at most times

2.2. RECORD DATE CAPTURE

- Example (Henderson)
  - Henderson Land offered to buy the 25% minority interest in Henderson Investment at a premium.
  - Henderson Investment's share price rose on anticipation that its shareholders would approve the buyout.
  - Under Hong Kong law, however, the buyout could be blocked by a negative vote of 10% of the "free floating" shares -- about 2.5% of the outstanding shares.

2.2. RECORD DATE CAPTURE

- Example (Henderson)
  - To everybody's surprise, 2.7% of the shares were voted against the buyout. Henderson Investments shares promptly fell 17%.
  - Apparently, a hedge fund borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, profiting from private knowledge that the buyout would be defeated.
  - One fund apparently held enough votes to defeat the buyout by itself.

3. HIDDEN OWNERSHIP

- Hidden ownership
  - In many cases, the investor has shed the formal voting rights that trigger disclosure, while retaining the *de facto* ability to acquire votes quickly when needed.

3. HIDDEN OWNERSHIP

- Example (Perry)
  - In early 2001, Perry was a major holder of Rubicon. New Zealand's ownership disclosure rules, similar to U.S. rules, required disclosure by 5% shareholders. Perry reported in June 2001 that it was no longer a 5% holder.

  - A year later, in July 2002, Perry suddenly disclosed that it held 16% of Rubicon, just before Rubicon's shareholder meeting.

3. HIDDEN OWNERSHIP

- Example 1:
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  - It sold 31 million shares to two derivatives dealers and simultaneously acquired from them an equivalent long equity swap position, which it treated as **not requiring disclosure**.

  - When Perry needed voting rights, it terminated the swaps and reacquired the shares from the dealers.

  - Another shareholder challenged Perry's right to vote, based on its failure to disclose its ownership, but the New Zealand courts upheld Perry's nondisclosure.

3. HIDDEN OWNERSHIP

- Example 1:
  - How did Perry know it could reacquire Rubicon shares when it wanted to vote them?
  - The dealers needed to hedge their exposure on the swaps, and were likely to do so by holding the Rubicon shares they had bought from Perry.
  - Perry could also expect the dealers to sell the shares back to Perry if Perry chose to unwind the equity swaps.

3. HIDDEN OWNERSHIP

- Example 2:
  - In 2005, Centennial made a takeover bid for Austral Coal.
  - Rival Glencore acquired a "blocking position" sufficient to prevent Centennial from reaching 90% ownership and then squeezing out remaining shareholders through a combination of shares and equity swaps.
  - They did not disclose its swap position.

3. HIDDEN OWNERSHIP

- Example 2:
  - The Australian Takeovers Panel held that Glencore should have disclosed its combined position under Australia's large shareholder disclosure rules
  - But the decision was reversed on appeal by the Australian courts.

3. HIDDEN OWNERSHIP

- Example 3:
  - Avoiding mandatory bid rules: In many countries, a shareholder who exceeds a threshold ownership percentage must offer to buy all remaining shares at a formula price.
  - Having economic but not voting ownership can let an acquirer avoid these rules.
  - The Agnelli family's use of equity swaps for Fiat shares in 2005 offers a recent example.

3. HIDDEN OWNERSHIP

- Much new vote buying is undisclosed.

- Its extent and how often it has affected voting outcomes are thus unclear.

3. HIDDEN OWNERSHIP

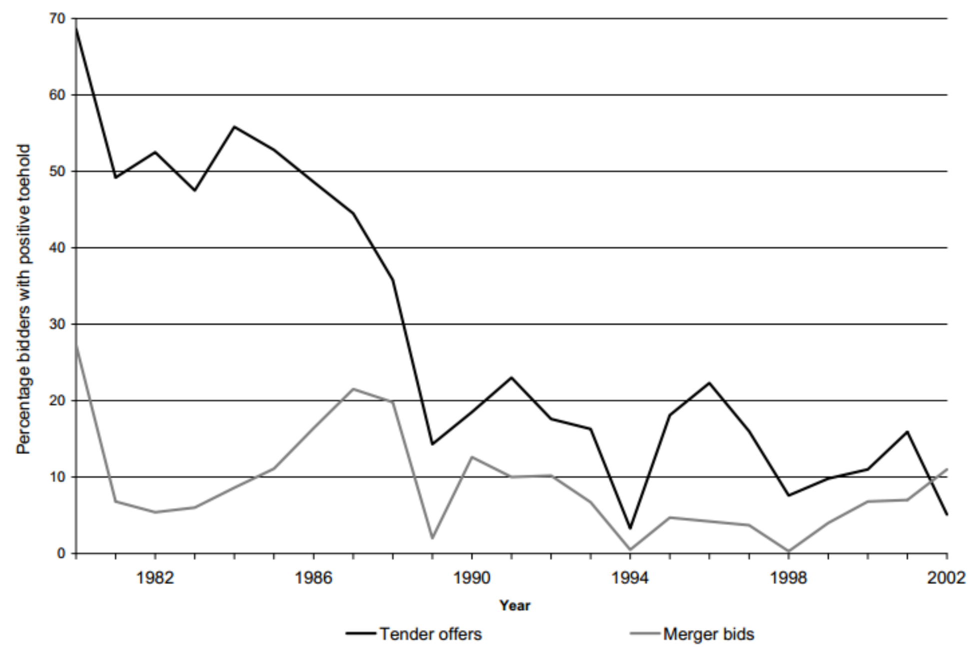
- But the responses to market activity suggest that the underlying practices are reasonably common.
  - Regulatory changes in Hong Kong (2003) and the U.K. (2005) to require disclosure of economic ownership in certain circumstances
  - U.K. self-regulatory efforts to limit record date capture
  - As of early 2007, the Securities and Exchange Commission in the U.S. and the Financial Services Authority in the U.K. were considering changing disclosure rules to address new vote buying

4. IMPLICATIONS FOR NEW VOTE BUYING

- Potential advantages to decoupling shares from votes
  - Decoupling has traditionally been used by insiders to retain voting control.
  - This structure can let firms pursue growth opportunities.
  - It can make it easier for firms to make long-term, positive NPV investments with unobservable payoffs.
  - Decoupling can also potentially reduce shareholder collective action problems and reduce transaction costs in a contest for corporate control.

4. IMPLICATIONS FOR NEW VOTE BUYING

- Takeover Defenses and Toeholds
  - Toehold stake can facilitate takeover bids
  - Toehold puzzle from 1990s
    - Why few takeover bidders acquire toeholds, even though doing so appears to be profitable



4. IMPLICATIONS FOR NEW VOTE BUYING

- Takeover Defenses and Toeholds
  - Hidden ownership through an equity swap could offer a quiet toehold
  - This strategy could delay the need for disclosure until a formal bid is made, and thus facilitate acquiring toeholds.

4. IMPLICATIONS FOR NEW VOTE BUYING

- Differences Between New Vote Buying and Other Decoupling (Dual, Pyramid, Cross-holding)
  - When it occurs:
    - before shares are sold to investors or after
  - The period of time during which decoupling is permitted:
    - at any time or only for a limited period
  - Whether and when it is disclosed
    - before it occurs, after it occurs, or never
  - Who does it
    - insiders, outside shareholders, or both

4. IMPLICATIONS FOR NEW VOTE BUYING

- Policy Implications?